AtriCure, Inc.
Form 10-Q
November 01, 2013
**Table of Contents**

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

# FORM 10-Q

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

**For the quarterly period ended September 30, 2013**

**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 October 25, 2013 |
|---|---|
| Common Stock, $.001 par value | 21,019,410 |

Table of Contents

## Table of Contents

Table of Contents

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**ATRICURE, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(In Thousands, Except Per Share Amounts)**

**(Unaudited)**

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 25,821 | $ 7,753 |
| Short-term investments | 3,864 | 4,247 |
| Accounts receivable, less allowance for doubtful accounts of $17 and $49, respectively | 11,031 | 9,948 |
| Inventories | 7,062 | 5,718 |
| Other current assets | 779 | 873 |
| Total current assets | 48,557 | 28,539 |
| Property and equipment, net | 4,135 | 3,430 |
| Long-term investments | 4,678 | |
| Intangible assets | 23 | 32 |
| Other assets | 244 | 430 |
| Total Assets | $ 57,637 | $ 32,431 |
| **Liabilities and Stockholders Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 5,720 | $ 5,103 |
| Accrued liabilities | 8,518 | 5,073 |
| Current maturities of long-term debt and capital lease obligations | 2,037 | 2,029 |
| Total current liabilities | 16,275 | 12,205 |
| Long-term debt and capital lease obligations | 4,922 | 6,407 |
| Other liabilities | 195 | 1,319 |
| Total Liabilities | 21,392 | 19,931 |
| Commitments and contingencies (Note 7) | | |
| Stockholders Equity: | | |
| Common stock, $.001 par value, 90,000 shares authorized and 21,018 and 16,896 issued and outstanding, respectively | 21 | 17 |

| | | |
|---|---|---|
| Additional paid-in capital | 153,420 | 123,157 |
| Accumulated other comprehensive income | 37 | 77 |
| Accumulated deficit | (117,233) | (110,751) |
| Total Stockholders Equity | 36,245 | 12,500 |
| Total Liabilities and Stockholders Equity | $ 57,637 | $ 32,431 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS**

**(In Thousands, Except Per Share Amounts)**

**(Unaudited)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Revenue | $ 20,146 | $ 16,139 | $ 60,005 | $ 51,883 |
| Cost of revenue | 5,461 | 4,590 | 16,111 | 14,871 |
| Gross profit | 14,685 | 11,549 | 43,894 | 37,012 |
| Operating expenses: | | | | |
| Research and development expenses | 3,237 | 2,905 | 9,792 | 9,180 |
| Selling, general and administrative expenses | 14,062 | 11,173 | 40,155 | 33,178 |
| Total operating expenses | 17,299 | 14,078 | 49,947 | 42,358 |
| Loss from operations | (2,614) | (2,529) | (6,053) | (5,346) |
| Other income (expense): | | | | |
| Interest expense | (123) | (190) | (428) | (616) |
| Interest income | 2 | 3 | 8 | 8 |
| Other | (9) | 160 | 5 | 460 |
| Loss before income tax expense | (2,744) | (2,556) | (6,468) | (5,494) |
| Income tax expense | 4 | 11 | 14 | 20 |
| Net loss | $ (2,748) | $ (2,567) | $ (6,482) | $ (5,514) |
| Basic and diluted net loss per share | $ (0.13) | $ (0.16) | $ (0.32) | $ (0.34) |
| Weighted average shares outstanding basic and diluted | 20,725 | 16,278 | 20,311 | 16,143 |
| Comprehensive loss: | | | | |
| Unrealized gains (losses) on investments | 5 | 1 | 4 | (1) |
| Foreign currency translation adjustment | 88 | 96 | (44) | 46 |
| Other comprehensive income (loss) | 93 | 97 | (40) | 45 |
| Net loss | (2,748) | (2,567) | (6,482) | (5,514) |
| Comprehensive loss | $ (2,655) | $ (2,470) | $ (6,522) | $ (5,469) |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(In Thousands)**

**(Unaudited)**

| | Nine Months Ended September 30, | |
|---|---|---|
| | **2013** | **2012** |
| Cash flows from operating activities: | | |
| Net loss | $ (6,482) | $ (5,514) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Share-based compensation expense | 2,072 | 2,941 |
| Depreciation | 1,456 | 1,511 |
| Loss (gain) on disposal of equipment | 30 | (12) |
| Amortization of deferred financing costs | 69 | 81 |
| Amortization of intangible assets | 9 | 9 |
| Amortization/accretion on investments | (4) | 16 |
| Change in allowance for doubtful accounts | (14) | (21) |
| Changes in assets and liabilities: | | |
| Accounts receivable | (1,049) | 125 |
| Inventories | (1,313) | (319) |
| Other current assets | 117 | 122 |
| Accounts payable | 427 | (467) |
| Accrued liabilities | 2,317 | (43) |
| Other non-current assets and non-current liabilities | 207 | (174) |
| Net cash used in operating activities | (2,158) | (1,745) |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (1,930) | (2,372) |
| Purchases of available-for-sale securities | (9,186) | (8,538) |
| Maturities of available-for-sale securities | 4,900 | 8,100 |
| Net proceeds from the sale of equipment | 2 | 24 |
| Net cash used in investing activities | (6,214) | (2,786) |
| Cash flows from financing activities: | | |
| Proceeds from sale of stock, net of offering costs of $212 | 26,872 | |
| Proceeds from debt borrowings | | 10,000 |
| Payments on debt and capital leases | (1,547) | (7,568) |
| Payment of debt fees | (99) | (78) |
| Proceeds from issuance of common stock under employee stock purchase plan | 326 | 372 |
| Proceeds from stock option exercises | 1,277 | 562 |
| Shares repurchased for payment of taxes on stock awards | (279) | (372) |
| Net cash provided by financing activities | 26,550 | 2,916 |

| | | |
|---|---|---|
| Effect of exchange rate changes on cash and cash equivalents | (110) | 59 |
| Net increase (decrease) in cash and cash equivalents | 18,068 | (1,556) |
| Cash and cash equivalents beginning of period | 7,753 | 9,759 |
| Cash and cash equivalents end of period | $ 25,821 | $ 8,203 |
| Supplemental cash flow information: | | |
| Cash paid for interest | $ 381 | $ 457 |
| Cash paid for taxes | 30 | 14 |
| Non-cash investing activities: | | |
| Accrued purchases of property and equipment | 184 | 49 |
| Assets acquired through capital lease | 68 | 5 |
| Capital lease asset early termination | 24 | 5 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

**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 generally accepted accounting principles generally accepted in the United States ( 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, 2012 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, 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.

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

Pursuant to the Company s standard terms of sale, revenue is recognized when title to the goods and risk of loss transfers to customers and there are no remaining obligations that will affect the customers final acceptance of the sale. Generally, the Company s standard terms of sale define the transfer of title and risk of loss to occur upon shipment to the respective customer. The Company generally does not maintain any post-shipping obligations to the recipients of the products. 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 $193 and $225 for the three months ended September 30, 2013 and 2012, respectively, and $582 and $542 for the nine months ended September 30, 2013 and 2012, 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.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

***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.

***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:

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Raw materials | $ 2,512 | $ 3,066 |
| Work in process | 1,170 | 675 |
| Finished goods | 3,380 | 1,977 |
| Inventories | $ 7,062 | $ 5,718 |

***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 being used. Maintenance and repair costs are expensed as incurred.

Included in property and equipment are generators and other capital equipment (such as the Company s switchbox units and cryosurgical consoles) that are loaned at no cost to direct customers that use the Company s disposable products. These generators are depreciated over a period of one to three years, which approximates their useful lives, and such depreciation is included in cost of revenue. The estimated useful lives of this equipment are based on anticipated usage by our customers and the timing and impact of expected new technology rollouts by the Company. To the extent the Company experiences changes in the usage of this equipment or introductions of new technologies, the estimated useful lives of this equipment may change in a future period. Depreciation related to these generators was $322 and $229 for the three months ended September 30, 2013 and 2012, respectively, and $891 and $903 for the nine months ended September 30, 2013 and 2012, respectively. As of September 30, 2013 and December 31, 2012, the net carrying amount of loaned equipment included in net property and equipment in the Condensed Consolidated Balance Sheets was $2,608 and $2,197, respectively.

***Impairment of Long-Lived Assets*** The Company reviews property and equipment annually 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.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

***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 (losses) of $17 and ($42) for the three months ended September 30, 2013 and 2012, respectively, and $73 and ($77) for the nine months ended September 30, 2013 and 2012, respectively, in connection with settlements of its intercompany balance with AtriCure Europe.

The Company periodically is awarded grants to support research and development activities. The Company recognizes grant income when the funds are earned. The Company recorded grant income of $0 and $117 during the three months ended September 30, 2013 and 2012, respectively. Grant income of $0 and $379 was recorded for the nine month periods ended September 30, 2013 and 2012, 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 September 30, 2013 and 2012, $26 and ($85), respectively, of expense (income) was recorded as a result of the remeasurement of the fair value of these fully vested stock options. During the nine months ended September 30, 2013 and 2012, $68 and ($159), respectively, of expense (income) was recorded as a result of the remeasurement of the fair value of these fully vested stock options.

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

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

projections, or if the Company s expectations of future results change, it may be necessary to adjust the valuation allowance. 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 Patient Act ) requires manufacturers of medical devices to pay a 2.3% 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 $151 for the three months ended September 30, 2013 and $399 for the nine months ended September 30, 2013.

***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 2,761 and 2,881 options, restricted stock and performance-based shares as of September 30, 2013 and 2012, respectively, because they are anti-dilutive. Therefore the number of shares calculated for basic net loss per share is also used for the diluted net loss per share calculation.

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

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Total accumulated other comprehensive (loss) income at beginning of period | $ (56) | $ (90) | $ 77 | $ (37) |
| Unrealized Gains on Investments | | | | |
| Balance at beginning of period | $ 0 | $ 0 | $ 1 | $ 2 |
| Other comprehensive income before reclassifications | 5 | 1 | 4 | (1) |
| Amounts reclassified from accumulated other comprehensive income to other income on the statement of operations | 0 | 0 | 0 | 0 |
| Balance at end of period | $ 5 | $ 1 | $ 5 | $ 1 |
| Foreign Currency Translation Adjustment | | | | |
| Balance at beginning of period | $ (56) | $ (90) | $ 76 | $ (39) |
| Other comprehensive income before reclassifications | 71 | 138 | (117) | 123 |
| Amounts reclassified from accumulated other comprehensive income to other income on the statement of operations | 17 | (42) | 73 | (78) |
| Balance at end of period | $ 32 | $ 6 | $ 32 | $ 6 |
| Total accumulated other comprehensive income at end of period | $ 37 | $ 7 | $ 37 | $ 7 |

***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 September 30, 2013 and 2012 was $734 and $1,111, respectively, and $2,072 and $2,941 for the nine months ended September 30, 2013 and 2012, 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. For non-employee options, the fair value at the date of grant is subject to adjustment at each vesting date based upon the fair value of the Company s common stock. The 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 our Condensed Consolidated Statements of Operations and Comprehensive Loss. The expense has been reduced for estimated forfeitures.

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.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

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

The Company has historically issued stock options to non-employee consultants as a form of compensation for services provided to the Company. The Company accounts for the options granted to non-employees prior to their vesting date in accordance with ASC 505-50, Equity-Based Payments to Non-Employees ( ASC 505-50 ). Because these options do not contain specific performance provisions, there is no measurement date of fair value until the options vest. Therefore, the fair value of the options granted and outstanding prior to their vesting date is remeasured each reporting period.

Fully vested options to acquire 38 shares of common stock held by non-employee consultants remained unexercised as of both September 30, 2013 and December 31, 2012. A liability of $146 and $78 was included in accrued liabilities in the Condensed Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012, 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, other liabilities and fixed interest rate debt, 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). Fixed interest rate debt fair value is determined by calculating the net present value of future debt payments and is classified as Level 2. 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.

**2. RECENT ACCOUNTING PRONOUNCEMENTS**

In February 2013 the FASB issued FASB Accounting Standards Update ( ASU ) 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income . This new guidance requires presentation of the effect

of significant amounts reclassified from each component of accumulated other comprehensive income based on its source and the income statement line items affected by the reclassification. If a component is not required to be reclassified to net income in its entirety, a cross reference to the related footnote for additional information will be required. This ASU is effective for interim and annual reporting periods beginning after December 15, 2012. The Company has evaluated the provisions of ASU 2013-02 and determined that the new guidance does not have a material impact on the Company s financial reporting.

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 determined that the guidance does not have a material impact on the Company s financial reporting.

**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:

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

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.

In accordance with ASC 820, the following table represents the Company s fair value hierarchy for its financial assets and liabilities measured at fair value on a recurring basis as of September 30, 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 | $ | $ 23,813 | $ | $ 23,813 |
| Commercial paper | | 2,898 | | 2,898 |
| Corporate bonds | | 1,486 | | 1,486 |
| U.S. government agencies and securities | 4,158 | | | 4,158 |
| Total assets | $ 4,158 | $ 28,197 | $ | $ 32,355 |

| | | | | |
|---|---|---|---|---|
| **Liabilities:** | | | | |
| Derivative instruments | $ | $ | $ 146 | $ 146 |
| Total liabilities | $ | $ | $ 146 | $ 146 |

There were no changes in the levels of financial assets and liabilities during the nine month period ended September 30, 2013.

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, 2012:

| | **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 | $ | $ 5,261 | $ | $ 5,261 |
| Commercial paper | | 3,247 | | 3,247 |
| U.S. government agencies and securities | 1,000 | | | 1,000 |
| Total assets | $ 1,000 | $ 8,508 | $ | $ 9,508 |
| **Liabilities:** | | | | |
| Derivative instruments | $ | $ | $ 78 | $ 78 |
| Total liabilities | $ | $ | $ 78 | $ 78 |

There were no changes in the levels of financial assets and liabilities during the twelve months ended December 31, 2012.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

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

| | As of September 30, 2013 | As of December 31, 2012 |
|---|---|---|
| Risk free interest rate | 0.10% 1.15% | 0.23% 0.74% |
| Expected life of option (years) | 1.00 4.36 | 1.75 5.10 |
| Expected volatility of stock | 69.00% | 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 awards allow the options to be partially net-cash settled, these vested options are no longer eligible for equity classification and are, thus, accounted for as derivative liabilities under FASB ASC 815 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 September 30, 2013:

| | |
|---|---|
| Beginning Balance January 1, 2013 | $ 78 |
| Total gains/losses (realized/unrealized) included in earnings | 68 |
| Purchases (exercises) | |
| Reclassification from equity to liability when fully vested | |
| Ending Balance September 30, 2013 | $ 146 |
| Losses included in earnings (or changes in net assets attributable to the change in unrealized gains relating to assets held at reporting date) | $ (68) |

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, 2012:

| | |
|---|---|
| Beginning Balance January 1, 2012 | $ 208 |
| Total gains/losses (realized/unrealized) included in earnings | (179) |
| Purchases (exercises) | (50) |
| Reclassification from equity to liability when fully vested | 99 |
| Ending Balance December 31, 2012 | $ 78 |
| Gains included in earnings (or changes in net assets attributable to the change in unrealized losses relating to assets held at reporting date) | $ 179 |

**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 |
|---|---|
| Net carrying amount as of December 31, 2011 | $ 45 |
| Amortization | (13) |
| Net carrying amount as of December 31, 2012 | 32 |
| Amortization | (9) |
| Net carrying amount as of September 30, 2013 | $ 23 |

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

The Company s amortization term for a non-compete agreement is eight years. Amortization expense related to intangible assets with definite lives was $3 for both the three month periods ended September 30, 2013 and 2012 and $9 for both the nine month periods ended September 30, 2013 and 2012.

Estimated future amortization expense related to intangible assets with definite lives is as follows:

| Year | Amortization |
|---|---|
| 2013 | $ 4 |
| 2014 | 12 |
| 2015 | 7 |
| Total | $ 23 |

**5. ACCRUED LIABILITIES**

Accrued liabilities consisted of the following:

| | September 30, 2013 | December 31, 2012 |
|---|---|---|
| Accrued commissions | $ 3,121 | $ 1,464 |
| Accrued bonus | 1,565 | 487 |
| Accrued settlement reserve | 1,486 | 1,120 |
| Accrued taxes and value-added taxes payable | 456 | 366 |
| Other accrued liabilities | 405 | 610 |
| Accrued vacation | 370 | 349 |
| Withheld payroll taxes | 243 | 126 |
| Stock purchase plan withholdings | 242 | 97 |
| Accrued payroll | 231 | 153 |
| Accrued royalties | 148 | 118 |
| Accrued non-employee stock options | 146 | 78 |
| Sales/returns allowance - trade | 105 | 105 |
| Total | $ 8,518 | $ 5,073 |

**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 $10,000 term loan which matures on February 2, 2017 and a $10,000 revolving credit facility which matures on April 30, 2014. The 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 loan facility or when the Company achieves specific covenant milestones. Financial covenants under the credit facility, as amended, include a minimum EBITDA, a limitation on capital expenditures, 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 September 30, 2013. 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.

Effective January 30, 2013 the Company and SVB entered into a Joinder and Loan Modification Agreement and an Export-Import Bank Joinder and Loan Modification Agreement which set forth certain amendments to the Company s credit facility with the Bank. These Modification Agreements added the Company s wholly-owned subsidiary, AtriCure, LLC, as a borrower, and such Loan Modification Agreement modified the Company s timing for submitting a forecast to the Bank and decreased the EBITDA amount the Company must achieve to meet the minimum EBITDA covenant.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

Effective March 29, 2013 the Company and SVB entered into a Loan Modification Agreement and an Export-Import Bank Loan Modification Agreement which set forth certain amendments to the Company s credit facility with the Bank. These Modification Agreements provide for (i) a change in the applicable borrowing rate on the revolving credit facility from 0.25% to 1.25% above the prime rate based on the Company s Liquidity Ratio to the prime rate during a Streamline Period and prime plus 1.25% during a Non-Streamline Period, (ii) a reduction in the collateral handling fee on the revolving credit facility, (iii) a reduction in the fixed interest rate on the term loan from 6.75% to 4.75% and (iv) modifications to the Liquidity Ratio and EBITDA financial covenants. The interest rate was 4.75% as of September 30, 2013 and 6.75% as of September 30, 2012.

As of September 30, 2013 the Company had no borrowings under the revolving credit facility and had borrowing availability of approximately $8,175. As of December 31, 2012 the Company had no borrowings under its revolving credit facility and borrowing availability of $5,303. As of September 30, 2013 and December 31, 2012, $6,833 and $8,333, respectively, was outstanding under the term loan, which included $2,000 classified as current maturities of long-term debt. The effective interest rate on borrowings under the modified term loan, including debt issuance costs, was 6.5% as of September 30, 2013. The Company has 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. No letters of credit were outstanding at December 31, 2012. As of and for the period ended September 30, 2013, the Company was in compliance with all of the financial covenants of the 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, the Company must repay all loans under the Export-Import agreement.

As of September 30, 2013 the Company had capital leases for computer and office equipment that expire at various terms through 2017, and the cost of the assets under lease was $255. These assets are depreciated over their estimated useful lives, which equal the terms of the leases. Accumulated amortization on the capital leases was $133 at September 30, 2013.

Maturities on debt, including capital lease obligations, are as follows:

| | | |
|---|---|---|
| 2013 | $ 509 | October 1, 2013 through December 31, 2013 |
| 2014 | 2,038 | |
| 2015 | 2,038 | |
| 2016 | 2,030 | |
| 2017 | 344 | |
| Total | $ 6,959 | |

**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 2015.

***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 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 $194 and $141 was recorded as part of cost of revenue for the three months ended September 30, 2013 and 2012, respectively, and $733 and $438 for the nine months ended September 30, 2013 and 2012, respectively.

***Purchase Agreements***

On June 15, 2007 the Company entered into a purchase agreement with MicroPace Pty Ltd Inc. ( MicroPace ). 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 for worldwide distribution by the Company. Pursuant to the terms of the amended agreement, in order for the Company to retain exclusive distribution rights, the Company was required to purchase a minimum of 40 units during the period December 1, 2010 through December 31, 2011 to extend exclusivity through 2012 and an additional 40 units during 2012 to extend exclusivity through December 31, 2013. Units purchased in excess of yearly minimums reduce future minimum purchase requirements. A total of 56 units were purchased by the Company between December 1, 2010 and December 31, 2011, thereby extending exclusive distribution rights through December 31, 2012. A total of 60 units were purchased by the Company during 2012, fulfilling the purchase requirement to extend exclusive distribution rights through 2013. The Company has purchased 53 units during 2013.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

In April 2012 the Company entered into a development and manufacturing services agreement with Stellartech Research Corporation ( Stellartech ). Under the terms of the agreement, Stellartech will provide development services for the next generation of the Company s radio frequency generators and will manufacture at least the first 300 units of the product. The agreement also establishes Stellartech as the exclusive supplier of the generators during the three years after product completion. There is no minimum purchase requirement beyond the initial 300 units.

***Distributor Termination***

In July 2010 the Company terminated a distributor agreement with a European distributor. Under the terms of the agreement the Company paid the distributor a termination fee, repurchased saleable disposable product inventory and assigned the distributor s capital equipment to AtriCure Europe. Additionally, the Company entered into a consulting agreement with the distributor to provide ongoing consulting services through September 30, 2012. In exchange for these services, beginning October 1, 2010, the distributor earned 50 (approximately $68) per quarter for a total of 400 (approximately $541).

**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 September 30, 2013 the Company had made $2,838 in payments (including interest), and had a liability related to this

settlement totaling $1,486, 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.

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 September 30, 2013 and 2012 was (0.13%) and (0.45%), respectively. The effective tax rate for the nine months ended September 30, 2013 and 2012 was (0.22%) and (0.36%), respectively.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

The Company has not accrued 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 line in the accompanying Condensed Consolidated Statements of Operations and Comprehensive Loss and within the related tax liability 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 2001 Plan and the 2005 Plan generally expire ten years from the date of grant. Options granted from the 2001 Plan are generally exercisable beginning one year from the date of grant in cumulative yearly amounts of 25% of the shares granted. 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 September 30, 2013 6,893 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, 2013 an additional 549 shares were authorized for issuance under the 2005 Plan representing 3.25% of the outstanding shares on that date. As of September 30, 2013 there were 1,575 shares available for future grants under the plans.

Activity under the Plans during the nine months ended September 30, 2013 was as follows:

| Stock Options | Number of Shares Outstanding | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at January 1, 2013 | 3,172 | $ 8.81 | | |
| Granted | 446 | 8.95 | | |
| Exercised | (234) | 5.46 | | |
| Cancelled or forfeited | (911) | 10.34 | | |
| Outstanding at September 30, 2013 | 2,473 | $ 8.59 | 6.8 | $ 6,673 |
| Vested and expected to vest | 2,331 | $ 8.65 | 6.6 | $ 6,200 |
| Exercisable at September 30, 2013 | 1,233 | $ 9.41 | 4.3 | $ 2,602 |

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

| Restricted Stock | Number of Shares Outstanding | Weighted Average Grant Date Fair Value |
|---|---|---|
| Outstanding at January 1, 2013 | 504 | $ 7.93 |
| Granted | 55 | 9.35 |
| Released | (87) | 9.26 |
| Forfeited | (184) | 8.20 |
| Outstanding at September 30, 2013 | 288 | $ 7.62 |

The total intrinsic value of options exercised during the three month periods ended September 30, 2013 and 2012 was $12 and $34, respectively. The total intrinsic value of options exercised during the nine month periods ended September 30, 2013 and 2012 was $611 and $1,278, respectively. As a result of the Company s tax position, no tax benefit was recognized related to the stock option exercises. For the nine month periods ended September 30, 2013 and 2012, respectively, $1,277 and $562 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 performance shares vested during both of the three month periods ended September 30, 2013 and 2012 was $0, and the total fair value of performance shares vested during the nine month periods ended September 30, 2013 and 2012 was $0 and $99, respectively. The total fair value of restricted stock vested during the three month periods ended September 30, 2013 and 2012 was $33 and $468 respectively. The total fair value of restricted stock vested during the nine month periods ended September 30, 2013 and 2012 was $738 and $1,193, 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 stock options and restricted stock for the three months ended September 30, 2013 and 2012 of $654 and $1,054, respectively. The Company recognized expense related to stock options and restricted stock for the nine months ended September 30, 2013 and 2012 of $1,860 and $2,731, respectively. Incremental compensation expense of $396 was recorded during the second quarter of 2012 due to the modification of share-based compensation of the Company s former Chief Financial Officer, and incremental compensation expense of $522 was recorded during the third quarter of 2012 due to the modification of share-based compensation of the Company s former Chief Executive Officer. As of September 30, 2013 there was $9,563 of unrecognized compensation costs related to non-vested stock option and restricted stock arrangements ($6,487 relating to stock options and $3,076 relating to restricted stock). This cost is expected to be recognized over a weighted average period of 3.1 years for stock options and 2.8 years for restricted stock.

The Company awarded 225 performance options to its new President and Chief Executive Officer when he joined the Company in November 2012. 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 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 of $46 related to the performance options during the three months ended September 30, 2013. The Company recognized expense of $129 related to the performance options during the nine months ended September 30, 2013. As of September 30, 2013 there was $503 of unrecognized compensation costs related to non-vested performance options. The cost is expected to be recognized over a weighted-average period of 2.5 to 5.2 years. None of the market conditions were met as of September 30, 2013; therefore, none of the performance options were exercisable.

The Company historically issued performance shares to certain employees and consultants to incent and reward them for the achievement of specified performance over various service periods. The participants receive awards for a specified number of shares of the Company s common stock at the beginning of the award period, which entitles the participants to the shares at the end of the award period if achievement of the specified metrics and service requirements occurs. The Company did not release any performance shares (gross) during the three months ended September 30, 2013 and 2012 related to the participants achievement of certain specified metrics. The Company released 0 and 10 performance shares (gross) during the nine months ended September 30, 2013 and 2012, respectively, related to the participants achievement of certain specified metrics. As of September 30, 2013 the Company has no performance shares outstanding. In accordance with FASB ASC 718, the Company estimates the number of shares to be granted based upon the probability that the performance metric and service period will be achieved. The fair value of the estimated award,

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

based on the market value of the Company s stock on the date of award, is expensed over the award period. The probability of meeting the specified metrics is reviewed quarterly. The Company recognized no expense related to performance shares during the three months ended September 30, 2013 and 2012 or the nine months ended September 30, 2013 and 2012. As of September 30, 2013 there was no unrecognized compensation cost related to non-vested share-based compensation arrangements associated with performance shares.

***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, 2009, may not purchase more than 1.5 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 September 30, 2013 there were 720 shares available for future issuance under the ESPP. Share-based compensation expense with respect to the ESPP was $79 and $57 for the three months ended September 30, 2013 and 2012, respectively. Share-based compensation expense with respect to the ESPP was $211 and $210 for the nine months ended September 30, 2013 and 2012, 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 nine months ended September 30, 2013 and 2012. This expense was allocated as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Cost of revenue | $ 68 | $ 68 | $ 195 | $ 202 |
| Research and development expenses | 44 | 49 | 144 | 181 |
| Selling, general and administrative expenses | 622 | 994 | 1,733 | 2,558 |
| | $ 734 | $ 1,111 | $ 2,072 | $ 2,941 |

Total share-based compensation expense related to employees

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 September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Risk free interest rate | 1.48% 2.29% | 0.65% 0.68% | 0.75% 2.29% | 0.65% 1.37% |
| Expected life of option (years) | 5.33 6.94 | 5.38 5.58 | 5.31 7.38 | 5.38 7.14 |
| Expected volatility of stock | 69.00% | 70.00% | 69.00% | 70.00-71.00% |
| Weighted-average volatility | 69.00% | 70.00% | 69.00% | 71.00% |
| 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.

Table of Contents

**ATRICURE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

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 September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| Stock options | $ 6.00 | $ 5.00 | $ 5.67 | $ 6.18 |
| Restricted stock | 9.59 | 8.38 | 9.35 | 9.76 |

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:

| | |
|---|---|
| Strike price | $ 5.91 |
| Contractual term | 10.00 |
| Expected volatility of stock | 69.60% |
| Expected rate of return | 1.75% |
| Dividend yield | 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 in 2012 was as follows:

| | Price Target | Fair Value |
|---|---|---|
| Tranche 1 | $ 10.00 | $ 4.32 |
| Tranche 2 | 12.50 | 4.30 |
| Tranche 3 | 15.00 | 4.27 |
| Tranche 4 | 17.50 | 4.23 |
| Tranche 5 | 20.00 | 4.19 |
| Tranche 6 | 25.00 | 4.10 |
| Tranche 7 | 30.00 | 4.01 |
| Tranche 8 | 35.00 | 3.92 |

| | | |
|---|---|---|
| Tranche 9 | 40.00 | 3.83 |

***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 accounts for the options granted to non-employees prior to their vesting date in accordance with ASC 505-50. Because these options do not contain specific performance provisions, there is no measurement date of fair value until the options vest. Therefore, the fair value of the options granted and outstanding prior to their vesting date is remeasured each reporting period. 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 non-vested portion of the non-employee stock options have been 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 September 30, 2013 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 awards 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 September 30, 2013 and 2012, $26 and ($85), respectively, of expense (income) was recorded as a result of the remeasurement of the fair value of these stock options. During the nine months ended September 30, 2013 and 2012, $68 and ($159), respectively, of expense (income) was recorded as a result of the remeasurement of the fair value of these stock options. As of both September 30, 2013 and December 31, 2012, fully vested stock options to acquire 38 shares of common stock held by non-employee consultants remained unexercised and a liability of $146 and $78 was included in accrued liabilities in the Condensed Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012, respectively.

Table of Contents

**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.

Geographic revenue was as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 |
| United States | $ 15,832 | $ 12,361 | $ 45,925 | $ 38,966 |
| International | 4,314 | 3,778 | 14,080 | 12,917 |
| Total | $ 20,146 | $ 16,139 | $ 60,005 | $ 51,883 |

Revenue by product type was as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| **Revenue:** | 2013 | 2012 | 2013 | 2012 |
| Open-heart | $ 9,637 | $ 7,656 | $ 27,912 | $ 24,529 |
| Minimally Invasive | 3,486 | 3,112 | 10,129 | 9,324 |
| AtriClip | 2,709 | 1,593 | 7,884 | 5,113 |
| Total United States | 15,832 | 12,361 | 45,925 | 38,966 |
| International | 4,314 | 3,778 | 14,080 | 12,917 |
| Total | $ 20,146 | $ 16,139 | $ 60,005 | $ 51,883 |

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. The Company intends to use the proceeds from the offering for general corporate purposes and working capital.

Table of Contents

## 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, 2012 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, 2012. 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 Synergy Ablation System ( 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 ablation clamp system and related radiofrequency ( RF ) ablation devices. 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 ) System ( AtriClip system ), which is designed to safely and effectively 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 142,000 patients since January 2003, 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 also 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 or coronary bypass. Additionally, although our products are not FDA-approved for

this specific use, cardiothoracic surgeons have adopted our products as a treatment alternative for Afib patients who may be candidates for sole-therapy minimally invasive surgical procedures. Our 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 for the treatment of other forms of Afib or for other uses for the treatment of Afib. Additionally, the FDA has not cleared or approved our products for a reduction in 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 or for the exclusion of the left atrial appendage.

**Recent Developments**

The December 2011 FDA approval of our Synergy System included the requirement to implement a 350-patient post-approval study ( PAS ). The trial is designed to evaluate the long-term treatment effect of our 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 187 patients have been enrolled in the trial. The approval also included the requirement to implement a physician training and education program for existing and new users.

Table of Contents

We are also conducting a Staged DEEP Feasibility clinical trial. The Staged DEEP AF trial protocol was submitted to the FDA in February 2012. The trial evaluates the effectiveness of a staged approach, where a minimally invasive ablation procedure is performed initially and the catheter and mapping optimization procedure is performed on a different day during the same hospitalization. Final FDA approval was received in June 2012. Enrollment in the Staged DEEP trial was initiated during the third quarter of 2012, and there are currently 28 patients enrolled. We expect to enroll up to 30 patients at six medical centers during the course of the trial.

We are also in the initial start-up of a Stroke Feasibility clinical trial with the AtriClip. 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 for stroke prophylaxis (i.e. prevention of stroke) in patients with non-valvular atrial fibrillation 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 is expected to begin in the first quarter of 2014.

A provision of The Patient Protection and Affordable Care Act enacted in 2010, as amended, (the Patient Act ) requires manufacturers of medical devices to pay a 2.3% excise tax on all U.S. medical device sales beginning in January 2013. We recorded $151 related to the medical device excise tax in cost of revenue during the three months ended September 30, 2013 and $399 during the nine months ended September 30, 2013.

In January 2013 we completed a public offering of common stock under our July 2011 shelf registration. We sold 3,996,250 shares of common stock, par value $0.001 per share, at a price of $7.25 per share to generate proceeds of $26,872 after expenses. Offering costs were recorded in additional paid in capital to offset proceeds. We plan to use the proceeds from the offering for general corporate purposes and working capital.

**Results of Operations**

***Three months ended September 30, 2013 compared to three months ended September 30, 2012***

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 September 30, | | | |
|---|---|---|---|---|
| | 2013 | | 2012 | |
| | Amount | % of Revenues | Amount | % of Revenues |
| Revenue | $ 20,146 | 100.0% | $ 16,139 | 100.0% |
| Cost of revenue | 5,461 | 27.1% | 4,590 | 28.4% |
| Gross profit | 14,685 | 72.9% | 11,549 | 71.6% |
| Operating expenses: | | | | |
| Research and development expenses | 3,237 | 16.1% | 2,905 | 18.0% |
| Selling, general and administrative expenses | 14,062 | 69.8% | 11,173 | 69.2% |
| Total operating expenses | 17,299 | 85.9% | 14,078 | 87.2% |
| Loss from operations | (2,614) | (13.0%) | (2,529) | (15.6%) |

| | | | | |
|---|---|---|---|---|
| Other income (expense): | | | | |
| Interest expense | (123) | (0.6%) | (190) | (1.2%) |
| Interest income | 2 | 0.0% | 3 | 0.0% |
| Other | (9) | (0.0%) | 160 | 1.0% |
| Total other income (expense) | (130) | (0.6%) | (27) | (0.2%) |
| Loss before income tax expense | (2,744) | (13.6%) | (2,556) | (15.8%) |
| Income tax expense | 4 | 0.0% | 11 | 0.0% |
| Net loss | $ (2,748) | (13.6%) | $ (2,567) | (15.8%) |

**Revenue.** Total revenue increased 24.8% (24.0% on a constant currency basis) from $16,139 for the three months ended September 30, 2012 to $20,146 for the three months ended September 30, 2013. Revenue from sales to customers in the United States increased $3,471, or 28.1%, and revenue from sales to international customers increased $536, or 14.2% (10.8% 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 $1,981 and increased sales of the AtriClip system of $1,116. The increase in international revenue was primarily due to an increase in sales to direct customers and certain distributors.

Table of Contents

**Cost of revenue and gross margin.** Cost of revenue increased $871, from $4,590 for the three months ended September 30, 2012 to $5,461 for the three months ended September 30, 2013. As a percentage of revenue, cost of revenue decreased from 28.4% for the three months ended September 30, 2012 to 27.1% for the three months ended September 30, 2013. Gross margin for the three months ended September 30, 2013 and 2012 was 72.9% and 71.6%, respectively. The increase in gross margin was primarily due to volume-driven leverage of manufacturing overhead expenses, a higher mix of domestic sales and the strong performance of our new AtriClip Pro product.

**Research and development expenses.** Research and development expenses increased $332, from $2,905 for the three months ended September 30, 2012 to $3,237 for the three months ended September 30, 2013. The increase in expense was primarily due to a $102 increase in product development project expense, a $337 increase in product development and clinical personnel expense and a $228 increase in clinical trial spending, offset by a $316 decrease in clinical affairs consulting.

**Selling, general and administrative expenses.** Selling, general and administrative expenses increased $2,889, or 25.9%, from $11,173 for the three months ended September 30, 2012 to $14,062 for the three months ended September 30, 2013. The increase was primarily due to an increase in sales and marketing expenditures and an increase in training related to the FDA clearance of our Synergy System for the treatment of Afib.

**Net interest expense.** Net interest expense for the three months ended September 30, 2013 and 2012 was $121 and $187, respectively. Net interest expense primarily represents interest expense related to amounts outstanding on our term loan and amortization of debt issuance costs.

**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 (expense) income for the three months ended September 30, 2013 and 2012 totaled ($9) and $160, respectively.

***Nine months ended September 30, 2013 compared to nine months ended September 30, 2012***

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

| | Nine Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2013 | | 2012 | |
| | Amount | % of Revenues | Amount | % of Revenues |
| Revenue | $ 60,005 | 100.0% | $ 51,883 | 100.0% |
| Cost of revenue | 16,111 | 26.9% | 14,871 | 28.7% |
| Gross profit | 43,894 | 73.1% | 37,012 | 71.3% |
| Operating expenses: | | | | |
| Research and development expenses | 9,792 | 16.3% | 9,180 | 17.7% |
| Selling, general and administrative expenses | 40,155 | 66.9% | 33,178 | 63.9% |
| Total operating expenses | 49,947 | 83.2% | 42,358 | 81.6% |

| | | | | |
|---|---|---|---|---|
| Loss from operations | (6,053) | (10.1%) | (5,346) | (10.3%) |
| Other income (expense): | | | | |
| Interest expense | (428) | (0.7%) | (616) | (1.2%) |
| Interest income | 8 | 0.0% | 8 | 0.0% |
| Other | 5 | 0.0% | 460 | 0.9% |
| Total other income (expense) | (415) | (0.7%) | (148) | (0.3%) |
| Loss before income tax expense | (6,468) | (10.8%) | (5,494) | (10.6%) |
| Income tax expense | 14 | 0.0% | 20 | 0.0% |
| Net loss | $ (6,482) | (10.8%) | $ (5,514) | (10.6%) |

**Revenue.** Total revenue increased 15.7% (15.3% on a constant currency basis) from $51,883 for the nine months ended September 30, 2012 to $60,005 for the nine months ended September 30, 2013. Revenue from sales to customers in the United States increased $6,959, or 17.9%, and revenue from sales to international customers increased $1,163, or 9.0% (7.5% 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 $3,383 and increased sales of the AtriClip system of $2,771. The increase in international revenue was primarily due to an increase in sales to direct customers and certain distributors.

Table of Contents

**Cost of revenue and gross margin.** Cost of revenue increased $1,240, from $14,871 for the nine months ended September 30, 2012 to $16,111 for the nine months ended September 30, 2013. As a percentage of revenue, cost of revenue decreased from 28.7% for the nine months ended September 30, 2012 to 26.9% for the nine months ended September 30, 2013. Gross margin for the nine months ended September 30, 2013 and 2012 was 73.1% and 71.3%, respectively. The increase in gross margin was primarily due to volume-driven leverage of manufacturing overhead expenses, a higher mix of domestic sales, lower sales of capital equipment and the strong performance of our new AtriClip Pro product.

**Research and development expenses.** Research and development expenses increased $612, from $9,180 for the nine months ended September 30, 2012 to $9,792 for the nine months ended September 30, 2013. The increase in expense was primarily due to a $534 increase in product development project expense, a $679 increase in product development and clinical personnel expense and a $420 increase in clinical trial spending, offset by a $930 decrease in clinical affairs consulting.

**Selling, general and administrative expenses.** Selling, general and administrative expenses increased $6,977, or 21.0%, from $33,178 for the nine months ended September 30, 2012 to $40,155 for the nine months ended September 30, 2013. The increase was primarily due to an increase in sales and marketing expenditures and an increase in training related to the FDA clearance of our Synergy System for the treatment of Afib.

**Net interest expense.** Net interest expense for the nine months ended September 30, 2013 and 2012 was $420 and $608, respectively. Net interest expense primarily represents interest expense related to amounts outstanding on our term loan and amortization of debt issuance costs.

**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 nine months ended September 30, 2013 and 2012 totaled $5 and $460, respectively.

**Liquidity and Capital Resources**

As of September 30, 2013 the Company had cash, cash equivalents and investments of $34,363 and short-term and long-term debt of $6,833, resulting in a net cash position of $27,530. We had unused borrowing capacity of approximately $8,175 under our revolving credit facility. We had net working capital of $32,282 and an accumulated deficit of $117,233 as of September 30, 2013.

**Cash flows used in operating activities.** Net cash used in operating activities for the nine months ended September 30, 2013 was $2,158. The primary net uses of cash for operating activities were as follows:

- the net loss of $6,482, offset by $3,618 of non-cash expenses, including $2,072 in share-based compensation and $1,465 in depreciation and amortization; and

- a net decrease in cash used related to changes in operating assets and liabilities of $706, due primarily to the following:

an increase in accounts receivable of $1,049, due primarily to an increase in sales during the first three quarters of 2013 as compared to the first three quarters of 2012;

an increase in inventory of $1,313, due primarily to increased inventory levels in support of new products and anticipated revenue growth; and

a $2,744 increase in accounts payable and accrued liabilities due primarily to the timing of payments.

**Cash flows used in investing activities.** Net cash used in investing activities was $6,214 for the nine months ended September 30, 2013. The primary net uses of cash for investing activities were:

a use of cash of $1,930 related to the purchase of equipment, which consisted primarily of the placement of our RF and cryo generators with our customers; and

net investment purchases of $4,286.

**Cash flows provided by financing activities.** Net cash provided by financing activities during the nine months ended September 30, 2013 was $26,550, which was primarily due to proceeds from the sale of stock of $26,872 and proceeds from stock option exercises of $1,277, partially offset by shares repurchased for payment of taxes on stock awards of $279 and debt and capital lease payments of $1,547.

Table of Contents

**Credit facility.** The Company s Loan and Security Agreement with Silicon Valley Bank ( SVB ), as amended, restated, and modified (the Agreement ) provides for a term loan and a revolving credit facility under which we could borrow a maximum of $20,000. As of September 30, 2013 we had no borrowings under the revolving credit facility, and we had borrowing availability of approximately $8,175. 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, 2014. Also, as of September 30, 2013, $6,833 was outstanding under the term loan, which included $2,000 classified as current maturities of long-term debt. The term loan has a five year term, and principal payments in the amount of $167, together with accrued interest, are due and payable monthly. The term loan accrues interest at a fixed rate of 4.75% and matures in February 2017.

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 loan 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 September 30, 2013 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.

The effective interest rate on borrowings under the modified term loan, including debt issuance costs, is 6.5%. 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.

**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.

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. Significant cash needs over the next twelve months include debt service of approximately $2,285 ($167 per month plus interest) on our outstanding term loan and payments under our settlement agreement with the DOJ and Relator of $1,513. 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. In the event we cannot or do not comply with such covenants, our debt may be callable and become currently due. 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 September 30, 2013 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, which we believe arises from fewer people choosing to undergo elective procedures during the summer months.

Table of Contents

**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 ( 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, 2012 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 September 30, 2013 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, 2012.

**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 September 30, 2013 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.

Table of Contents

**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, 2012, 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, 2012.

Table of Contents

**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 |

# Compensatory plan or arrangement.

* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

Table of Contents

## 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: November 1, 2013

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

**(Principal Executive Officer)**

Date: November 1, 2013

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

**(Principal Accounting and Financial Officer)**

Table of Contents

## EXHIBIT INDEX

| 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 |

# Compensatory plan or arrangement.

* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.