

THORATEC CORP
Form 10-Q
November 12, 2009

Table of Contents

**U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

(Mark one)

**Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934
For the quarterly period ended October 3, 2009**

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: 000-49798

THORATEC CORPORATION

(Exact name of registrant as specified in its charter)

California

**(State or other jurisdiction of incorporation
or organization)**

94-2340464

(I.R.S. Employer Identification No.)

**6035 Stoneridge Drive, Pleasanton, California
(Address of principal executive offices)**

94588

(Zip Code)

(925) 847-8600

(Registrant's telephone number, including area code)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting
company

(Do not check if a 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

As of October 31, 2009 the registrant has 56,868,989 shares of common stock outstanding.

THORATEC CORPORATION
TABLE OF CONTENTS

| | |
|-----------------------------------------------------------------------------------------------------------------------------------|----|
| <u>Part I. Financial Information</u> | 3 |
| <u>Item 1. Condensed Consolidated Financial Statements (unaudited)</u> | 3 |
| <u>Condensed Consolidated Balance Sheets as of October 3, 2009 and January 3, 2009</u> | 3 |
| <u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended October 3, 2009 and September 27, 2008</u> | 4 |
| <u>Condensed Consolidated Statements of Shareholders' Equity for the Nine Months Ended October 3, 2009 and September 27, 2008</u> | 5 |
| <u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended October 3, 2009 and September 27, 2008</u> | 6 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 7 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 28 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 42 |
| <u>Item 4. Controls and Procedures</u> | 43 |
| <u>Part II. Other Information</u> | 44 |
| <u>Item 1A. Risk Factors</u> | 44 |
| <u>Item 2. Unregistered Sale of Equity Securities and Use of Proceeds</u> | 45 |
| <u>Item 6. Exhibits</u> | 46 |
| <u>Signatures</u> | 47 |
| Exhibits | |
| <u>EX-31.1</u> | |
| <u>EX-31.2</u> | |
| <u>EX-32.1</u> | |
| <u>EX-32.2</u> | |

Thoratec, the Thoratec logo, Thoralon, HeartMate, and HeartMate II are registered trademarks of Thoratec Corporation, and IVAD is a trademark of Thoratec Corporation.

CentriMag is a registered trademark of Levitronix LLC.

ITC, A-VOX Systems, AVOXimeter, HEMOCHRON, ProTime, Surgicutt, Tenderlett, Tenderfoot, and IRMA are registered trademarks of International Technidyne Corporation, Thoratec Corporation's wholly-owned subsidiary.

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****THORATEC CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS****(unaudited)
(in thousands)**

| | October 3, 2009 | January 3, 2009 As adjusted (1) |
|------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------|----------------------------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 28,000 | \$ 107,053 |
| Short-term available-for-sale investments | 235,328 | 141,598 |
| Receivables, net of allowances of \$1,346 and \$947, respectively | 58,802 | 55,065 |
| Inventories | 74,759 | 61,373 |
| Deferred tax assets | 8,250 | 8,397 |
| Prepaid expenses and other assets | 8,801 | 7,415 |
| Total current assets | 413,940 | 380,901 |
| Property, plant and equipment, net | 51,462 | 50,138 |
| Goodwill | 99,287 | 99,287 |
| Purchased intangible assets, net | 100,517 | 108,584 |
| Long-term restricted cash and cash equivalents | 16,000 | |
| Long-term available-for-sale investments | 24,620 | 29,959 |
| Other long-term assets | 24,380 | 15,216 |
| Total Assets | \$ 730,206 | \$ 684,085 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 13,485 | \$ 10,563 |
| Accrued compensation | 19,605 | 25,550 |
| Other accrued liabilities | 15,729 | 12,410 |
| Total current liabilities | 48,819 | 48,523 |
| Senior subordinated convertible notes | 129,932 | 124,115 |
| Long-term deferred tax liability | 35,804 | 38,842 |
| Other | 8,265 | 6,326 |
| Total Liabilities | 222,820 | 217,806 |
| Shareholders equity: | | |
| Common shares: no par, authorized 100,000; issued and outstanding 56,806 and 56,395 as of October 3, 2009 and January 3, 2009, respectively | | |
| Additional paid-in capital | 549,300 | 528,657 |

| | | |
|--------------------------------------------|------------|------------|
| Accumulated deficit | (39,506) | (56,634) |
| Accumulated other comprehensive loss: | | |
| Unrealized loss on investments | (872) | (3,337) |
| Cumulative translation adjustments | (1,536) | (2,407) |
| Total accumulated other comprehensive loss | (2,408) | (5,744) |
| Total shareholders' equity | 507,386 | 466,279 |
| Total Liabilities and Shareholders' Equity | \$ 730,206 | \$ 684,085 |

(1) Adjusted for the retrospective adoption of the accounting for convertible debt instruments that may be settled in cash upon conversion, including partial settlements in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 470-20, *Debt*. See Note 12, Long-Term Debt.

See notes to the unaudited condensed consolidated financial statements.

Table of Contents

THORATEC CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)
(in thousands, except per share data)

| | Three Months Ended | | Nine Months Ended | |
|----------------------------------------------|--------------------------------|----------------------------------------------------------|--------------------------------|----------------------------------------------------------|
| | October 3, 2009 | September 27, 2008 As adjusted(1) | October 3, 2009 | September 27, 2008 As adjusted(1) |
| Product sales | \$ 87,917 | \$ 80,815 | \$ 269,442 | \$ 227,890 |
| Cost of product sales | 34,185 | 32,045 | 110,928 | 92,460 |
| Gross profit | 53,732 | 48,770 | 158,514 | 135,430 |
| Operating expenses: | | | | |
| Selling, general and administrative | 24,226 | 23,845 | 82,457 | 68,338 |
| Research and development | 13,350 | 13,443 | 40,862 | 38,801 |
| Amortization of purchased intangible assets | 2,568 | 3,295 | 8,067 | 9,887 |
| Total operating expenses | 40,144 | 40,583 | 131,386 | 117,026 |
| Income from operations | 13,588 | 8,187 | 27,128 | 18,404 |
| Other income and (expense): | | | | |
| Interest expense and other | (3,261) | (2,834) | (9,167) | (8,249) |
| Interest income and other | 7,134 | 2,183 | 9,759 | 6,642 |
| Income before income taxes | 17,461 | 7,536 | 27,720 | 16,797 |
| Income tax expense | (5,684) | (1,478) | (8,483) | (3,793) |
| Net income | \$ 11,777 | \$ 6,058 | \$ 19,237 | \$ 13,004 |
| Net income per share: | | | | |
| Basic | \$ 0.21 | \$ 0.11 | \$ 0.34 | \$ 0.24 |
| Diluted | \$ 0.20 | \$ 0.11 | \$ 0.33 | \$ 0.23 |
| Shares used to compute net income per share: | | | | |
| Basic | 56,683 | 55,328 | 56,511 | 54,702 |
| Diluted | 58,006 | 56,703 | 57,859 | 55,689 |

(1) Adjusted for the retrospective adoption of the accounting for convertible debt instruments that may be settled

in cash upon
conversion,
including partial
settlements, in
accordance with
ASC 470-20,
Debt. See Note
12, Long-Term
Debt.

See notes to the unaudited condensed consolidated financial statements.

4

Table of Contents

THORATEC CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY
(unaudited)
(in thousands)

| | Common Shares | Additional Paid-in Capital | Accumulated Deficit | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity | Total Comprehensive Income (loss) |
|-----------------------------------------------------------------------------|------------------|----------------------------------|------------------------|-----------------------------------------------------------|----------------------------------|--------------------------------------------|
| BALANCE, DECEMBER 29, 2007, as previously reported | 54,108 | \$ 458,383 | \$ (61,577) | \$ 1,223 | \$ 398,029 | |
| Retrospective application of accounting for convertible debt , net of taxes | | 28,462 | (12,682) | | 15,780 | |
| BALANCE, DECEMBER 29, 2007, as adjusted (1) | 54,108 | 486,845 | (74,259) | 1,223 | 413,809 | |
| Exercise of common stock options for cash | 1,484 | 18,959 | | | 18,959 | |
| Issuance of common shares under Employee Stock Purchase Plan | 77 | 1,050 | | | 1,050 | |
| Repurchase of common shares, net | 375 | (637) | (555) | | (1,192) | |
| Share-based compensation | | 7,792 | | | 7,792 | |
| Tax deduction related to employees and directors stock plans | | 5,386 | | | 5,386 | |
| Comprehensive income (loss): | | | | | | |
| Unrealized loss on available-for-sale investments (net of taxes of \$2,104) | | | | (4,225) | (4,225) | \$ (4,225) |
| Foreign currency translation adjustment | | | | (837) | (837) | (837) |
| Net income (1) | | | 13,004 | | 13,004 | 13,004 |
| Total comprehensive income | | | | | | \$ 7,942 |
| BALANCE, SEPTEMBER 27, 2008 (1) | 56,044 | \$ 519,395 | \$ (61,810) | \$ (3,839) | \$ 453,746 | |
| BALANCE, JANUARY 3, 2009, as previously reported | 56,395 | \$ 500,195 | \$ (39,751) | \$ (5,744) | \$ 454,700 | |
| Retrospective application of accounting for convertible debt , net of taxes | | 28,462 | (16,883) | | 11,579 | |
| BALANCE, JANUARY 3, 2009, as adjusted (1) | 56,395 | 528,657 | (56,634) | (5,744) | 466,279 | |
| Exercise of common stock options for cash | 463 | 6,598 | | | 6,598 | |
| Issuance of common shares under Employee Stock Purchase Plan | 76 | 1,628 | | | 1,628 | |

Edgar Filing: THORATEC CORP - Form 10-Q

| | | | | | | |
|-----------------------------------------------------------------------------|--------|------------|-------------|------------|------------|-----------|
| Tax deduction related to employees and directors stock plans | | 2,883 | | | 2,883 | |
| Repurchase and retirement of common shares, net | (128) | (1,146) | (2,109) | | (3,255) | |
| Share-based compensation | | 10,680 | | | 10,680 | |
| Comprehensive income (loss): | | | | | | |
| Unrealized gain on available-for-sale investments (net of taxes of \$1,643) | | | | 2,465 | 2,465 | \$ 2,465 |
| Foreign currency translation adjustment | | | | 871 | 871 | 871 |
| Net income | | | 19,237 | | 19,237 | 19,237 |
| Total comprehensive income | | | | | | \$ 22,573 |
| BALANCE, OCTOBER 3, 2009 | 56,806 | \$ 549,300 | \$ (39,506) | \$ (2,408) | \$ 507,386 | |

(1) Adjusted for the retrospective adoption of the accounting for convertible debt instruments that may be settled in cash upon conversion, including partial settlements, in accordance with ASC 470-20, *Debt*. See Note 12, Long-Term Debt.

See notes to the unaudited condensed consolidated financial statements.

Table of Contents

THORATEC CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

| | Nine Months Ended | |
|-------------------------------------------------------------------------------------------------|--------------------------------|-------------------------------------------------------|
| | October 3, 2009 | September 27, 2008 As adjusted (1) |
| Cash flows from operating activities: | | |
| Net income | \$ 19,237 | \$ 13,004 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 16,441 | 17,675 |
| Investment premium amortization, net | 2,099 | 1,313 |
| Write-down of investment | | 490 |
| Non-cash expenses, net | 1,836 | 198 |
| Non-cash interest on convertible subordinated debt | 5,816 | 5,376 |
| Mark-to-market adjustment on HeartWare International, Inc. (HeartWare) conversion option | (1,786) | |
| Recording of fair value of conversion option upon termination of the HeartWare merger agreement | (3,454) | |
| Tax benefit related to stock options | 2,885 | 5,386 |
| Share-based compensation expense | 10,685 | 7,967 |
| Excess tax benefits from share-based compensation | (2,397) | (3,598) |
| Loss on disposal of assets | 146 | 448 |
| Change in net deferred tax liability | (3,528) | (6,590) |
| Changes in assets and liabilities: | | |
| Receivables | (3,456) | (13,811) |
| Inventories | (14,825) | (7,019) |
| Prepaid expenses and other assets | (5,412) | 322 |
| Accounts payable and other liabilities | 40 | 12,114 |
| Accrued income taxes, net | 1,607 | (3,368) |
| Net cash provided by operating activities | 25,934 | 29,907 |
| Cash flows from investing activities: | | |
| Purchases of available-for-sale investments | (224,817) | (143,797) |
| Sales of available-for-sale investments | 97,577 | 90,419 |
| Maturities of available-for-sale investments | 44,773 | 52,742 |
| Restricted cash and cash equivalents | (16,000) | |
| HeartWare loan receivable | (4,000) | |
| Purchases of property, plant and equipment | (9,681) | (6,876) |
| Net cash (used in) investing activities | (112,148) | (7,512) |
| Cash flows from financing activities: | | |

Edgar Filing: THORATEC CORP - Form 10-Q

| | | |
|-------------------------------------------------------------------------------------------|-----------|-----------|
| Excess tax benefits from share-based compensation | 2,397 | 3,598 |
| Proceeds from stock option exercises | 6,598 | 18,959 |
| Proceeds from stock issued under employee stock purchase plan | 1,628 | 1,050 |
| Repurchase and retirement of common shares | (3,255) | (1,192) |
| Net cash provided by financing activities | 7,368 | 22,415 |
| Effect of exchange rate changes on cash and cash equivalents | (207) | (6) |
| Net (decrease) increase in cash and cash equivalents | (79,053) | 44,804 |
| Cash and cash equivalents at beginning of period | 107,053 | 20,689 |
| Cash and cash equivalents at end of period | \$ 28,000 | \$ 65,493 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for taxes | \$ 7,834 | \$ 8,701 |
| Cash paid for interest | \$ 1,707 | \$ 1,707 |
| Supplemental disclosure of non-cash investing and financing activities: | | |
| Transfers of equipment from inventory | \$ 1,732 | \$ 2,369 |
| Purchases of property, plant and equipment through accounts payable and other liabilities | \$ 1,682 | \$ 1,184 |

(1) Adjusted for the retrospective adoption of the accounting for convertible debt instruments that may be settled in cash upon conversion, including partial settlements, in accordance with ASC 470-20, *Debt*. See Note 12, Long-Term Debt.

See notes to the unaudited condensed consolidated financial statements.

Table of Contents

THORATEC CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Operations and Significant Accounting Policies*Basis of Presentation*

The interim condensed consolidated financial statements of Thoratec Corporation (Thoratec or the Company) have been prepared and presented in accordance with accounting principles generally accepted in the United States of America (GAAP) and the rules and regulations of the Securities and Exchange Commission (SEC), without audit, and reflect all adjustments necessary (consisting only of normal recurring adjustments) to present fairly the Company s financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in the Company s annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. The accompanying financial statements should be read in conjunction with the Company s fiscal 2008 consolidated financial statements, and the accompanying notes thereto, filed with the SEC in the Company s Annual Report on Form 10-K as updated by the Current Report on Form 8-K dated June 11, 2009 (the 2008 Annual Report). The operating results for any interim period are not necessarily indicative of the results that may be expected for any future period. The financial statements of the prior periods presented in this Quarterly Report on Form 10-Q have been adjusted for the retrospective adoption of the accounting for convertible debt instruments that may be settled in cash upon conversion, including partial settlements, as required by ASC 470-20, *Debt*. See Note 12, Long-Term Debt to these unaudited condensed consolidated financial statements for further discussion.

The preparation of the Company s unaudited condensed consolidated financial statements necessarily requires the Company s management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities on the unaudited condensed consolidated balance sheet dates and the reported amounts of revenues and expenses for the periods presented.

The Company has evaluated subsequent events for the period from October 3, 2009, the date of these financial statements, through November 12, 2009, which represents the date these financial statements are being filed with the SEC. Pursuant to the requirements of the ASC 855, *Subsequent Events*, there were no events or transactions occurring during this subsequent reporting period which require recognition or disclosure in these unaudited condensed consolidated financial statements.

Revenue Recognition and Product Warranty

The Company recognizes revenue from product sales of its Cardiovascular and ITC segments when evidence of an arrangement exists, and title has passed (generally upon shipment) or services have been rendered, the selling price is fixed or determinable and collectability is reasonably assured. Sales to distributors are recorded when title transfers. One distributor has certain limited product return rights. Other distributors have certain rights of return upon termination of their distribution agreement. A reserve for sales returns is recorded for these customers by applying a reasonable estimate of product returns based upon historical experience. No other direct sales customers or distributors have return rights.

The majority of the Company s products are covered by up to a two-year limited manufacturer s warranty. Estimated contractual warranty obligations are recorded when related sales are recognized and any additional amounts are recorded when such costs are probable, can be reasonably estimated and are included in Cost of product sales. The change in accrued warranty expense is summarized in the following table:

Table of Contents

| | Three Months Ended | | Nine Months Ended | |
|--------------------------------|--------------------------------|-----------------------------------|--------------------------------|-----------------------------------|
| | October 3, 2009 | September 27, 2008 | October 3, 2009 | September 27, 2008 |
| | (in thousands) | | | |
| Balance at beginning of period | \$ 1,762 | \$ 1,367 | \$ 1,071 | \$ 1,006 |
| Accruals for warranties issued | 1,201 | 281 | 3,506 | 1,170 |
| Settlements made | (682) | (682) | (2,296) | (1,210) |
| Balance at end of period | \$ 2,281 | \$ 966 | \$ 2,281 | \$ 966 |

2. Recently Issued Accounting Standards

In October 2009, the FASB issued Accounting Standards Updates (ASU) No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (a consensus of the FASB Emerging Issues Task Force)*, which amends ASC 605-25, *Revenue Recognition: Multiple-Element Arrangements*. ASU No. 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how to allocate consideration to each unit of accounting in the arrangement. This ASU replaces all references to fair value as the measurement criteria with the term selling price and establishes a hierarchy for determining the selling price of a deliverable. ASU No. 2009-13 also eliminates the use of the residual value method for determining the allocation of arrangement consideration. Additionally, ASU No. 2009-13 requires expanded disclosures. This ASU will become effective for the Company for revenue arrangements entered into or materially modified after fiscal year ended 2010. Earlier application is permitted with required transition disclosures based on the period of adoption. The Company is currently evaluating the application date and the impact of this standard on its unaudited condensed consolidated financial statements.

In October 2009, the FASB issued ASU No. 2009-14, *Software (Topic 985): Certain Revenue Arrangements That Include Software Elements (a consensus of the FASB Emerging Issues Task Force)*. ASU No. 2009-14 amends ASC 985-605, *Software: Revenue Recognition*, such that tangible products, containing both software and non-software components that function together to deliver the tangible product's essential functionality, are no longer within the scope of ASC 985-605. It also amends the determination of how arrangement consideration should be allocated to deliverables in a multiple-deliverable revenue arrangement. This ASU will become effective for the Company for revenue arrangements entered into or materially modified after fiscal year ended 2010. Earlier application is permitted with required transition disclosures based on the period of adoption. The Company is currently evaluating the application date and the impact of this standard on its unaudited condensed consolidated financial statements. Both ASU No. 2009-13 and ASU No. 2009-14 must be adopted in the same period and must use the same transition disclosures.

In September 2009, the FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, which amends ASC 820-10, *Fair Value Measurements and Disclosures Overall*. ASU No. 2009-12 permits a reporting entity to measure the fair value of certain alternative investments that do not have a readily determinable fair value on the basis of the investments' net asset value per share or its equivalent. This ASU also requires expanded disclosures. This guidance became effective for the Company on October 1, 2009 and did not have a material impact on its unaudited condensed consolidated financial statements upon adoption; however, it may impact the valuation of the Company's future investments.

Table of Contents

On July 1, 2009, the Company adopted ASU No. 2009-1, *Topic 105 – Generally Accepted Accounting Principles*, which amended Accounting Standards Codification (ASC) 105, *Generally Accepted Accounting Principles*, to establish the ASC as the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date, the ASC superseded all then-existing non-SEC accounting and reporting standards. All previous references to the superseded standards in the Company's consolidated financial statements have been replaced by references to the applicable sections of the ASC. The adoption of these sections did not have an impact on the Company's unaudited condensed consolidated financial statements.

In April 2009, the Company adopted ASC 320, *Investments – Debt and Equity Securities*, to modify the existing impairment model with respect to debt securities falling within the scope of investments for debt and equity securities. ASC 320 defines whether an other-than-temporary impairment (OTTI) will have occurred when either: (i) an entity has the intent to sell an impaired security; (ii) it is more likely than not that an entity will be required to sell an impaired security prior to its anticipated recovery in value; or (iii) an entity does not expect to recover the entire cost basis of an impaired security. In addition, this ASC 320 modifies the manner in which an OTTI is measured and presented on the statement of operations and requires expanded disclosures. ASC 320 is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of this standard did not have a material impact on the Company's unaudited condensed consolidated financial statements, but resulted in additional disclosure requirements about the Company's investments. See Note 4, *Investments in Available-for-Sale Securities* for further discussion.

On January 4, 2009, the Company adopted ASC 820, *Fair Value Measurements and Disclosures*, which provides a consistent definition of fair value that focuses on exit price, prioritizes the use of market-based inputs over entity-specific inputs for measuring fair value and establishes a three-level hierarchy for fair value measurements. On January 4, 2008, the Company adopted the applicable sections of ASC 820 for financial assets and financial liabilities and for nonfinancial assets and nonfinancial liabilities that are remeasured at least annually. At that time, the Company elected to defer adoption of ASC 820 for one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. On January 4, 2009, the Company adopted the sections of ASC 820 regarding nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The applicable sections of ASC 820 were applied prospectively. The adoption of the various sections of ASC 820 is disclosed in Note 6, *Fair Value Measurements*, which are included in these unaudited condensed consolidated financial statements.

On January 4, 2009, the Company adopted the applicable sections of ASC 805, *Business Combinations*, which provides revised guidance for recognizing and measuring identifiable assets and goodwill acquired, liabilities assumed and any noncontrolling interest in the acquiree in a business combination. Additionally, this ASC provides disclosure requirements to enable users of the financial statements to evaluate the nature and financial effects of the business combination. ASC 805 amends the applicable sections of ASC 740, *Income Taxes*, such that adjustments made to valuation allowances on deferred taxes and acquired tax contingencies related to acquisitions made prior to January 4, 2009 also fall within the scope of these sections. During the nine months ended October 3, 2009, the Company expensed approximately \$12.3 million of transaction costs recorded to *Selling, general and administrative expenses* in the unaudited condensed consolidated statements of operations related to the termination of the merger with HeartWare. The Company and HeartWare mutually agreed effective July 31, 2009 to terminate the definitive merger agreement pursuant to which the Company would have acquired HeartWare.

On January 4, 2009, the Company adopted the applicable sections of ASC 805, *Business Combinations*, that address accounting for assets acquired and liabilities assumed in a business combination that arise from contingencies. These applicable sections address application issues raised on the initial recognition and measurement, subsequent measurement and accounting and disclosure of assets and liabilities arising from contingencies in a business combination. These sections generally apply to assets acquired and liabilities assumed in a business combination that arise from contingencies that would be within the scope of ASC 450, *Contingencies*, if not acquired or assumed in a business combination. The adoption of these applicable sections did not have a material impact on the Company's unaudited condensed consolidated financial statements; however, these sections may have an impact on the

accounting for any future acquisitions.

Table of Contents

On January 4, 2009, the Company adopted the applicable sections of ASC 275, *Risks and Uncertainties*, and ASC 350, *Intangibles – Goodwill and Other*, that addresses the determination of the useful life of intangible assets. These sections address the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. The adoption of these applicable sections did not have a material impact on the Company's unaudited condensed consolidated financial statements.

3. Cash and Cash Equivalents

Cash and cash equivalents are defined as short-term, highly liquid investments with original maturities of 90 days or less at the date of purchase.

4. Investments in Available-for-Sale Securities

The Company's investment portfolio consists of short-term and long-term investments. Investments classified as short-term available-for-sale consist primarily of municipal bonds, variable demand notes and corporate bonds. Investments classified as long-term available-for-sale consist of auction rate securities, whose underlying assets are student loans.

The Company's investments in available-for-sale securities are recorded at estimated fair value on its financial statements, and the temporary differences between cost and estimated fair value are presented as a separate component of accumulated other comprehensive income.

As of October 3, 2009, the Company had gross unrealized gains from the Company's investment in municipal bonds of \$1.6 million and gross unrealized losses from its auction rate securities of \$3.2 million.

The aggregate market value, cost basis and gross unrealized gains and losses of available-for-sale investments as of October 3, 2009 and as of January 3, 2009 are as follows:

| | Amortized cost | Gross unrealized gains (losses) (in thousands) | Fair value |
|------------------------------------------------------------|---------------------------|-----------------------------------------------------------------------|-----------------------|
| October 3, 2009: | | | |
| Short-term investments: | | | |
| Municipal bonds, variable demand notes and corporate bonds | \$ 233,698 | \$ 1,630 | \$ 235,328 |
| Long-term investments: | | | |
| Auction rate securities | \$ 27,800 | \$ (3,180) | \$ 24,620 |
| January 3, 2009: | | | |
| Short-term investments: | | | |
| Municipal bonds | \$ 139,931 | \$ 1,667 | \$ 141,598 |
| Long-term investments: | | | |
| Auction rate securities | \$ 37,200 | \$ (7,241) | \$ 29,959 |

As of October 3, 2009, the Company owned approximately \$27.8 million face amount of auction rate securities. The assets underlying these investments are student loans predominantly backed by the U.S. government under the Federal Family Education Loan Program or by private insurers and are rated between A- and AAA. Historically, these securities have provided liquidity through a Dutch auction process that resets the applicable interest rate periodically every seven to 365 days. Beginning in February of 2008, these auctions began to fail. The principal amount of these auction rate securities will not be accessible until future auctions for these securities are successful, a secondary market is established, these securities are called for redemption, or they are paid at maturity.

Table of Contents

As a result of these auction failures, these auction rate securities do not have a readily determinable market value. Consistent with the fair value methodology used on January 3, 2009, the Company estimated fair values at October 3, 2009, using a discounted cash flow model based on estimated interest rates, the present value of future principal and interest payments discounted at rates considered to reflect current market conditions, and the credit quality of the underlying securities. Specifically, the Company's management estimated the future cash flows over a five-year period, and applied a credit default rate to reflect the risk in the marketplace for these investments that has arisen due to the lack of an active market. As a result of feedback from outside consultants, and government activities including recent settlement agreements, management's assumption on the expected recovery was modified to five years beginning at January 3, 2009 and this assumption continues to be applicable at October 3, 2009.

The Company has recorded an estimated cumulative unrealized loss of \$3.2 million (\$1.9 million, net of tax) related to the temporary impairment of the auction rate securities, which was included in accumulated other comprehensive gain/loss within shareholders' equity. In addition, the Company's management reviews impairments and credit loss associated with its investments, including auction rate securities to determine the classification of the impairment as temporary or other-than-temporary and to bifurcate the credit and non-credit component of an other-than-temporary impairment event. The Company (i) does not intend to sell any of the auction rate securities prior to maturity at an amount below the original purchase value; (ii) intends to hold the investment to recovery and based on a more-likely-than-not probability assessment that will not be required to sell the security before recovery; and (iii) deems that it is not probable that it will receive less than 100% of the principal and accrued interest from the issuer. Therefore, 100% of the impairment was charged to other comprehensive income. The Company's auction rate securities are classified as long-term and are valued at \$24.6 million using significant unobservable inputs. Further, the Company continues to liquidate investments in auction rate securities as opportunities arise. During the nine months ended October 3, 2009, \$9.4 million in auction rate securities were liquidated at par in connection with issuer calls.

If the issuers of the auction rate securities are unable to successfully complete future auctions and their credit ratings deteriorate, the Company may in the future be required to record an impairment charge to earnings on these investments. It could conceivably take until the final maturity of the underlying notes (up to 30 years) to realize the investments' carrying value.

5. Long-Term Restricted Cash and Cash Equivalents

On February 12, 2009, the Company entered into a definitive merger agreement with HeartWare, pursuant to which the Company intended to acquire HeartWare. The Company and HeartWare mutually agreed effective July 31, 2009 to terminate the definitive merger agreement pursuant to which the Company would have acquired HeartWare. As announced on July 29, 2009, the U.S. Federal Trade Commission (FTC) informed the Company and HeartWare that it would file a complaint in U.S. Federal District Court to challenge the Company's proposed acquisition of HeartWare. HeartWare and the Company's decision to terminate the definitive merger agreement was in response to the FTC's determination to challenge the proposed acquisition of HeartWare by the Company.

Pursuant to the loan agreement entered into concurrently with the execution and delivery of the merger agreement, the Company deposited \$20.0 million (the Loan Amount) into an escrow account on February 13, 2009 and agreed to loan such funds to HeartWare. As of October 3, 2009, HeartWare has drawn \$4.0 million under the agreement (See Note 11 Other Assets), with the remaining balance of \$16.0 million classified as long-term restricted cash and cash equivalents.

6. Fair Value Measurements

On December 30, 2007, the Company adopted ASC 820, *Fair Value Measurements and Disclosure*. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement date. In determining fair value, the Company uses various approaches, including market, income and/or cost approaches, and each of these approaches requires certain inputs. Fair value measurement establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions as

compared to the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances.

Table of Contents

The Company valued its financial and nonfinancial assets and liabilities based on the observability of inputs used in the valuation of such assets and liabilities, using the following fair value hierarchy. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial and nonfinancial assets and liabilities carried or disclosed at fair value were classified and disclosed in one of the following three categories:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Directly or indirectly observable market based inputs used in models or other valuation methodologies.

Level 3: Unobservable inputs that are not corroborated by market data which require significant management judgment or estimation.

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

| | October 3, 2009 | | | | |
|------------------------------------------------------------------------------------------|---------------------------------------------------------------------|---------------------------------|------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------|--------------------------------------------------------------|
| | Assets and liabilities at carrying value | Total fair value | Quoted prices in active markets for identical assets (Level 1) (in thousands) | Significant Other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
| Assets | | | | | |
| Short-term investments – municipal bonds, variable demand notes and corporate bonds | \$ 235,328 | \$ 235,328 | \$ 235,328 | \$ | |
| Long-term investments – auction rate securities | 24,620 | 24,620 | | | 24,620 |
| Mark to market on foreign exchange instruments (Note 7) | 70 | 70 | | 70 | |
| Convertible debenture with Levitronix LLC (disclosure only) | 5,792 | 6,000 | | | 6,000 |
| HeartWare loan receivable (Note 11) (disclosure only) | 4,000 | 4,174 | | | 4,174 |
| Conversion option on HeartWare loan agreement (Note 11) | 5,240 | 5,240 | | | 5,240 |
| Liabilities | | | | | |
| Make-whole provision (Note 12) | 31 | 31 | | | 31 |
| Senior subordinated convertible notes (fair value for purposes of disclosure in Note 12) | 129,932 | 224,540 | | 224,540 | |

| | January 3, 2009 | | | |
|--------------------|---------------------------------------------------------------------|---------------------------------|------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------|
| | Assets and liabilities at carrying value | Total fair value | Quoted prices in active markets for identical assets (Level 1) (in thousands) | Significant Other observable inputs (Level 2) |
| Assets | | | | |
| Liabilities | | | | |

| | value | fair value | active markets for identical assets (Level 1) (in thousands) | inputs (Level 2) | inputs (Level 3) |
|------------------------------------------------------------------------------------------|------------|---------------|-----------------------------------------------------------------------------------|---------------------|---------------------|
| Assets | | | | | |
| Short-term investments municipal bonds | \$ 141,598 | \$ 141,598 | \$ | \$ 141,598 | \$ |
| Long-term investments auction rate securities | 29,959 | 29,959 | | | 29,959 |
| Convertible debenture with Levitronix LLC (disclosure only) | 5,711 | 4,200 | | | 4,200 |
| Liabilities | | | | | |
| Mark to market on foreign exchange instruments (Note 7) | 73 | 73 | | 73 | |
| Make-whole provision (Note 12) | 46 | 46 | | | 46 |
| Senior subordinated convertible notes (fair value for purposes of disclosure in Note 12) | 124,115 | 215,880 | | 215,880 | |

12

Table of Contents

Assets measured at fair value on a recurring basis using significant unobservable Level 3 inputs consist of securities with an auction reset feature (auction rate securities) whose underlying assets are student loans issued by various tax-exempt state agencies, most of which are supported by federal government guarantees and some of which are supported by private insurers. In addition the Company is using significant unobservable Level 3 inputs to value the conversion option included in the HeartWare loan agreement and recorded at fair value as referred to in Note 11

Other Assets. The Company is also using significant unobservable Level 3 inputs for its disclosure of the fair value of its convertible debenture with Levitronix LLC (Levitronix) and the HeartWare loan receivable disclosed in Note 11.

The following table provides a reconciliation of the beginning and ending balances for the assets and liabilities for which fair value is measured using significant unobservable inputs (Level 3):

| | Fair Value Measurement Using Significant Unobservable Inputs (Level 3) | | |
|-----------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------|----------------------------------|--------------------|
| | Fair Value Unobservable Inputs (Level 3) | Assets (in thousands) | Liabilities |
| Balance at January 3, 2009 | \$ 29,959 | \$ | \$ 46 |
| Settlement at par | (100) | | |
| Unrealized holding loss on make-whole provision, included in interest income and other | | | 25 |
| Unrealized holding gain on auction rate securities, included in other comprehensive income | 69 | | |
| Balance at April 4, 2009 | \$ 29,928 | \$ | \$ 71 |
| Settlements at par | (9,300) | | |
| Unrealized holding gain on make-whole provision, included in interest income and other | | | (20) |
| Unrealized holding gain on auction rate securities, included in other comprehensive income | 4,054 | | |
| Balance at July 4, 2009 | \$ 24,682 | \$ | \$ 51 |
| Unrealized holding gain on make-whole provision, included in interest income and other | | | (20) |
| Recording of fair value of conversion option upon termination of the HeartWare merger agreement (Note 11) | | 3,454 | |
| Mark-to-market adjustment on conversion option for Heartware loan agreement (Note 11) | | 1,786 | |
| Unrealized holding loss on auction rate securities, included in other comprehensive income | (62) | | |
| Balance at October 3, 2009 | \$ 24,620 | \$ 5,240 | \$ 31 |

The fair value, calculated using level 3 inputs, for disclosure purposes, on the Levitronix loan receivable as of October 3, 2009, and as of July 4, 2009 was \$6.0 million, an increase of \$1.8 million from balances at both April 4,

2009 and January 3, 2009. The fair value, calculated using level 3 inputs, for disclosure purposes, on the HeartWare loan receivable was \$4.2 million as of October 3, 2009.

The Company's management will continue to monitor the market for auction rate securities and consider its impact (if any) on the fair value of the Company's investments. If the current market conditions deteriorate further, or the anticipated recovery in fair values does not occur, the Company may be required to record additional unrealized losses in other comprehensive income or other-than-temporary impairment charges to the unaudited condensed consolidated statements of operations in future periods.

Table of Contents**7. Foreign Exchange Instruments**

The Company utilizes foreign currency forward exchange contracts and options to mitigate against future movements in foreign exchange rates that affect certain existing and forecasted foreign currency denominated sales and purchase transactions (primarily assets and liabilities on its U.K. subsidiary's consolidated balance sheet that are not denominated in U.K. pounds). The Company does not use derivative financial instruments for speculative or trading purposes. The Company routinely hedges its exposures to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations. If a financial counterparty to any of the Company's hedging arrangements experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency forward contract, the Company may experience material financial losses.

On January 4, 2009, the Company adopted the accounting pronouncement which requires the disclosure about the Company's objective of using derivative instruments for its forward foreign currency contracts that qualify as derivatives which is incorporated in ASC 815, *Derivatives and Hedging*, and do not qualify for hedge accounting. The impacts of the outstanding foreign currency contracts, with a maximum maturity of three months were as follows:

| | Notional Amounts | |
|-----------|--------------------------------|-----------------------------------|
| | October 3, 2009 | September 27, 2008 |
| | (in thousands) | |
| Purchases | \$ 8,816 | \$ 8,570 |
| Sales | 13,900 | 9,461 |

As of October 3, 2009, the Company had forward contracts to sell euros with a notional value of 9.6 million and to purchase U.K. pounds with a notional value of £5.5 million, and as of September 27, 2008, the Company had forward contracts to sell euros with a notional value of 6.4 million and to purchase U.K. pounds with a notional value of £4.6 million. As of October 3, 2009, the Company's forward contracts had an average exchange rate of one U.S. dollar to 0.687 euros and one U.S. dollar to 0.624 U.K. pounds. The forward contracts are valued based on exchange rates derived from an independent source of market participant assumptions and compiled from the information available. As of October 3, 2009, the estimated fair value of these foreign currency contracts was \$70,000, which was recorded in Prepaid expenses and other assets.

The following represents the Company's realized fair value of the forward currency contracts and offsets to the foreign currency exchange gains and losses which were included in Interest income and other in the unaudited condensed consolidated statements of operations.

| | Three Months Ended | | Nine Months Ended | |
|--------------------------------------------------------------------------|--------------------------------|-----------------------------------|--------------------------------|-----------------------------------|
| | October 3, 2009 | September 27, 2008 | October 3, 2009 | September 27, 2008 |
| | (in thousands) | | | |
| Foreign currency exchange (loss) gain on foreign currency contracts | \$ (803) | \$ 325 | \$ 132 | \$ (822) |
| Foreign currency exchange gain (loss) on foreign translation adjustments | 1,042 | (303) | (406) | 928 |

Table of Contents**8. Inventories**

Inventories consisted of the following:

| | October 3, 2009 | January 3, 2009 |
|-----------------|--------------------------------|----------------------------|
| | (in thousands) | |
| Finished goods | \$ 24,008 | \$ 24,373 |
| Work in process | 11,011 | 9,174 |
| Raw materials | 39,740 | 27,826 |
| Total | \$ 74,759 | \$ 61,373 |

9. Property, Plant and Equipment, net

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

| | October 3, 2009 | January 3, 2009 |
|--------------------------------------|--------------------------------|----------------------------|
| | (in thousands) | |
| Land, building and improvements | \$ 16,135 | \$ 16,135 |
| Equipment and capitalized software | 72,101 | 68,029 |
| Furniture and leasehold improvements | 30,986 | 27,424 |
| Total | 119,222 | 111,588 |
| Less accumulated depreciation | (67,760) | (61,450) |
| Total | \$ 51,462 | \$ 50,138 |

Depreciation expense for the three months ended October 3, 2009 and September 27, 2008 was \$2.9 million and \$2.8 million, respectively, and for the nine months ended October 3, 2009 and September 27, 2008 was \$8.3 million and \$7.8 million, respectively.

10. Goodwill and Purchased Intangible Assets

The carrying amount of goodwill was \$99.3 million as of October 3, 2009 and as of January 3, 2009. The components of goodwill at October 3, 2009 were \$95.0 million attributable to the Cardiovascular division and \$4.3 million attributable to the ITC acquisition of the outstanding common shares of privately held A-VOX Systems, Inc. (Avox).

The changes in the carrying amount of goodwill were as follows:

| | October 3, 2009 | January 3, 2009 |
|-----------------------------------------------------------------------|----------------------------|----------------------------|
| | (in thousands) | |
| Balance at the beginning of the fiscal period | \$ 99,287 | \$ 98,368 |
| Adjustment for the acquisition related to the Cardiovascular division | | 919 |
| Balance at the end of the fiscal period | \$ 99,287 | \$ 99,287 |

On February 2001, the Company merged with Thermo Cardiosystems, Inc. (TCA). Prior to the merger with TCA (the Merger), TCA was a subsidiary of Thermo Electron Corporation (TCI). The components of identifiable intangible

assets related to the Merger include: patents and trademarks, core technology (Thoralon, the Company's proprietary bio-material), and developed technology (patent technology, other than core technology, acquired in the Merger). The components of intangible assets related to the October 2006 Avox acquisition include: patents and trademarks, developed technology and customer and distributor relationships and other. The combined components are included in purchased intangibles on the unaudited condensed consolidated balance sheets as follows:

Table of Contents

| | October 3, 2009 | | |
|--------------------------------------------------|--------------------------------------|------------------------------------------------------------|------------------------------------|
| | Gross Carrying Amount | Accumulated Amortization (in thousands) | Net Carrying Amount |
| Patents and trademarks | \$ 38,515 | \$ (29,771) | \$ 8,744 |
| Core technology | 37,485 | (15,243) | 22,242 |
| Developed technology | 125,742 | (56,610) | 69,132 |
| Customer and distributor relationships and other | 897 | (498) | 399 |
| Total purchased intangible assets | \$ 202,639 | \$ (102,122) | \$ 100,517 |

| | January 3, 2009 | | |
|--------------------------------------------------|--------------------------------------|------------------------------------------------------------|------------------------------------|
| | Gross Carrying Amount | Accumulated Amortization (in thousands) | Net Carrying Amount |
| Patents and trademarks | \$ 38,515 | \$ (28,803) | \$ 9,712 |
| Core technology | 37,485 | (13,765) | 23,720 |
| Developed technology | 125,742 | (51,098) | 74,644 |
| Customer and distributor relationships and other | 897 | (389) | 508 |
| Total purchased intangible assets | \$ 202,639 | \$ (94,055) | \$ 108,584 |

Amortization expense related to purchased intangible assets for the three months ended October 3, 2009 and September 27, 2008 was \$2.6 million and \$3.3 million, respectively and for the nine months ended October 3, 2009 and September 27, 2008 was \$8.1 million and \$9.9 million, respectively. The Company's amortization expense is expected to be approximately \$10.6 million in 2009, declining to \$8.7 million by 2013. This decline in amortization expense is due to certain assets that were fully amortized at the beginning of 2009. Patents and trademarks have useful lives ranging from one to fifteen years, core and developed technology assets have useful lives ranging from two to thirteen years and customer and distributor relationships and other have useful lives ranging from one to six years.

11. Other Assets*HeartWare Loan Agreement:*

On February 12, 2009, the Company entered into a definitive merger agreement with HeartWare, pursuant to which the Company intended to acquire HeartWare. The Company and HeartWare mutually agreed effective July 31, 2009 to terminate the definitive merger agreement pursuant to which the Company would have acquired HeartWare. As announced on July 29, 2009, FTC informed the Company and HeartWare that it would file a complaint in U.S. Federal District Court to challenge the Company's proposed acquisition of HeartWare. HeartWare and the Company's decision to terminate the definitive merger agreement was in response to the FTC's determination to challenge the proposed acquisition of HeartWare by the Company.

Pursuant to the HeartWare loan agreement, the Company deposited \$20.0 million (the Loan Amount) into an escrow account on February 13, 2009 and agreed to loan such funds to HeartWare. Despite the mutual termination of the definitive merger agreement by the Company and HeartWare, the Loan Amount continues to remain available for borrowing by HeartWare at any time prior to the earlier of (i) November 1, 2011, (ii) the date on which the outstanding portion of the Loan Amount borrowed by HeartWare, including any accrued and unpaid interest, as well

as the portion of the Loan Amount remaining in the escrow account that have not been loaned to HeartWare, are converted into shares of HeartWare's common stock, as further described below, or (iii) the date on which the outstanding principal of the Loan Amount borrowed by HeartWare becomes due and payable in full, whether by acceleration or otherwise, pursuant to the terms of the loan agreement. Beginning as of May 1, 2009, HeartWare was able to borrow up to an aggregate of \$12.0 million and beginning as of July 31, 2009, HeartWare was able to borrow up to an aggregate of \$20.0 million, under certain conditions provided in the loan agreement. The loan to HeartWare bears interest at a rate per annum equal to 10%. The principal amount, together with any accrued and unpaid interest on the principal amount, will be due and payable in full in cash on the earlier of (i) November 1, 2011 or (ii) the date on which the outstanding principal of the Loan Amount borrowed by HeartWare becomes due and payable in full, whether by acceleration or otherwise, pursuant to the terms of the loan agreement. Following the mutual termination of the definitive merger agreement by the Company and HeartWare on July 31, 2009 and pursuant to the terms of the loan agreement, the Company may convert the Loan Amount including the amounts drawn down by HeartWare and accrued but unpaid interest thereon, into shares of HeartWare's common stock, at the Company's option. The Loan Amount is convertible into shares of HeartWare's common stock, at the conversion price equal to \$35.00 Australian dollars per share of HeartWare common stock, as adjusted pursuant to the terms of the loan agreement.

Table of Contents

The conversion option represents an embedded derivative that is required to be separated from the loan agreement as a derivative asset, in accordance with ASC 815, *Derivatives and Hedging* but was not considered outstanding for accounting purposes until the option becomes exercisable on the termination of the merger agreement.

On July 31, 2009, upon termination of the merger agreement, the conversion option was initially recorded at fair value because the option was part of the merger negotiations and if the merger was consummated as planned, the option would have expired unexercised. Since the merger was terminated, the option became exercisable at the fair value of \$3.5 million which is recorded upon termination of the HeartWare merger agreement in *Other income and expenses* in the unaudited condensed consolidated statement of operations. Additionally, the change in the fair value of the conversion option from July 31, 2009 to October 3, 2009 of \$1.7 million was accounted for as a mark-to-market adjustment and classified in *Other income and expenses* in the unaudited condensed consolidated statements of operations. The fair value of the conversion option of \$5.2 million is classified in *Other long-term assets* on the Company's unaudited condensed consolidated balance sheets.

The fair value of the conversion option is valued at the reporting date using a Binomial pricing model with assumptions on HeartWare's stock price as of October 3, 2009, volatility rate of 49%, risk free interest rates based on Australian Treasury yields for two years and foreign exchange rates from Australian dollars to U.S. dollars as of October 3, 2009.

On August 5, 2009 the loan to HeartWare of \$4.0 million represents a draw down from the Loan Amount in escrow pursuant to the loan agreement. This loan is accounted for as long-term note bearing interest at a rate equal to 10% per annum, accrued monthly. As of October 3, 2009, the loan receivable of \$4.0 million was included in *Other long-term assets* on the Company's unaudited condensed consolidated balance sheets. The fair value of the loan receivable, based on a discounted cash flow valuation approach, was \$4.2 million. If the Company had exercised its option to convert the Loan Amount to shares of HeartWare, as of October 3, 2009, its ownership in HeartWare would have been 7.4%.

Levitronix Convertible Debenture:

On August 23, 2006, the Company purchased a \$5.0 million convertible debenture from Levitronix, a company with which it has a distribution arrangement to sell Levitronix products. The convertible debenture is a long-term note receivable with an annual interest rate of 5.7%, to be accrued monthly and at the option of Levitronix, paid in cash or in-kind semi-annually on February 23 and August 23 until its maturity on August 23, 2013. The Company may convert the debenture at any time at its option into membership interests of Levitronix at a conversion price of \$4.2857, which may be adjusted as a result of certain corporate events. This conversion feature is not an embedded derivative, because the membership interests of the issuer are not readily convertible to cash. If the Company had converted the debenture as of October 3, 2009, its ownership in Levitronix would have been less than 5%.

As of October 3, 2009, the convertible debenture of \$5.0 million plus accrued interest of \$0.8 million was included in *Other long-term assets* on the Company's unaudited condensed consolidated balance sheets. The fair value of the convertible debenture, based on a discounted cash flows valuation approach, was \$6.0 million at October 3, 2009.

Table of Contents**12. Long-Term Debt**

In 2004, the Company completed the sale of \$143.8 million initial principal amount of senior subordinated convertible notes due in 2034. The convertible notes were sold to Qualified Institutional Buyers pursuant to the exemption from the registration requirements of the Securities Act of 1933, as amended, provided by Rule 144A thereunder. A portion of the proceeds was used to repurchase 4.2 million shares of the Company's outstanding common stock for \$60 million. The balance of the proceeds has been and will be used for general corporate purposes, which may include additional stock repurchases, strategic investments or acquisitions. The principal amount of the convertible notes at maturity is \$247.4 million offset by the original issue discount of \$103.7 million and net debt issuance costs of \$4.3 million, equaling net proceeds of \$139.4 million.

The senior subordinated convertible notes were issued at an issue price of \$580.98 per note, which is 58.098% of the principal amount at maturity of the notes. The senior subordinated convertible notes bear interest at a rate of 1.3798% per year on the principal amount at maturity, payable semi-annually in arrears in cash on May 16 and November 16 of each year, from November 16, 2004 until May 16, 2011. Beginning on May 16, 2011, the original issue discount will accrue daily at a rate of 2.375% per year on a semi-annual bond equivalent basis and, on the maturity date, a holder will receive \$1,000 per note. As a result, the aggregate principal amount of the notes at maturity will be \$247.4 million.

Holder of the senior subordinated convertible notes may convert their convertible notes into shares of the Company's common stock at a conversion rate of 29.4652 shares per \$1,000 principal amount of senior subordinated convertible notes, which represents a conversion price of \$19.72 per share, subject to adjustments upon the occurrence of certain events as set forth in the indenture. Holders have been and are able to convert their convertible notes at any point after the close of business on October 30, 2004 if, as of the last day of the preceding calendar quarter, the closing price of the Company's common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of such preceding calendar quarter is more than 120% of the accreted conversion price per share of its common stock. Commencing October 1, 2008, this market price conversion feature was satisfied, such that holders of the senior subordinated convertible notes may convert their notes through the final maturity date of the notes into shares of the Company's common stock at a conversion rate of 29.462 shares per \$1,000 principal amount of senior subordinated convertible notes, subject to adjustments as provided in the indenture. If holders elect conversion, the Company may, at its option, deliver shares of common stock, pay a holder in cash, or deliver a combination of shares and cash, as determined pursuant to the terms of the notes. As of October 3, 2009, no notes had been converted.

Holder may require the Company to repurchase all or a portion of their senior subordinated convertible notes on each of May 16, 2011, 2014, 2019, 2024 and 2029 at a repurchase price equal to 100% of the issue price, plus accrued original issue discount, if any. In addition, if the Company experiences a change in control or a termination of trading of its common stock each holder may require the Company to purchase all or a portion of such holder's notes at the same price, plus, in certain circumstances, to pay a make-whole premium. This premium is considered an embedded derivative and has been bifurcated from the senior subordinated convertible notes and recorded at its estimated fair value, \$31,000 as of October 3, 2009. There are significant variables and assumptions used in valuing the make-whole provision including, but not limited to, the Company's stock price, volatility of the Company's stock, the probability of the Company being acquired and the probability of the type of consideration used by a potential acquirer.

The senior subordinated convertible notes are subordinated to all of the Company's senior indebtedness and structurally subordinated to all indebtedness of its subsidiaries. Therefore, in the event of a bankruptcy, liquidation or dissolution of the Company or one or more of its subsidiaries and acceleration of or payment default on its senior indebtedness, holders of the convertible notes will not receive any payment until holders of any senior indebtedness the Company may have outstanding have been paid in full.

On January 4, 2009, the Company adopted ASC 470-20, *Debt*, which applies to certain convertible debt instruments that may be settled in cash or other assets, or partially in cash, upon conversion. ASC 470-20 requires retrospective application as of May 16, 2004. Additionally, the Company is required to account for the liability and equity components of the senior subordinated convertible notes separately in a manner that reflects the Company's nonconvertible debt borrowing rate when interest expense is subsequently recognized. The Company estimated the fair value of the senior subordinated convertible notes without the conversion feature as of the date of issuance

(liability component). The estimated fair value of the liability component was approximately \$95.1 million and was determined using a discounted cash flow approach. Key inputs used to estimate the fair value of the liability component included the following:

Table of Contents

The Company's estimated non-convertible borrowing rate as of May 16, 2004 – the date the senior subordinated convertible notes were issued;

The amount and timing of cash flows; and

The expected life.

The excess of the proceeds received over the estimated fair value of the liability component totaling \$48.5 million was allocated to the conversion feature (equity component) and a corresponding offset was recognized as a discount to reduce the net carrying value of the senior subordinated convertible notes. The discount is being amortized to interest expense over a seven-year period ending May 16, 2011 (the expected life of the liability component) using the effective interest method. Additionally, the Company is required to allocate transaction costs on the same percentage as the liability and equity component, such that a portion of the deferred debt issuance costs is allocated to the liability component to be amortized using the effective interest method until May 16, 2011, and the equity component to be included in additional paid-in capital.

The adoption of this accounting pronouncement increased interest expense associated with the Company's senior subordinated convertible notes by adding a non-cash component to amortize a debt discount calculated based on the difference between the cash coupon rate (2.375% per year) of the senior subordinated convertible notes and the effective interest rate on debt borrowing (9% per year). The reconciliation of the results of operations for the three and nine months ended October 3, 2009 and September 27, 2008 consisted of the following:

| | Three Months Ended October 3, 2009 | | | Nine Months Ended October 3, 2009 | | |
|---------------------------------------------------------------------------|--------------------------------------------|----------------------------------------------------------------|----------------|--------------------------------------------|----------------------------------------------------------------|----------------|
| | Excluding impact of ASC 470-20 | Incremental impact of adoption of ASC 470-20 | As reported | Excluding impact of ASC 470-20 | Incremental impact of adoption of ASC 470-20 | As reported |
| | (in thousands, except per share amounts) | | | | | |
| Net income before interest and amortization expense (net of tax) | \$ 13,553 | | \$ 13,553 | \$ 24,325 | | \$ 24,325 |
| Interest and amortization expense (net of tax): | | | | | | |
| Interest expense | (853) | \$ (1,996) | (2,849) | (2,559) | \$ (5,816) | (8,375) |
| Amortization of debt issuance costs | (155) | 52 | (103) | (465) | 156 | (309) |
| Income tax benefit | 398 | 778 | 1,176 | 1,194 | 2,402 | 3,596 |
| Impact on net income | (610) | \$ (1,166) | (1,776) | (1,830) | \$ (3,258) | (5,088) |
| Net income | \$ 12,943 | | \$ 11,777 | \$ 22,495 | | \$ 19,237 |
| Net income per share: | | | | | | |
| Basic | \$ 0.23 | | \$ 0.21 | \$ 0.40 | | \$ 0.34 |
| Diluted | \$ 0.21 | | \$ 0.20 | \$ 0.37 | | \$ 0.33 |

Shares used to compute
net income per share

| | | | | |
|---------|--------|--------|--------|--------|
| Basic | 56,683 | 56,683 | 56,511 | 56,511 |
| Diluted | 65,296 | 58,006 | 65,149 | 57,859 |

Table of Contents

| | Three Months Ended September 27, 2008 | | | Nine Months Ended September 27, 2008 | | |
|---------------------------------------------------------------------------|--------------------------------------------|-------------------------------------------------------------|----------------|--------------------------------------------|-------------------------------------------------------------|----------------|
| | Excluding impact of ASC 470-20 | Incremental impact of adoption of ASC 470-20 | As reported | Excluding impact of ASC 470-20 | Incremental impact of adoption of ASC 470-20 | As reported |
| | (in thousands, except per share amounts) | | | | | |
| Net income before interest and amortization expense (net of tax) | \$ 7,792 | | \$ 7,792 | \$ 18,012 | | \$ 18,012 |
| Interest and amortization expense (net of tax): | | | | | | |
| Interest expense | (853) | \$ (1,878) | (2,731) | (2,559) | \$ (5,376) | (7,935) |
| Amortization of debt issuance costs | (155) | 53 | (102) | (465) | 157 | (308) |
| Income tax benefit | 398 | 701 | 1,099 | 1,194 | 2,041 | 3,235 |
| Impact on net income | (610) | \$ (1,124) | (1,734) | (1,830) | \$ (3,178) | (5,008) |
| Net income | \$ 7,182 | | \$ 6,058 | \$ 16,182 | | \$ 13,004 |
| Net income per share: | | | | | | |
| Basic | \$ 0.13 | | \$ 0.11 | \$ 0.30 | | \$ 0.24 |
| Diluted | \$ 0.12 | | \$ 0.11 | \$ 0.28 | | \$ 0.23 |
| Shares used to compute net income per share | | | | | | |
| Basic | 55,328 | | 55,328 | 54,702 | | 54,702 |
| Diluted | 63,993 | | 56,703 | 62,979 | | 55,689 |

The impact of the adoption of ASC 470-20 in the opening balance sheets consisted of the following:

| | Net Increase (Decrease) | | | | |
|-----------------------------------------------------------------------------------------------------|-------------------------|---------------------------|---------------------------------------------------|----------------------------------|--------------|
| | Long-term debt | Debt issuance Costs | Deferred tax liability (in thousands) | Additional paid-in capital | Deficit |
| Allocation of long-term debt proceeds and issuance costs to equity component on issuance date | \$ (48,508) 21,718 | \$ (1,462) 754 | \$ 18,584 (8,282) | \$ 28,462 | \$ 12,682 |

Cumulative retrospective impact
from amortization of discount on
liability component and debt
issuance costs

| | | | | | |
|------------------------------------------------------------------------------------------------------------------------------|-------------|----------|----------|-----------|-----------|
| Cumulative retrospective impact as of December 29, 2007 | (26,790) | (708) | 10,302 | 28,462 | 12,682 |
| Retrospective impact from amortization of discount on liability component and debt issuance costs during the period | 7,155 | 209 | (2,745) | | 4,201 |
| Cumulative retrospective impact as of January 3, 2009 | \$ (19,635) | \$ (499) | \$ 7,557 | \$ 28,462 | \$ 16,883 |

| | Long-term debt | Debt issuance costs | Deferred tax liability (in thousands) | Additional paid-in capital | Deficit |
|----------------------------------------------------------|---------------------------|------------------------------------|--------------------------------------------------------------|-------------------------------------------|----------------|
| January 3, 2009, balance as previously reported | \$ 143,750 | \$ 1,475 | \$ 31,285 | \$ 500,195 | \$ 39,751 |
| Cumulative retrospective impact as of January 3, 2009 | (19,635) | (499) | 7,557 | 28,462 | 16,883 |
| January 3, 2009, as adjusted | \$ 124,115 | \$ 976 | \$ 38,842 | \$ 528,657 | \$ 56,634 |

Table of Contents

As of October 3, 2009 and January 3, 2009, long-term debt and equity component (recorded in additional paid-in-capital, net of income tax benefit) consisted of the following:

| | October 3, 2009 | January 3, 2009 |
|---------------------------------------------|----------------------------|----------------------------|
| | (in thousands) | |
| Long-term debt | | |
| Principal amount | \$ 143,750 | \$ 143,750 |
| Unamortized discount | (13,818) | (19,635) |
| Net carrying amount | \$ 129,932 | \$ 124,115 |
| Equity component, net of income tax benefit | \$ 28,462 | \$ 28,462 |

The Company may redeem either in whole or in part any of the senior subordinated convertible notes at any time beginning May 16, 2011, by giving the holders at least 30 days notice, at a redemption price equal to the sum of the issue price and the accrued original issue discount. If the holders converted the senior subordinated convertible notes into shares of the Company's stock as of October 3, 2009, the if-converted value would be \$216.3 million, based on the Company's stock price of \$29.67 per share on October 3, 2009, which amount exceeds the original value of \$143.8 million by \$72.5 million. This if-converted value is \$31.1 million less than the \$247.4 million face amount at maturity in 2034.

The aggregate fair value of the senior subordinated convertible notes at October 3, 2009 was \$224.5 million.

13. Share-Based Compensation

Share-based compensation expense is measured based on the grant-date fair value of the share-based awards. The Company recognizes share-based compensation expense for the portion of the award that will ultimately be expected to vest over the requisite service period for those awards with graded vesting and service conditions. The Company develops an estimate of the number of share-based awards which will ultimately vest, primarily based on historical experience. The estimated forfeiture rate is reassessed periodically throughout the requisite service period. Such estimates are revised if they differ materially from actual forfeitures. As required, the forfeiture estimates will be adjusted to reflect actual forfeitures when an award vests.

Share-based compensation included in the unaudited condensed consolidated statements of operations consists of the following:

| | Three Months Ended | | Nine Months Ended | |
|-----------------------------------------------------|--------------------------------|-----------------------------------|--------------------------------|-----------------------------------|
| | October 3, 2009 | September 27, 2008 | October 3, 2009 | September 27, 2008 |
| | (in thousands) | | | |
| Cost of product sales | \$ 515 | \$ 371 | \$ 1,535 | \$ 1,284 |
| Selling, general and administrative | 1,993 | 1,511 | 6,459 | 4,747 |
| Research and development | 792 | 593 | 2,691 | 1,936 |
| Total share-based compensation expense before taxes | 3,300 | 2,475 | 10,685 | 7,967 |
| Tax benefit for share-based compensation expense | 1,159 | 1,124 | 3,219 | 2,919 |
| Total share-based compensation (net of taxes) | \$ 2,141 | \$ 1,351 | \$ 7,466 | \$ 5,048 |

For the nine months ended October 3, 2009 and September 27, 2008, share-based compensation expense of \$0.4 million and \$0.5 million, respectively, was capitalized to inventory.

The Company receives a tax deduction for certain stock option exercises during the period the options are exercised, generally for the excess of the fair market value of the options at the date of exercise over the exercise prices of the options. The Company reports the excess tax benefits from share-based compensation as financing cash flows in the unaudited condensed consolidated statements of cash flows. These amounts were \$2.4 million and \$3.6 million for the nine months ended October 3, 2009 and September 27, 2008, respectively.

Table of Contents

Cash proceeds from the exercise of stock options were \$6.6 million and cash proceeds from the Company's employee stock purchase plan were \$1.6 million for the nine months ended October 3, 2009. Cash proceeds from the exercise of stock options were \$19.0 million and cash proceeds from the Company's employee stock purchase plan were \$1.1 million for the nine months ended September 27, 2008. Additionally, for the nine months ended October 3, 2009, the Company purchased \$3.3 million of restricted stock for payment of income tax withholding due upon vesting. For the nine months ended September 27, 2008, the Company purchased \$1.2 million of restricted stock for payment of income tax withholding due upon vesting.

Equity Plan

In April 2006, the Board of Directors approved the 2006 Incentive Stock Plan (the 2006 Plan). In May 2006 the 2006 Plan was amended by the Board of Directors and such amendment was approved by the Company's shareholders and in May 2008 the 2006 Plan was amended by the Board of Directors and such amendment was approved by the Company's shareholders. The 2006 Plan allows the Company to grant to employees and directors of, and consultants to, the Company up to a total of 5.4 million shares of stock awards. Each share issued from and after May 20, 2008 as restricted stock bonuses, restricted stock units, phantom stock units, performance share bonuses, or performance share units reduces the number of shares available for issuance under the 2006 Plan by one and seventy-four hundredths (1.74) shares, and each share issued as stock options, restricted stock purchases or stock appreciation rights reduces the shares available for issuance under the 2006 Plan on a share-for-share basis. During the nine months ended October 3, 2009, approximately 344,000 options were granted under the 2006 Plan at an exercise price equal to the fair market value on the date of grant, and approximately 482,000 shares of restricted stock units were granted under the 2006 Plan. As of October 3, 2009, 2.1 million shares remained available for grant under the 2006 Plan.

Stock Options

Upon approval in May 2006, the 2006 Plan replaced the Company's previous common stock option plans and equity incentive plans. At October 3, 2009, the Company had options outstanding under the 2006 Plan and the replaced plans. Options under the 2006 Plan may be granted by the Board of Directors at the fair market value on the date of grant and generally become fully exercisable within four years after the grant date and expire between five and ten years from the date of grant. Vesting on options granted to officers will be accelerated in certain circumstances following a change in control of the Company.

The fair value of each option is estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions:

| | Three Months Ended | | Nine Months Ended | |
|--------------------------------------------|---------------------------|---------------------------|--------------------------|---------------------------|
| | October 3, 2009 | September 27, 2008 | October 3, 2009 | September 27, 2008 |
| Risk-free interest rate (weighted average) | 3.08% | 3.12% | 2.34% | 3.25% |
| Expected volatility | 53% | 40% | 53% | 40% |
| Expected option term (years) | 4.90 to 6.03 | 4.89 to 6.07 | 4.91 to 6.02 | 5.08 to 6.07 |
| Dividends | None | None | None | None |

The risk-free interest rate is based on the United States Treasury yield curve in effect at the time of grant. The expected term of options represents the period of time that options are expected to be outstanding. The Company uses separate assumptions for groups of employees (for example, officers) that have similar historical exercise behavior. The range above reflects the expected option impact of these separate groups. The Company bases the expected volatility on historical trends, because it has determined that the historical volatility trends are reflective of market conditions.

At October 3, 2009, there was \$3.9 million of unrecognized compensation expense related to stock options, which expense the Company expects to recognize over a weighted average period of 1.15 years. The aggregate intrinsic value of in-the-money options outstanding was \$50.9 million, based on the closing price of the Company's common stock on October 2, 2009, the last trading day for the nine months ended October 3, 2009, of \$29.67, and the aggregate intrinsic value of options exercisable was \$38.9 million. The aggregate intrinsic value of options vested and expected

to vest was \$50.1 million as of October 3, 2009. The intrinsic value of options exercised was \$6.0 million as of October 3, 2009. The aggregate fair value of the options granted during the nine months ended October 3, 2009 was \$4.1 million.

Table of Contents

Stock option activity is summarized as follows:

| | Number of Options (in thousands) | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Term (years) |
|--------------------------------------------------------------------|-----------------------------------------------------|------------------------------------------------------------------|----------------------------------------------------------------------------|
| Outstanding options at January 3, 2009 | 4,259 | \$ 16.37 | 5.98 |
| Granted | 344 | 24.01 | |
| Exercised | (463) | 14.26 | |
| Forfeited or expired | (84) | 23.27 | |
| Outstanding options at October 3, 2009 | 4,056 | \$ 17.11 | 5.77 |
| Outstanding options exercisable at October 3, 2009 | 2,841 | \$ 15.99 | 4.86 |
| Outstanding options vested at October 3, 2009 and expected to vest | 3,936 | \$ 17.02 | 5.69 |

The weighted average grant-date fair value of options granted during the first nine months of 2009 was \$12.06 per share.

Restricted Stock

The 2006 Plan allows for the issuance of restricted stock awards and restricted stock units, which awards or units may not be sold or otherwise transferred until certain restrictions have lapsed. The unearned share-based compensation related to these awards is being amortized to share-based compensation expense over the period of the restrictions, generally four years. The expense for these awards is determined based on the market price of the Company's shares on the date of grant applied to the total number of shares that are granted.

Recognized share-based compensation expense related to these restricted stock award grants was \$4.3 million for the nine months ended October 3, 2009. As of October 3, 2009, the Company had \$6.4 million of unrecognized compensation expense related to these restricted stock awards, which expense the Company expects to recognize over a weighted average period of 1.83 years. There were no restricted stock awards granted during the first nine months of 2009.

Restricted stock award activity is summarized as follows:

| | Number of Shares (in thousands) | Weighted Average Grant Date Fair Value |
|-----------------------------------------------------------------|----------------------------------------------------|-----------------------------------------------------------|
| Outstanding unvested restricted stock awards at January 3, 2009 | 983 | \$ 16.83 |
| Granted | | |
| Vested | (313) | 17.07 |
| Forfeited or expired | (39) | 17.32 |
| Outstanding unvested restricted stock awards at October 3, 2009 | 631 | \$ 16.68 |

Table of Contents**Restricted Stock Units**

As of October 3, 2009, the Company had \$7.6 million of unrecognized compensation expense related to restricted stock units, which expense the Company expects to recognize over a weighted average period of 3.36 years. The aggregate intrinsic value of the units outstanding, based on the Company's stock price on October 3, 2009, was \$13.6 million. In the first nine months of 2009, the Company issued restricted stock units to U.S and non-U.S. employees.

Restricted stock unit activity is summarized as follows:

| | Number of Units (in thousands) | Weighted Average Grant Date Fair Value | Weighted Average Remaining Contractual Term (in years) |
|--------------------------------------|-----------------------------------------|----------------------------------------------------|--------------------------------------------------------------------|
| Outstanding units at January 3, 2009 | 28 | \$ 16.66 | 2.46 |
| Granted | 482 | 24.49 | |
| Released | (40) | 23.91 | |
| Forfeited or expired | (11) | 23.93 | |
| Outstanding units at October 3, 2009 | 459 | \$ 24.09 | 3.36 |

Employee Stock Purchase Plan

In May 2002, the Company's shareholders approved the Company's Employee Stock Purchase Plan (ESPP) under which 500,000 shares of common stock were reserved for issuance. In addition, the ESPP provides for an annual, automatic increase of up to 250,000 shares in the total number of shares available for issuance thereunder on March 1st of each year, unless the Company's Board of Directors specifies a smaller increase or no increase. Under this provision, an additional 250,000 shares were reserved for issuance under the ESPP on each of March 1, 2006, March 1, 2008 and March 1, 2009; the Company's Board of Directors specified no increase as of each other year. Eligible employees may purchase a limited number of shares, over a six month period, of the Company's common stock at 85% of the lower of the market value on the offering date or the market value on the purchase date. During the nine months ended October 3, 2009, approximately 75,843 shares of common stock were issued under the ESPP. As of October 3, 2009, approximately 356,568 shares remained available for issuance under this plan.

The estimated subscription date fair value of the current offering under the ESPP is approximately \$0.4 million using the Black-Scholes option pricing model and the following assumptions:

| | |
|-------------------------|-------|
| Risk-free interest rate | 0.31% |
| Expected volatility | 55% |
| | 0.50 |
| Expected option life | years |
| Dividends | None |

As of October 3, 2009, there was approximately \$0.1 million of unrecognized compensation expense related to ESPP subscriptions that began on May 1, 2009, which amount the Company expects to recognize during the fourth quarter of 2009.

14. Income Taxes

The Company's effective income tax rates were 32.6% and 19.6% for the three months ended October 3, 2009 and September 27, 2008, respectively, and 30.6% and 22.6% for the nine months ended October 3, 2009 and September 27, 2008, respectively. The Company's effective income tax rate for the three and nine month periods ended September 27, 2008 was lower than the Company's effective income tax rate for the three and nine month periods ended October 3, 2009 primarily due to a significant reduction in the amount of tax exempt interest income

earned relative to pre-tax income.

For the nine months ended October 3, 2009, the Company recorded a discrete benefit of approximately \$0.6 million. Included in the \$0.6 million is a discrete benefit of \$0.9 million recorded in the first quarter of 2009 to reflect the effect of a change in California tax law which will permit the Company to make a beneficial apportionment election beginning in 2011. This election will impact the California state tax rate for certain of the Company's existing long-term deferred tax assets and liabilities which are anticipated to reverse subsequent to 2010.

Table of Contents

The tax years 2006 through 2008 remain subject to audit by certain jurisdictions in which the Company is subject to taxation with the exception of California and New Jersey, which remain subject to audit from tax years 2004 to 2008, and the U.K., which remains subject to audit from tax years 2007 through 2008. However, because the Company had net operating losses and credits carried forward in several jurisdictions including U.S. federal and California, certain items attributed to closed years remain subject to adjustment by the relevant tax authority through an adjustment to tax attributes carried forward to open years. The Company is under audit by the state of California for its tax years from 2003 to 2007. Although the ultimate outcome and the timing of the conclusion of this examination is unknown, the Company believes that adequate amounts have been provided for any adjustments that may result from the current examination and that the final outcome will not have a material adverse effect on the Company's unaudited condensed consolidated statements of operations.

As of October 3, 2009 and January 3, 2009, the Company reported a net deferred tax liability of approximately \$27.2 million and \$29.1 million, respectively, comprised principally of temporary differences between the financial statement and income tax bases of intangible assets, and subordinated convertible notes.

The Company evaluates tax positions for recognition using a more-likely-than-not recognition threshold, and those tax positions eligible for recognition are measured as the largest amount of tax benefit that is greater than fifty percent likely of being realized upon the effective settlement with a taxing authority that has full knowledge of all relevant information. Unrecognized tax benefits increased by approximately \$0.7 and \$0.9 million for the three and nine months ended October 3, 2009, respectively, primarily as a result of positions taken during the current and prior year. Included in this increase is \$0.2 million related to prior year positions taken on returns for compensation deductions, transfer pricing, apportionment methodologies, and as a result of foreign exchange rate fluctuations. These increases were offset by a decrease of approximately \$0.1 million attributable to tax positions taken in prior years. The Company believes it is reasonably possible that unrecognized tax benefits will decrease by approximately \$5.0 million within the next twelve months as a result of tax positions which may be taken on tax returns yet to be filed, the settlement of outstanding audits and the closure of certain years subject to examination under the relevant statute of limitations.

15. Net Income Per Share

Basic and diluted net income per share was calculated as follows:

| | Three Months Ended | | Nine Months Ended | |
|----------------------------------------------------|----------------------------------------------|-----------------------------------|--------------------------------|-----------------------------------|
| | October 3, 2009 | September 27, 2008 | October 3, 2009 | September 27, 2008 |
| | (in thousands, except per share data) | | | |
| Net income for basic and diluted share calculation | \$ 11,777 | \$ 6,058 | \$ 19,237 | \$ 13,004 |
| Weighted average number of common shares-basic | 56,683 | 55,328 | 56,511 | 54,702 |
| Dilutive effect of stock-based compensation plans | 1,323 | 1,375 | 1,348 | 987 |
| Weighted average number of common shares-diluted | 58,006 | 56,703 | 57,859 | 55,689 |
| Net income per common share: | | | | |
| Basic | \$ 0.21 | \$ 0.11 | \$ 0.34 | \$ 0.24 |
| Diluted | \$ 0.20 | \$ 0.11 | \$ 0.33 | \$ 0.23 |

Basic net income per share is computed by dividing net income per share by the weighted-average number of common shares outstanding during the period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, using the treasury stock method.

| | Three Months Ended | | Nine Months Ended | |
|--------------------------------------------------------------------------------------------------------------------------------------|---------------------------|------------------|--------------------------|------------------|
| | October | September | October | September |
| | 3, | 27, | 3, | 27, |
| | 2009 | 2008 | 2009 | 2008 |
| | (in thousands) | | | |
| Options to purchase shares not included in the computation of diluted income per share because their inclusion would be antidilutive | 333 | 506 | 280 | 2,131 |

The computation of diluted net income per share for the three and nine months ended October 3, 2009 and September 27, 2008 excludes the effect of assuming the conversion of the Company's senior subordinated convertible notes, which are convertible at \$19.72 per share into 7.3 million shares of common stock, because the effect would have been antidilutive for those periods.

Table of Contents**16. Enterprise and Related Geographic Information**

The Company organizes and manages its business by functional operating entities. The functional entities operate in two segments: Cardiovascular and ITC. The Cardiovascular segment designs, develops, manufactures and markets proprietary medical devices used for circulatory support and vascular graft applications. The ITC segment designs, develops, manufactures and markets proprietary point-of-care diagnostic test systems and incision devices.

Business Segments:

| | Three Months Ended | | Nine Months Ended | |
|----------------------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
| | October 3, 2009 | September 27, 2008 | October 3, 2009 | September 27, 2008 |
| | (in thousands) | | | |
| Product sales: | | | | |
| Cardiovascular | \$ 65,114 | \$ 57,091 | \$ 198,964 | \$ 154,818 |
| ITC | 22,803 | 23,724 | 70,478 | 73,072 |
| Total product sales | \$ 87,917 | \$ 80,815 | \$ 269,442 | \$ 227,890 |
| Income (loss) before income taxes and other: | | | | |
| Cardiovascular (a)(c) | \$ 19,264 | \$ 11,647 | \$ 54,850 | \$ 26,871 |
| ITC(a)(c) | (602) | 793 | (3,865) | 2,870 |
| Corporate (b)(c) | (5,074) | (4,253) | (23,857) | (11,337) |
| Income from operations | 13,588 | 8,187 | 27,128 | 18,404 |
| Other income and (expense): | | | | |
| Interest expense (b) | (3,261) | (2,834) | (9,167) | (8,249) |
| Interest income and other (b) | 7,134 | 2,183 | 9,759 | 6,642 |
| Income before income taxes | \$ 17,461 | \$ 7,536 | \$ 27,720 | \$ 16,797 |

| | October 3, 2009 | January 3, 2009 |
|----------------|-----------------------|--------------------|
| | | (in thousands) |
| Total assets: | | |
| Cardiovascular | \$ 343,770 | \$ 321,605 |
| ITC | 59,147 | 61,552 |
| Corporate (b) | 327,289 | 300,928 |
| Total assets | \$ 730,206 | \$ 684,085 |

(a) The Cardiovascular segment includes amortization expense on

purchased intangible assets of \$2.4 million and \$7.5 million for the three and nine months ended October 3, 2009, respectively, and \$3.1 million and \$9.3 million for the three and nine months ended September 27, 2008, respectively. The ITC segment also includes amortization expense of \$0.2 million and \$0.6 million for the three and nine months ended October 3, 2009, respectively, and \$0.2 million and \$0.6 million for the three and nine months ended September 27, 2008, respectively.

- (b) Represents unallocated costs or assets, not specifically identified to any particular business segment.
- (c) Includes share-based

compensation expense of \$1.9 million, \$1.0 million and \$0.4 million for Cardiovascular, ITC and Corporate, respectively, for the three months ended October 3, 2009 and \$1.4 million, \$0.7 million and \$0.4 million for Cardiovascular, ITC and Corporate, respectively, for the three months ended September 27, 2008 and share-based compensation expense of \$6.1 million, \$3.1 million and \$1.5 million for Cardiovascular, ITC and Corporate, respectively, for the nine months ended October 3, 2009; and \$4.7 million, \$2.1 million and \$1.2 million for Cardiovascular, ITC and Corporate, respectively, for the nine months ended September 27, 2008.

Table of Contents

Geographic Areas:

Revenue attributed to a country or region includes product sales to hospitals, physicians and distributors and is based on the final destination where the products are sold. During the third quarter ended and first nine months of October 3, 2009 and September 27, 2008, no customer or international country represented individually greater than 10% of the Company's total product sales. The geographic composition of the Company's product sales was as follows:

| | Three Months Ended | | Nine Months Ended | |
|---------------------|----------------------------|-------------------------------|----------------------------|-------------------------------|
| | October 3, 2009 | September 27, 2008 | October 3, 2009 | September 27, 2008 |
| | (in thousands) | | | |
| Domestic | \$ 66,297 | \$ 61,674 | \$ 203,448 | \$ 167,731 |
| International | 21,620 | 19,141 | 65,994 | 60,159 |
| Total product sales | \$ 87,917 | \$ 80,815 | \$ 269,442 | \$ 227,890 |

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****Forward-Looking Statements**

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements can be identified by the words expects, projects, hopes, believes, intends, should, estimate, will, may, anticipates, plans, could and other similar words. Actual results, events or performance could differ materially from these forward-looking statements based on a variety of factors, many of which are beyond our control.

Therefore, readers are cautioned not to put undue reliance on these statements. Factors that could cause actual results or conditions to differ from those anticipated by these and other forward-looking statements include those more fully described in the Risk Factors section of our 2008 Annual Report on Form 10-K (the 2008 Annual Report), the Risk Factors section of our first quarter 2009 Quarterly Report on Form 10-Q (Q1 2009 Quarterly Report) and in other documents we file with the Securities and Exchange Commission (SEC). These forward-looking statements speak only as of the date hereof. We are not under any obligation, and we expressly disclaim any obligation, to publicly release any revisions or updates to these forward-looking statements that may be made to reflect events or circumstances after the date hereof, or to reflect the occurrence of unanticipated events.

The following presentation of management's discussion and analysis of our financial condition and results of operations should be read together with our unaudited condensed consolidated financial statements included in this Quarterly Report on Form 10-Q.

OVERVIEW

Thoratec Corporation (we, our, us, or the Company) is the world leader in mechanical circulatory support with a product portfolio to treat the full range of clinical needs for advanced heart failure patients. We develop, manufacture and market proprietary medical devices used for circulatory support. We also develop, manufacture and market point-of-care diagnostic test systems and skin incision products. Our business is comprised of two operating divisions: Cardiovascular and International Technidyne Corporation (ITC), a wholly owned subsidiary.

For advanced heart failure (HF), our Cardiovascular division develops, manufactures and markets proprietary medical devices used for mechanical circulatory support (MCS). Our primary product lines are our ventricular assist devices (VADs): the Thoratec Paracorporeal Ventricular Assist Device (PVAD), the Thoratec Implantable Ventricular Assist Device (IVAD), the HeartMate Left Ventricular Assist System (HeartMate XVE), and the HeartMate II Left Ventricular Assist System (HeartMate II). We refer to the PVAD and the IVAD collectively as the Thoratec product line and we refer to the HeartMate XVE and the HeartMate II collectively as the HeartMate product line. The PVAD, IVAD, HeartMate XVE and HeartMate II are approved by the U.S Food and Drug Administration (FDA) and Conformite Europeene (CE) Mark approved in Europe. In addition, for acute HF we market the CentriMag Blood Pumping System (CentriMag), which is manufactured by Levitronix LLC (Levitronix) and distributed by us in the U.S. under a distribution agreement with Levitronix. We also manufacture a vascular access graft for renal dialysis.

VADs supplement the pumping function of the heart in patients with advanced HF. In most cases, a cannula connects the left ventricle of the heart to a blood pump. Blood flows from the left ventricle to the pump chamber via the cannula, powered by an electric or air driven mechanism that drives the blood through another cannula into the aorta. From the aorta, the blood then circulates throughout the body. Mechanical or tissue valves enable unidirectional flow in some devices. Currently, the power source remains outside the body for all FDA-approved VADs.

Our ITC division develops, manufactures and markets two product lines: point-of-care diagnostic test systems for hospital point-of-care and alternate site point-of-care markets, including diagnostic test systems that monitor blood coagulation while a patient is being administered certain anticoagulants, and that monitor blood gas/electrolytes, oxygenation and chemistry status; and incision products including devices used to obtain a patient's blood sample for diagnostic testing and screening for platelet function.

Table of Contents

Our Business Model

Our business is comprised of two operating divisions: Cardiovascular and ITC.

The product line of our Cardiovascular division is:

Circulatory Support Products. Our mechanical circulatory support products include the PVAD, IVAD, HeartMate XVE, HeartMate II and CentriMag for acute, intermediate and long-term mechanical circulatory support for patients with advanced HF. We also manufacture and sell small diameter grafts using our proprietary materials to address the vascular access market for hemodialysis.

The product lines of our ITC division are:

Point-of-Care Diagnostics. Our point-of-care products include diagnostic test systems that monitor blood coagulation while a patient is being administered certain anticoagulants, as well as monitor blood gas/electrolytes, oxygenation and chemistry status.

Incision. Our incision products include devices used to obtain a patient's blood sample for diagnostic testing and screening for platelet function.

Cardiovascular Division

VADs supplement the pumping function of the heart in patients with severe HF. In most cases, a cannula connects the left ventricle of the heart to a blood pump. Blood flows from the left ventricle to the pump chamber via the cannula, powered by an electric or air driven mechanism that drives the blood through another cannula into the aorta. From the aorta, the blood then circulates throughout the body. Mechanical or tissue valves enable unidirectional flow in some devices. Currently, the power source remains outside the body for all FDA-approved VADs.

Certain VADs are implanted internally, while others are placed outside the body. Some external devices are placed immediately adjacent to the body (paracorporeal), while other external VADs are positioned at a distance from the body (extracorporeal).

In addition to our MCS devices, we sell vascular access graft products used in hemodialysis for patients with late-stage renal disease.

Our product portfolio of implantable and external MCS devices and graft products is described below.

The Paracorporeal Ventricular Assist Device

The PVAD is an external, pulsatile, ventricular assist device, FDA approved for bridge-to-transplantation (BTT), including home discharge, and post-cardiotomy myocardial recovery and provides left, right and biventricular MCS. The PVAD is a paracorporeal device that is less invasive than implantable VADs since only the cannula is implanted. The paracorporeal nature of the PVAD has several benefits including shorter implantation times (approximately two hours) and the ability to use the device in smaller patients.

A pneumatic power source drives the PVAD. It is designed for short-to-intermediate duration use of a few weeks to several months, although this device has supported numerous patients for nine to eighteen months. Offering left, right or biventricular support, the PVAD and the IVAD, described below, are the only biventricular support systems approved for use as BTT. This characteristic is significant because approximately 50% of BTT patients treated with the PVAD and the IVAD require right as well as left-sided ventricular assistance. The PVAD and the IVAD are also the only devices approved for both BTT and recovery following cardiac surgery. The PVAD incorporates our proprietary biomaterial, Thoralon, which has excellent tissue and blood compatibility and is resistant to blood clots.

Table of Contents*The Implantable Ventricular Assist Device*

The IVAD is an implantable, pulsatile, ventricular assist device FDA approved for BTT, including home discharge, and post-cardiotomy myocardial recovery and provides left, right or biventricular MCS. The IVAD maintains the same blood flow path, valves and blood pumping mechanism as the PVAD, but has an outer housing made of a titanium alloy that makes it suitable for implantation.

The HeartMate XVE

The HeartMate XVE is an implantable, pulsatile, left ventricular assist device for intermediate and longer-term MCS, FDA approved for BTT and for long-term support for patients suffering from advance stage HF who are not eligible for heart transplantation (Destination Therapy or DT). The HeartMate XVE is the only device approved in the U.S., Europe and Canada for long-term support of patients ineligible for heart transplantation. Patients with a HeartMate XVE do not require anticoagulation drugs, other than aspirin, because of the product's incorporation of proprietary textured surfaces and tissue valves. The system is comprised of the blood pump and a wearable controller and batteries providing a high degree of patient freedom and mobility.

The HeartMate II

The HeartMate II is an implantable, electrically powered, continuous flow, left ventricular assist device consisting of a miniature rotary blood pump designed to provide intermediate and long-term mechanical circulatory support (MCS). The HeartMate II is designed to improve survival and quality of life and to provide five to ten years of circulatory support for a broad range of advanced HF patients. Significantly smaller than the HeartMate XVE and with only one moving part, the HeartMate II is simpler and designed to operate more quietly than pulsatile devices. In April 2008, we received FDA approval for the HeartMate II for BTT. In addition, the HeartMate II is in a Phase II pivotal trial in the U.S. for DT. In December 2008, we announced that the HeartMate II had demonstrated superiority in a pre-specified interim analysis to the HeartMate XVE, the control device in the DT pivotal study. This allowed us to gain FDA approval to end randomization in the ongoing continuous access protocol (CAP) phase of the DT study. In April 2009, we filed a pre-market approval (PMA) supplement with the FDA seeking to add the intended use of DT for the HeartMate II LVAS. The PMA filing includes data on a pivotal study cohort of 200 randomized patients, including two-year data on the first 167 patients enrolled. The filing also provides data on adjunctive cohorts totaling an additional 409 patients, including those who had been originally supported by an XVE who then elected to receive a HeartMate II, based on the need for device replacement, and patients enrolled under CAP. We filed an amendment to the PMA supplement submission with complete two-year data on all 200 randomized patients in July 2009. We have been in an interactive dialog with the FDA for most of the third quarter regarding the DT PMA supplement submission and believe that we have now provided responses to all engineering and clinical questions. We continue to believe that we are on track to receive approval for submission by early 2010. The device received CE Mark approval in November 2005, allowing for its commercial sale in Europe.

The CentriMag

The CentriMag is manufactured by Levitronix and is based on their magnetically levitated bearingless motor technology. We entered into a distribution agreement with Levitronix in August 2007, with an initial term effective through December 2011, to distribute the CentriMag in the U.S. The CentriMag is 510(k) cleared by the FDA for use up to six hours in patients requiring short-term extracorporeal circulatory support during cardiac surgery. Additionally, CentriMag is approved under a FDA humanitarian device exemption to be used as a right ventricular assist device for periods of support up to thirty days in patients in cardiogenic shock due to acute right ventricular failure. Levitronix has recently commenced a U.S. pivotal trial to demonstrate safety and effectiveness of the CentriMag for periods of support up to thirty days. Levitronix has CE Mark approval in Europe to market the product to provide support for up to thirty days.

Vascular Graft Products

The Vectra Vascular Access Graft is approved for sale in the U.S. and Europe. It is designed for use as a shunt between an artery and a vein, primarily to provide access to the bloodstream for renal hemodialysis patients requiring frequent needle punctures during treatment.

Table of Contents

ITC Division

Our product portfolio of point-of-care diagnostic test systems and incision products includes the following:

Hospital point-of-care

The HEMOCHRON Whole Blood Coagulation System

The HEMOCHRON Whole Blood Coagulation System (HEMOCHRON) is used to quantitatively monitor a patient's coagulation status while the patient is being administered anticoagulants. It may be used in various hospital settings. For instance, it is used in the cardiovascular operating room and cardiac catheterization lab to monitor the drug Heparin, and in an anticoagulation clinic to monitor the drug warfarin. The system consists of a small portable instrument and disposable test cuvettes or tubes and delivers results in minutes.

The IRMA TRUpoint Blood Analysis System

The IRMA TRUpoint Blood Analysis System (IRMA) is used to quantitatively monitor a patient's blood gas, electrolyte and chemistry status. This instrument is a self-contained, portable system which uses disposable test cartridges and delivers results in minutes.

The AVOXimeter Whole Blood Co-Oximeter/Oximeter System

The AVOXimeter Whole Blood Co-Oximeter/Oximeter System (AVOXimeter) is used to assess a patient's oxygenation status and is commonly used in the cardiac catheterization lab, the intensive care unit (ICU), the neonatal intensive care unit (NICU) and the emergency department. This portable instrument uses small, single-use test cuvettes and delivers results in less than ten seconds.

Our integrated data management system connects the HEMOCHRON, IRMA and AVOXimeter products.

Alternate site point-of-care

The ProTime Microcoagulation System

The ProTime Microcoagulation System (ProTime) is designed to safely monitor blood clotting activity in patients on anticoagulation therapy, specifically warfarin. The system can be prescribed for patient use at home or can be used in the physician's office or clinic. The system consists of a portable, quantitative instrument and disposable test cuvettes and delivers results in minutes.

The Hgb Pro Professional Hemoglobin Testing System

The Hgb Pro Professional Hemoglobin Testing System (Hgb Pro) is used by professionals, mainly in the physician's office, to test for anemia. Hgb Pro delivers quick results from a small blood sample placed on a disposable test strip inserted into a hand-held test meter.

The ProTime and Hgb Pro products are sold into the alternate site non-hospital point-of-care segment of the market comprised of physicians' offices, long-term care facilities, clinics, visiting nurse associations and home healthcare companies.

Table of Contents***Incision Products***

The Tenderfoot Heel Incision Device (Tenderfoot), the Tenderlett Finger Incision Device (Tenderlett) and the Surgicutt Bleeding Time Device (Surgicutt) are used by medical professionals to obtain a patient's blood sample for diagnostic testing. The Tenderfoot is a heel stick used for infant testing, the Tenderlett is used for finger incisions and the Surgicutt is used to perform screening tests to determine platelet function. These devices feature permanently retracting blades for safe incision with minimal pain, as compared to traditional lancets, which puncture the skin.

These products are sold to both the hospital point-of-care and alternate site point-of-care segments of the market. These products offer certain advantages, command a premium over the competition and are sold in the higher end of the market.

Critical Accounting Policies and Estimates

We have identified the policies and estimates below as critical to our business operations and the understanding of our results of operations. The impact of, and any associated risks related to, these policies and estimates on our business operations are discussed below. Preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenue and expenses and the disclosure of contingent assets and liabilities. There can be no assurance that actual results will not differ from those estimates and assumptions.

Revenue Recognition

We recognize revenue from product sales for our Cardiovascular and ITC business divisions when evidence of an arrangement exists, title has passed (generally upon shipment) or services have been rendered, the selling price is fixed or determinable and collectability is reasonably assured. Sales to distributors are recorded when title transfers. One distributor has certain limited product return rights. Other distributors have certain rights of return upon termination of their distribution agreement. A reserve for sales returns is recorded for these customers applying reasonable estimates of product returns based upon historical experience. No other direct sales customers or distributors have return rights.

We recognize sales of certain Cardiovascular division products to first-time customers when it has been determined that the customer has the ability to use the products. These sales frequently include the sale of products and training services under multiple element arrangements. Training is not considered essential to the functionality of the products. Revenue under these arrangements is allocated to training based upon fair market value of the training, which is typically performed on our behalf by third party providers. Under this method, the total value of the arrangement is allocated to the training and the Cardiovascular division products based on the relative fair market value of the training and products.

In determining when to recognize revenue, management makes decisions on such matters as the fair values of the product and training elements when sold together, customer credit worthiness and warranty reserves. If any of these decisions proves incorrect, the carrying value of these assets and liabilities on our unaudited condensed consolidated balance sheets or the recorded product sales could be significantly different, which could have a material adverse effect on our results of operations for any fiscal period.

Reserves

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make payments owed to us for product sales and training services. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

The majority of our products are covered by up to a two-year limited manufacturer's warranty from the date of shipment or installation. Estimated contractual warranty obligations are recorded when the related sales are recognized and any additional amounts are recorded when such costs are probable and can be reasonably estimated, at which time they are included in Cost of product sales in our unaudited condensed consolidated statements of operations. In determining the warranty reserve estimate, management makes judgments and estimates on such matters as repair costs and probability of warranty obligations.

Table of Contents

Estimated excess and obsolete inventory reserves are recorded when inventory levels exceed projected sales volume for a certain period of time. In determining the excess obsolete reserve, management makes judgments and estimates on matters such as forecasted sales volume. If sales volume differs from projections, adjustments to these reserves may be required.

Management must make judgments to determine the amount of reserves to accrue. If any of these decisions proves incorrect, our unaudited condensed consolidated financial statements could be materially and adversely affected.

Income Taxes

We make certain estimates and judgments in determining income tax expense for financial statement purposes. These estimates and judgments occur in the calculation of tax credits, benefits and deductions, such as tax benefits from our non-U.S. operations and in the calculation of certain tax assets and liabilities, which arise from differences in the timing of revenue and expense for tax and financial statement purposes.

We record a valuation allowance to reduce our deferred income tax assets to the amount that is more-likely-than-not to be realized. In evaluating our ability to recover our deferred income tax assets we consider all available positive and negative evidence, including our operating results, ongoing tax planning and forecasts of future taxable income on a jurisdiction by jurisdiction basis. In the event we were to determine that we would be able to realize our deferred income tax assets in the future in excess of their net recorded amount, we would make an adjustment to the valuation allowance which would reduce the provision for income taxes. Conversely, in the event that all or part of the net deferred tax assets are determined not to be realizable in the future, an adjustment to the valuation allowance would be charged to earnings in the period such determination is made.

We believe we have provided adequate reserves for uncertain tax positions for anticipated audit adjustments by U.S. federal, state and local, as well as foreign, tax authorities based on our estimate of whether, and the extent to which, additional taxes, interest and penalties may be due. If events occur which indicate payment of these amounts is unnecessary, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the accrued liabilities are no longer warranted. If our estimate of tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result.

Evaluation of Purchased Intangibles and Goodwill for Impairment

We periodically evaluate the carrying value of long-lived assets to be held and used, including intangible assets subject to amortization, when events or circumstances warrant such a review. The carrying value of a long-lived asset to be held and used is considered impaired when the anticipated separately-identifiable undiscounted cash flows from such an asset are less than the carrying value of the asset. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the long-lived asset. Fair value is determined primarily using the anticipated cash flows discounted at a rate commensurate with the risk involved. Management must make estimates of these future cash flows, if necessary, and the approximate discount rate, and if any of these estimates proves incorrect, the carrying value of these assets on our unaudited condensed consolidated balance sheets could become significantly impaired.

Purchased intangible assets with indefinite lives are not amortized but are subject to annual impairment tests. If there is an impairment, a new fair value would be determined. If the new fair value is less than the carrying amount, an impairment loss would be recognized.

Table of Contents***Valuation of Share-Based Awards***

Share-based compensation expense is measured at the grant date based on the value of the award and is recognized as expense over the vesting period. Determining the fair value of option awards at the grant date requires judgment, including estimating the expected term of stock options, the expected volatility of our stock, expected forfeitures and expected dividends. The computation of the expected volatility assumption used in the Black-Scholes option pricing model for option grants is based on historical volatility. When establishing the expected life assumption, we review annual historical employee exercise behavior of option grants with similar vesting periods. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. If actual forfeitures differ significantly from these estimates, share-based compensation expense and our results of operations could be materially affected.

Fair Value Measurements

Fair value measurement is defined as the price that would be received to sell an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement date.

In determining fair value, we use various approaches, including market, income and/or cost approaches, and each of these approaches requires certain inputs. Fair value measurement establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of us. Unobservable inputs are inputs that reflect our assumptions as compared to the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that we have the ability to access. Assets and liabilities utilizing Level 1 inputs include broker-dealer quote securities that can be traded in an active market. Since valuations are based on quoted prices that are readily and regularly available in an active market, a significant degree of judgment is not required.

Level 2 Valuations based on quoted prices of similar investments in active markets, of similar or identical investments in markets that are not active or model based valuations for which all significant inputs and value drivers are observable, directly or indirectly. Assets and liabilities utilizing Level 2 inputs primarily include municipal bonds, variable demand notes, corporate bonds and our senior subordinated convertible notes, except the make-whole provision, which uses Level 3 inputs, described below.

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement. Assets and liabilities utilizing Level 3 inputs include certain auction rate securities, our Levitronix convertible debenture, our HeartWare Loan Agreement and the make-whole feature of our senior subordinated convertible notes. Given the current credit market illiquidity for auction rate securities, our estimates are subject to significant judgment by management.

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, our own assumptions are developed to reflect those that market participants would use in pricing the asset or liability at the measurement date. See Note 6 Fair Value Measurements, to the unaudited condensed consolidated financial statements for further information about our financial assets that are accounted for at fair value.

Due to the uncertainty inherent in the valuation process, estimates of fair value may differ significantly from the values that would have been obtained had an active market for the securities existed, and the differences could be material. After determining the fair value of our available-for-sale securities, gains or losses on these investments are recorded to other comprehensive income, until either the investment is sold or we determine that the decline in value is other-than-temporary. Determining whether the decline in fair value is other-than-temporary requires management judgment based on the specific facts and circumstances of each investment. For investments in available-for-sale securities, these judgments primarily consider: the financial condition and liquidity of the issuer, the issuer's credit

rating, and any specific events that may cause us to believe that the debt instrument will not mature and be paid in full; and our ability and intent to hold the investment to maturity. Given the current market conditions, these judgments could prove to be incorrect, and companies with relatively high credit ratings and solid financial conditions may not be able to fulfill their obligations. In addition, if we decide not to hold an investment until its value recovers it may result in the recognition of an other-than-temporary impairment.

Table of Contents**Results of Operations**

The following table sets forth selected unaudited condensed consolidated statements of operations data for the periods indicated and as a percentage of total product sales:

| | Three Months Ended | | | | Nine Months Ended | | | |
|---------------------------------------------|-----------------------------------|------|--------------------|------|-------------------|------|--------------------|------|
| | October 3, 2009 | | September 27, 2008 | | October 3, 2009 | | September 27, 2008 | |
| | (in thousand, except percentages) | | | | | | | |
| | As adjusted (1) | | | | As adjusted (1) | | | |
| Product sales | \$ 87,917 | 100% | \$ 80,815 | 100% | \$ 269,442 | 100% | \$ 227,890 | 100% |
| Cost of product sales | 34,185 | 39 | 32,045 | 40 | 110,928 | 41 | 92,460 | 41 |
| Gross profit | 53,732 | 61 | 48,770 | 60 | 158,514 | 59 | 135,430 | 59 |
| Operating expenses: | | | | | | | | |
| Selling, general and administrative | 24,226 | 28 | 23,845 | 29 | 82,457 | 31 | 68,338 | 30 |
| Research and development | 13,350 | 15 | 13,443 | 17 | 40,862 | 15 | 38,801 | 17 |
| Amortization of purchased intangible assets | 2,568 | 3 | 3,295 | 4 | 8,067 | 3 | 9,887 | 4 |
| Total operating expenses | 40,144 | 46 | 40,583 | 50 | 131,386 | 49 | 117,026 | 51 |
| Income from operations | 13,588 | 15 | 8,187 | 10 | 27,128 | 10 | 18,404 | 8 |
| Other income and (expense): | | | | | | | | |
| Interest expense and other | (3,261) | (4) | (2,834) | (3) | (9,167) | (4) | (8,249) | (4) |
| Interest income and other | 7,134 | 8 | 2,183 | 3 | 9,759 | 4 | 6,642 | 3 |
| Income before income taxes | 17,461 | 19 | 7,536 | 10 | 27,720 | 10 | 16,797 | 7 |
| Income tax expense | (5,684) | (6) | (1,478) | (2) | (8,483) | (3) | (3,793) | (2) |
| Net income | \$ 11,777 | 13 | \$ 6,058 | 8 | \$ 19,237 | 7 | \$ 13,004 | 5 |

(1) Adjusted for the retrospective adoption of the accounting for convertible debt

instruments that
may be settled
in cash upon
conversion,
including partial
settlements, in
accordance with
ASC 470-20,
Debt. See Note
12, Long-Term
Debt to our
unaudited
condensed
consolidated
financial
statements.

See Note 16 to our unaudited condensed consolidated financial statements in this Quarterly Report for data presented by business segment and geographic composition.

Table of Contents**Three and nine months ended October 3, 2009 and September 27, 2008****Product Sales**

Product sales in the third quarter of 2009 increased by \$7.1 million or 8.8% as compared to the third quarter of 2008 and in the first nine months of 2009 increased by \$41.6 million or 18.2% as compared to the first nine months of 2008.

| | Three Months Ended | | | Nine Months Ended | | |
|---------------------|-----------------------------------------|--------------------------------------------|-------------|-----------------------------------------|--------------------------------------------|-------------|
| | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change |
| Cardiovascular | \$ 65,114 | \$ 57,091 | 14.0 | \$ 198,964 | \$ 154,818 | 28.5 |
| ITC | 22,803 | 23,724 | 3.9 | 70,478 | 73,072 | 3.5 |
| Total product sales | \$ 87,917 | \$ 80,815 | 8.8 | \$ 269,442 | \$ 227,890 | 18.2 |

In the third quarter of 2009 as compared to the third quarter of 2008, Cardiovascular product sales increased by \$8.0 million primarily due to higher sales of our HeartMate II, including the launch of new HeartMate external peripheral equipment, partially offset by a decline in the Thoratec product line and HeartMate XVE. ITC product sales decreased by \$0.9 million, primarily due to delayed capital purchases by hospitals due to the current economic conditions, competitive pressure on the ProTime and skin incision businesses.

In the first nine months of 2009 as compared to the first nine months of 2008, Cardiovascular product sales increased by \$44.2 million primarily due to higher sales of our HeartMate II following approval from the FDA of the HeartMate II for BTT in April 2008, this in part is offset by a decline in the Thoratec product line and HeartMate XVE. In the U.S., fourteen HeartMate II centers have been added in first nine months of 2009 bringing the HeartMate II implanting centers to 115. Additionally, we have added twelve new HeartMate II implanting centers internationally, and we now have eighty-nine total HeartMate II implanting centers outside of the U.S. In the first nine months of 2009, ITC product sales decreased by \$2.6 million compared to the first nine months of 2008, primarily due to delayed capital purchases by hospitals due to the current economic environment, competitive pressure on the ProTime and skin incision businesses.

Sales originating outside of the U.S. and U.S. export sales accounted for approximately 25% and 24% of our total product sales in the third quarter of 2009 and 2008, respectively and approximately 24% and 26% of our total product sales in the first nine months of 2009 and 2008, respectively.

Gross Profit

Gross profit and gross margin are as follows:

| | Three Months Ended | | Nine Months Ended | |
|--------------------|------------------------------------|--------------------------|-----------------------|--------------------------|
| | October 3, 2009 | September 27, 2008 | October 3, 2009 | September 27, 2008 |
| | (in thousands, except percentages) | | | |
| Total gross profit | \$ 53,732 | \$ 48,770 | 158,514 | \$ 135,430 |
| Total gross margin | 61.1% | 60.3% | 58.8% | 59.4% |

In the third quarter of 2009 as compared to the third quarter of 2008, Cardiovascular gross margin percentage increased by 2.1% primarily attributable to favorable manufacturing variance driven by HeartMate II volume, non-pump margins, partially offset by unfavorable foreign exchange rates. ITC division gross margin percentage

decreased by 6.2% primarily due to unfavorable manufacturing variances driven by volume and cuvette product quality control issue costs.

Table of Contents

In the first nine months of 2009 as compared to the first nine months of 2008, Cardiovascular gross margin percentage decreased by 0.3% primarily attributable to an excess inventory reserve related to the HeartMate XVE, increase in warranty reserves and unfavorable foreign currency exchange rates, partially offset by HeartMate II volume. ITC division gross margin percentage decreased by 6.4% primarily due to unfavorable manufacturing variance driven by volume and cuvette product quality control issue costs.

Selling, General and Administrative

Selling, general and administrative expenses were as follows:

| | Three Months Ended | | | Nine Months Ended | | |
|-------------------------------------------|-----------------------------------------|--------------------------------------------|-------------|-----------------------------------------|--------------------------------------------|-------------|
| | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change |
| Total selling, general and administration | \$ 24,226 | \$ 23,845 | 1.6 | \$ 82,457 | \$ 68,338 | 20.7 |

In the third quarter of 2009 as compared to the third quarter of 2008, Cardiovascular costs increased by \$0.1 million due to higher sales and marketing expense in preparation for the DT launch. ITC costs increased by \$0.2 million, primarily due to higher costs for quality system improvement offset by lower personnel expenses. Corporate costs increased by \$0.1 million primarily due to higher legal and consulting fees paid on the terminated merger agreement with HeartWare International Inc. (HeartWare) partially offset by lower personnel expenses.

In the first nine months of 2009 as compared to the first nine months of 2008, Cardiovascular costs increased by \$2.3 million due to customer training and market development initiatives, including the users meetings and higher share-based compensation expense. ITC costs increased by \$1.2 million, primarily due to higher quality system improvement costs offset by lower personnel expenses. Corporate costs increased by \$10.6 million primarily due to higher legal and consulting fees paid on the terminated merger agreement with HeartWare partially offset by lower personnel expenses.

Research and Development

Research and development expenses in the third quarter of 2009 were \$13.4 million, or 15% of product sales, compared to \$13.4 million, or 17% of product sales, in the third quarter of 2008 and in the first nine months of 2009 were \$40.9 million or 15% of product sales as compared to \$38.8 million or 17% of product sales in the first nine months of 2008.

| | Three Months Ended | | | Nine Months Ended | | |
|--------------------------------------|-----------------------------------------|--------------------------------------------|-------------|-----------------------------------------|--------------------------------------------|-------------|
| | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change |
| Total research and development costs | \$ 13,350 | \$ 13,443 | 0.1 | \$ 40,862 | \$ 38,801 | 5.3 |

Research and development costs are largely project driven, and fluctuate based on the level of project activity planned and subsequently approved and conducted.

In the third quarter of 2009 as compared to the third quarter of 2008, Cardiovascular costs increased by \$0.7 million primarily due to increased research and development costs associated with the HeartMate product line peripheral enhancements and new product technology. ITC costs decreased by \$0.7 million due to lower spending related to new product development.

In the first nine months of 2009 as compared to the first nine months of 2008, Cardiovascular costs increased by \$2.7 million primarily due to increased research and development costs associated with the HeartMate product line

peripheral enhancements and new product technology. ITC costs decreased by \$0.6 million primarily due to lower spending related to new product development.

Table of Contents**Amortization of Purchased Intangible Assets**

Amortization of purchased intangible assets in the third quarter of 2009 was \$2.6 million as compared to \$3.3 million in the third quarter of 2008 and in the first nine months of 2009 was \$8.1 million as compared to \$9.9 million in the first nine months of 2008. The decrease in amortization expense of \$0.7 million in the third quarter of 2009 and \$1.8 million in the first nine months of 2009 is attributable to certain intangible assets at our Cardiovascular division being fully amortized during the first quarter of 2009.

Interest Expense and Other

Interest expense and other was \$3.3 million in the third quarter of 2009 as compared to \$2.8 million in the third quarter of 2008 and \$9.2 million in the first nine months of 2009 as compared to \$8.2 million in the first nine months of 2008:

| | Three Months Ended | | | Nine Months Ended | | |
|-----------------------------------------------------------------------------------------------|-----------------------------------------|--------------------------------------------|-------------|-----------------------------------------|--------------------------------------------|-------------|
| | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change |
| Interest expense | \$ 3,158 | \$ 2,732 | 15.6 | \$ 8,858 | \$ 7,941 | 11.5 |
| Amortization of debt issuance costs related to senior subordinated convertible notes | 103 | 102 | | 309 | 308 | |
| Total interest expense | \$ 3,261 | \$ 2,834 | 15.1 | \$ 9,167 | \$ 8,249 | 11.1 |

Interest expense, primarily comprised of the senior subordinated convertible notes, is calculated using the interest rate method and increases interest expense over the term of the debt resulting in a higher expense in the third quarter of 2009 and first nine months of 2009 as compared to the same periods in 2008.

Interest Income and Other

Interest income and other in the third quarter of 2009 was \$7.1 million as compared to \$2.2 million in the third quarter of 2008 and in the first nine months of 2009 was \$9.8 million as compared to \$6.6 million in the first nine months of 2008. The components of interest and other income are as follows:

| | Three Months Ended | | | Nine Months Ended | | |
|----------------------------------------------------------------------------------------------------|-----------------------------------------|--------------------------------------------|-------------|-----------------------------------------|--------------------------------------------|-------------|
| | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change | October 3, 2009 (in thousands) | September 27, 2008 (in thousands) | % Change |
| Interest income | \$ 1,561 | \$ 1,954 | 20.1 | \$ 4,284 | \$ 6,203 | 30.9 |
| Foreign currency, net Recording of conversion option upon termination on merger agreement | 239 | 22 | 986.4 | (274) | 106 | 358.5 |
| Mark-to-market adjustment on HearWare conversion option | 3,454 | | | 3,454 | | |
| Other | 1,786 | 207 | 54.6 | 1,786 | 333 | 52.8 |

| | | | | | | |
|---------------------------------|----------|----------|-------|----------|----------|------|
| Total interest income and other | \$ 7,134 | \$ 2,183 | 226.8 | \$ 9,759 | \$ 6,642 | 46.9 |
|---------------------------------|----------|----------|-------|----------|----------|------|

Interest income in the third quarter of 2009 decreased by \$0.4 million from the third quarter of 2008, primarily due to the decline in market interest rates and shortened maturities on our investment portfolio. In the third quarter we recorded \$3.5 million in connection with the receipt of the conversion option under the HeartWare loan agreement and \$1.8 million mark-to-market adjustment on HeartWare conversion option.

Interest income in the first nine months of 2009 decreased by \$1.9 million from the first nine months of 2008, primarily due to the decline in market interest rates and shortened maturities on our investment portfolio. During the first nine months of 2009 we recorded \$3.5 million in connection with the receipt of the conversion option under the HeartWare loan agreement and \$1.8 million mark-to-market adjustment on HeartWare conversion option. In addition, foreign currency decreased by \$0.4 million in the first nine months of 2009 as compared to the first nine months of 2008 because of certain foreign currency transactions related to inventory for our foreign operations, which are not hedged in our foreign currency contracts.

Table of Contents***Income Taxes***

Our effective income tax rate was 32.6% for the third quarter of 2009 as compared to 19.6% for the third quarter of 2008. This 13.0% increase in our effective tax rate was primarily due to an increase in pre-tax earnings and lower tax exempt interest income and Internal Revenue Code (IRC) Section 162(m) compensation deduction limitation, partially offset by an increase in research and development credits and recognition of production tax credits realized in the third quarter of 2009 as compared to the same period in 2008.

Our effective income tax rate was 30.6% for the first nine months of 2009 as compared to 22.6% for the first nine months of 2008. This 8.0% increase in our effective tax rate was primarily due to an increase in pre-tax earnings, and lower tax exempt interest income and IRC Section 162(m) compensation deduction limitation, partially offset by an increase in research and development credits realized, recognition of production tax credits and a discrete benefit for \$0.9 million recorded in the first quarter of 2009 attributable to a change in California tax law.

Our effective tax rate is calculated based on the statutory tax rates imposed on projected annual pre-tax income or loss in various jurisdictions. Because relatively small changes in our forecasted profitability for 2009 can significantly affect our projected annual effective tax rate, we believe our quarterly tax rate will be dependent on our profitability and could fluctuate significantly.

Liquidity and Capital Resources***Cash, Cash Equivalents and Investments***

Cash and cash equivalents include highly liquid financial instruments that are readily convertible to cash and have maturities of 90 days or less from the date of purchase.

Cash and cash equivalents classified as restricted are funds held by a third party. Pursuant to the HeartWare loan agreement, we deposited \$20.0 million (the Loan Amount) into an escrow account on February 13, 2009 and agreed to loan such funds to HeartWare. Despite the mutual termination of the definitive merger agreement by the Company and HeartWare, the Loan Amount continues to remain available for borrowing by HeartWare at any time prior to the earlier of (i) November 1, 2011, (ii) the date on which the outstanding portion of the Loan Amount borrowed by HeartWare, including any accrued and unpaid interest, as well as the portion of the Loan Amount remaining in the escrow account that have not been loaned to HeartWare, are converted into shares of HeartWare s common stock, or (iii) the date on which the outstanding principal of the Loan Amount borrowed by HeartWare becomes due and payable in full, whether by acceleration or otherwise, pursuant to the terms of the loan agreement. Beginning as of May 1, 2009, HeartWare was able to borrow up to an aggregate of \$12.0 million and beginning as of July 31, 2009, HeartWare was able to borrow up to an aggregate of \$20.0 million, under certain conditions provided in the loan agreement. The loan to HeartWare bears interest at a rate per annum equal to 10%. The principal amount, together with any accrued and unpaid interest on the principal amount, will be due and payable in full in cash on the earlier of (i) November 1, 2011 or (ii) the date on which the outstanding principal of the Loan Amount borrowed by HeartWare becomes due and payable in full, whether by acceleration or otherwise, pursuant to the terms of the loan agreement. Following the mutual termination of the definitive merger agreement by the Company and HeartWare on July 31, 2009 and pursuant to the terms of the loan agreement, we may convert the Loan Amount including the amounts drawn down by HeartWare and accrued but unpaid interest thereon, into shares of HeartWare s common stock, at our option. The Loan Amount is convertible into shares of HeartWare s common stock, at the conversion price equal to \$35.00 Australian dollars per share of HeartWare common stock, as adjusted pursuant to the terms of the loan agreement.

Table of Contents

Investments classified as short-term consist of various financial instruments such as commercial paper, U.S. government agency obligations and corporate notes. Bonds with high credit quality with maturities of greater than 90 days when purchased are classified as available-for-sale. Investments classified as long-term consist of our investments in auction rate securities.

Following is a summary of our cash, cash equivalents and investments:

| | October 3, 2009 | January 3, 2009 |
|-----------------------------------------------------|--------------------------------|----------------------------|
| | (in thousands) | |
| Cash and cash equivalents | \$ 28,000 | \$ 107,053 |
| Short-term investments | 235,328 | 141,598 |
| Long-term restricted cash and cash equivalents | 16,000 | |
| Long-term investments | 24,620 | 29,959 |
| Total cash, cash equivalents and investments | \$ 303,948 | \$ 278,610 |

We believe that cash and cash equivalents, short-term available-for-sale investments and expected cash flows from operations, will be sufficient to fund our operations and capital requirements for at least the next twelve months.

As of October 3, 2009 we owned approximately \$27.8 million face value of auction rate securities. The assets underlying these investments are student loans predominantly backed by the U.S. government under the Federal Family Education Loan Program or by private insurers and are rated between A- and AAA. Historically, these securities have provided liquidity through a Dutch auction process that resets the applicable interest rate periodically every seven to 365 days. Beginning in February of 2008, these auctions began to fail. Although we have realized higher interest rates for many of these auction rate securities than the current market rates, the principal amount will not be accessible until future auctions for these securities are successful, a secondary market is established, these securities are called for redemption or paid upon maturity. Therefore, our auction rate securities are classified as long-term and are valued at \$24.6 million.

We recorded an estimated cumulative unrealized loss of \$3.2 million (\$1.9 million, net of tax) related to the temporary impairment of the auction rate securities, which was included in accumulated other comprehensive gain/loss within shareholders' equity. In addition, our management reviews impairments and credit loss associated with its investments, including auction rate securities to determine the classification of the impairment as temporary or other-than-temporary and to bifurcate the credit and non-credit component of an other-than-temporary impairment event. We do not intend to sell any of the auction rate securities prior to maturity at an amount below the original purchase value; intend to hold the investment to recovery and based on a more-likely-than-not probability assessment we will not be required to sell the security before recovery; and (deem that it is not probable that we will receive less than 100% of the principal and accrued interest from the issuer. Therefore, 100% of the impairment was charged to other comprehensive income. Our auction rate securities are classified as long-term and are valued at \$24.6 million using significant unobservable inputs. Further, we continue to liquidate investments in auction rate securities as opportunities arise. During the nine months ended October 3, 2009, \$9.4 million in auction rate securities were liquidated at par in connection with issuer calls.

Table of Contents*Long-term obligation*

In 2004, we completed the sale of \$143.8 million initial principal amount of senior subordinated convertible notes due in 2034. The senior subordinated convertible notes were issued at an issue price of \$580.98 per note, which is 58.098% of the principal amount at maturity of the notes. The senior subordinated convertible notes bear interest at a rate of 1.3798% per year on the principal amount at maturity, payable semi-annually in arrears in cash on May 16 and November 16 of each year, from November 16, 2004 until May 16, 2011. We have applied, retrospectively, the adoption of recent guidance for the accounting for convertible debt instruments that may be settled in cash upon conversion, including partial settlements, which increases non-cash interest expense based on the assumed market rate of 9% percent per annum as compared to the cash coupon rate of 2.375% as further discussed in Note 12, Long-Term Debt of the notes to the unaudited condensed consolidated financial statements. Holders of the senior subordinated convertible notes may convert their convertible notes into shares of our common stock at a conversion rate of 29.4652 shares per \$1,000 principal amount of senior subordinated convertible notes, which represents a conversion price of \$19.72 per share, subject to adjustments upon the occurrence of certain events as set forth in the indenture. Holders have been and are able to convert their convertible notes at any point after the close of business on October 30, 2004 if, as of the last day of the preceding calendar quarter, the closing price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of such preceding calendar quarter is more than 120% of the accreted conversion price per share of our common stock. Commencing October 1, 2008, this market price conversion feature was satisfied, such that holders of the senior subordinated convertible notes may convert their notes through the final maturity date of the notes into shares of our common stock at a conversion rate of 29.462 shares per \$1,000 principal amount of senior subordinated convertible notes, subject to adjustments as provided in the indenture. If holders elect conversion, we may, at our option, deliver shares of common stock, pay a holder in cash, or deliver a combination of shares and cash, as determined pursuant to the terms of the notes.

Cash Flow Activities

Following is a summary of our cash flow activities:

| | October 3, 2009 | September 27, 2008 |
|--------------------------------------------------------------|--------------------------------|-----------------------------------|
| | (in thousands) | |
| Net cash provided by operating activities | \$ 25,934 | \$ 29,907 |
| Net cash (used in) investing activities | (112,148) | (7,512) |
| Net cash provided by financing activities | 7,368 | 22,415 |
| Effect of exchange rate changes on cash and cash equivalents | (207) | (6) |
| Net (decrease) increase in cash and cash equivalents | \$ (79,053) | \$ 44,804 |

Cash Provided by Operating Activities

For the nine months ended October 3, 2009, cash provided by operating activities was \$25.9 million. This amount included net income of \$19.2 million increased by positive non-cash adjustments to net income of \$28.7 million primarily comprised of \$8.3 million related to depreciation, \$8.1 million related to amortization, \$2.9 million related to tax benefit associated with stock options, \$10.7 million related to share-based compensation expense, \$5.8 million related to interest on the convertible debt, and \$1.8 million related to non-cash interest. These positive cash contributions were partially offset by a decrease of \$2.4 million related to excess tax benefits from share-based compensation, , and a decrease of \$5.2 million non-cash gain on the convertible option related to the HeartWare loan agreement, and \$3.5 million in our net deferred tax liability. Changes in assets and liabilities used cash of \$22.0 million primarily due to the decrease in accrued compensation liability, and an increase in prepaid expenses and other assets, accounts receivable and inventory at our Cardiovascular division.

Cash Used in Investing Activities

For the nine months ended October 3, 2009, cash used in investing activities was \$112.1 million, due to purchases of investments of \$224.8 million and pursuant to the HeartWare loan agreement, a transfer of \$16.0 million to an escrow account and \$4.0 million loan to HeartWare, partially offset by sales and maturities of investments totaling \$142.3 million. In addition, we made \$9.7 million of purchases of property, plant and equipment which included \$7.6 million for leasehold improvements related to the expansion of our manufacturing facility and the office building at our Pleasanton headquarters and purchases of management information systems equipment at our Cardiovascular division and \$2.1 million for manufacturing equipment and management information systems equipment at our ITC division.

Cash Provided by Financing Activities

For the nine months ended October 3, 2009, cash provided by financing activities was \$7.4 million, primarily comprised of \$6.6 million from proceeds related to stock option exercises, \$1.6 million from proceeds from stock issued under our employee stock purchase plan and \$2.4 million from excess tax benefits from stock option exercises, offset by \$3.2 million of restricted stock purchased for payment of income tax withholding due upon vesting.

Table of Contents

Off Balance Sheet Arrangements

We maintain Irrevocable Standby Letters of Credit as part of our workers' compensation insurance program. The Letters of Credit are not collateralized. The Letters of Credit automatically renew on June 30th of each year, unless terminated by one of the parties. As of October 3, 2009, our Letters of Credit balance was approximately \$0.8 million.

Contractual Obligations

As of October 3, 2009, the liability for uncertain tax positions was \$10.9 million, including interest and penalties. Due to the high degree of uncertainty regarding the timing of potential future cash flows associated with these liabilities, we are unable to make a reasonably reliable estimate of the amount and period in which these liabilities might be paid.

During the three and nine months ended October 3, 2009 there were no other material changes to our contractual obligations reported in our 2008 Annual Report on Form 10-K, as updated by the Current Report on Form 8-K dated June 11, 2009, outside our normal course of business.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISK

Interest Rate Risk

Our investment portfolio is made up of marketable investments in money market funds, auction rate securities, U.S. Treasury securities and debt instruments of government agencies, local municipalities, and high quality corporate issuers. All investments are carried at fair market value and are treated as available-for-sale. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature due to the frequency with which the interest rate is reset and because such marketable securities represent the investment of cash that is available for current operations. Our auction rate securities that are not liquid are classified as long-term. Our holdings of the securities of any one issuer, except government agencies, do not exceed 10% of the portfolio. If interest rates rise, the market value of our investments may decline, which could result in a loss if we were forced to sell an investment before its scheduled maturity. If interest rates were to rise or fall from current levels by 25 basis points and by 50 basis points, the change in our net unrealized gain or loss on investments would be \$0.4 million and \$0.7 million, respectively. We do not utilize derivative financial instruments to manage interest rate risks. Our senior subordinated convertible notes, the Levitronix convertible debenture and the HeartWare loan do not bear interest rate risk as the notes and debenture were issued at a fixed rate of interest.

Foreign Currency Rate Fluctuations

We use forward foreign currency contracts to mitigate the gains and losses generated by the re-measurement of non-functional currency assets and liabilities (primarily assets and liabilities on our U.K. subsidiary's consolidated balance sheet that are not denominated in U.K. pounds). Our contracts typically have maturities of three months or less.

As of October 3, 2009, we had forward contracts to sell euros with a notional value of \$9.6 million and to purchase U.K. pounds with a notional value of £5.5 million, and as of September 27, 2008, we had forward contracts to sell euros with a notional value of \$6.4 million and to purchase U.K. pounds with a notional value of £4.6 million. As of October 3, 2009, our forward contracts had an average exchange rate of one U.S. dollar to 0.687 euros and one U.S. dollar to 0.624 U.K. pounds. The potential fair value loss for a hypothetical 10% adverse change in foreign currency exchange rates at October 3, 2009 would be approximately \$2.3 million.

Table of Contents**ITEM 4. CONTROLS AND PROCEDURES**

Attached as exhibits to this Form 10-Q are certifications of our Chief Executive Officer and Chief Financial Officer, which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended (the Exchange Act). This Controls and Procedures section includes information concerning the controls and controls evaluation referred to in the certifications.

Disclosure Controls and Procedures

An evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, as of October 3, 2009. The evaluation of our disclosure controls and procedures included a review of our processes and implementation and the effect on the information generated for use in this Quarterly Report on Form 10-Q. In the course of this evaluation, we sought to identify any significant deficiencies or material weaknesses in our disclosure controls and procedures, to determine whether we had identified any acts of fraud involving personnel who have a significant role in our disclosure controls and procedures, and to confirm that any necessary corrective action, including process improvements, was taken. This type of evaluation is done quarterly so that our conclusions concerning the effectiveness of these controls can be reported in our periodic reports filed with the SEC. The overall goals of these evaluation activities are to monitor our disclosure controls and procedures and to make modifications as necessary. We intend to maintain these disclosure controls and procedures, modifying them as circumstances warrant.

Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that as of October 3, 2009 the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and to provide reasonable assurance that such information is accumulated and communicated to our management, including our principal executive officer, as appropriate to allow timely decisions regarding required disclosures.

Changes to Internal Controls

There have been no changes in our internal controls over financial reporting during the quarter ended October 3, 2009 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

Inherent Limitations on Controls and Procedures

Our management, including the Chief Executive Officer and the Chief Financial Officer, does not expect that our disclosure controls and procedures and our internal controls will prevent all error and all fraud. A control system, no matter how well designed and operated, can only provide reasonable assurances that the objectives of the control system are met. The design of a control system reflects resource constraints; the benefits of controls must be considered relative to their costs. Because there are inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been or will be detected. As these inherent limitations are known features of the financial reporting process, it is possible to design into the process safeguards to reduce, though not eliminate, these risks. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns occur because of simple error or mistake. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events. While our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, there can be no assurance that any design will succeed in achieving its stated goals under all future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with the policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Table of Contents

We intend to review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to improve our controls and procedures over time and to correct any deficiencies that we may discover in the future. While our Chief Executive Officer and Chief Financial Officer have concluded that, as of October 3, 2009, the design of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, was effective, future events affecting our business may cause us to significantly modify our disclosure controls and procedures.

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this Quarterly Report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our 2008 Annual Report and Part II, Item 1A. Risk Factors in our Q1 2009 Quarterly Report, which could materially affect our business, financial condition or future results. The risks described in our 2008 Annual Report and Q1 2009 Quarterly Report 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 materially adversely affect our business, financial condition and/or operating results.

Table of Contents**ITEM 2: UNREGISTERED SALE OF EQUITY SECURITIES AND USE OF PROCEEDS**

There were no unregistered sales of our equity securities during the three months ended October 3, 2009.

The following table sets forth certain information about our common stock repurchased during the three months ended October 3, 2009:

| | Total number of shares purchased (2) | Average price paid per share (in thousands, except per share data) | Total number of shares purchased under publicly announced programs (1) | Approximate value of shares authorized to be purchased under publicly announced programs |
|----------------------------------------|-----------------------------------------------------------------|-------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------|
| July 5, 2009 through August 1, 2009 | 2.3 | \$ 25.34 | | \$ |
| August 2, 2009 through August 29, 2009 | 1.9 | 26.80 | | |
| August 30 through October 3, 2009 | 1.7 | 28.26 | | |
| Total | 5.9 | \$ 26.62 | | \$ |

(1) Our share repurchase programs, which authorized us to repurchase up to a total of \$130 million of our common shares, were announced on February 11, 2004 as a \$25 million program, on May 12, 2004 as a \$60 million program, on July 29, 2004 as a \$25 million program and on February 2, 2006 as a

\$20 million program. These programs authorize us to acquire shares in the open market or in privately negotiated transactions and do not have an expiration date. No shares were repurchased under these programs during the three months ended October 3, 2009. As of October 3, 2009, we have \$10.1 million remaining under our share repurchase programs.

- (2) Shares purchased that were not part of our publicly announced repurchase programs represent the surrender value of shares of restricted stock awards and restricted stock units used to pay income taxes due upon vesting, and do not reduce the dollar value that may yet be purchased under our publicly announced

repurchase
programs.

45

Table of Contents

ITEM 6. EXHIBITS

| | |
|------|-------------------------------------------------------|
| 31.1 | Section 302 Certification of Chief Executive Officer. |
| 31.2 | Section 302 Certification of Chief Financial Officer. |
| 32.1 | Section 906 Certification of Chief Executive Officer. |
| 32.2 | Section 906 Certification of Chief Financial Officer. |

Table of Contents

SIGNATURES

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

THORATEC CORPORATION

Date: November 12, 2009

/s/ Gerhard F. Burbach
Gerhard F. Burbach
Chief Executive Officer

Date: November 12, 2009

/s/ David V. Smith
David V. Smith
Executive Vice President,
Chief Financial Officer (Principal
Accounting Officer)

47