THORATEC CORP
Form 10-Q
August 05, 2015

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

**(Mark one)**

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

**For the quarterly period ended July 4, 2015**

**Or**

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

**For the transition period from to**

**COMMISSION FILE NUMBER: 000-49798**

# THORATEC CORPORATION

(Exact name of registrant as specified in its charter)

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

**(925) 847-8600**

(Registrant s telephone number, including area code)

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

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

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

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

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

As of July 31, 2015, the registrant had 54.8 million shares of common stock outstanding.

**THORATEC CORPORATION**

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**THORATEC CORPORATION**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(unaudited)**

**(in thousands)**

| | July 4, 2015 | January 3, 2015 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 144,925 | $ 72,814 |
| Short-term available-for-sale investments | 129,042 | 157,664 |
| Receivables, net of allowances of $1,892 in 2015 and $1,504 in 2014 | 79,915 | 72,847 |
| Inventories | 70,859 | 62,204 |
| Deferred tax assets | 15,782 | 15,727 |
| Income tax receivable | 14,476 | 10,778 |
| Prepaid expenses and other assets | 5,922 | 12,458 |
| Total current assets | 460,921 | 404,492 |
| Property, plant and equipment, net | 49,371 | 51,231 |
| Goodwill | 226,578 | 225,293 |
| Purchased intangible assets, net | 40,313 | 44,488 |
| Long-term available-for-sale investments | 4,212 | 4,239 |
| Other long-term assets | 35,787 | 34,240 |
| Total Assets | $ 817,182 | $ 763,983 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 20,969 | $ 12,662 |
| Accrued compensation | 25,472 | 22,836 |
| Warranty and related accrual | 8,648 | 10,639 |
| Contingent liabilities, current portion | 5,782 | 14,902 |
| Other accrued liabilities | 22,391 | 20,441 |
| Total current liabilities | 83,262 | 81,480 |
| Long-term deferred tax liability | 4,376 | 3,592 |
| Other long-term liabilities | 17,079 | 14,458 |
| Contingent liabilities, non-current portion (Note 2) | 32,237 | 31,656 |
| Total Liabilities | 136,954 | 131,186 |
| Shareholders equity: | | |
| Common shares: no par, authorized 100,000; issued and outstanding 54,741 in 2015 and 54,109 in 2014 | | |
| Additional paid-in capital | 652,793 | 614,577 |
| Retained earnings | 45,335 | 40,242 |
| Accumulated other comprehensive loss: | (17,900) | (22,022) |
| Total Shareholders Equity | 680,228 | 632,797 |

| | | | | | |
|---|---|---|---|---|---|
| Total Liabilities and Shareholders | Equity | $ | 817,182 | $ | 763,983 |

See notes to the unaudited condensed consolidated financial statements.

**THORATEC CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(unaudited)**

**(in thousands, except per share data)**

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| Product sales | $ 128,692 | $ 118,063 | $ 250,000 | $ 243,760 |
| Cost of product sales | 39,897 | 34,307 | 77,026 | 74,333 |
| Gross profit | 88,795 | 83,756 | 172,974 | 169,427 |
| Operating expenses: | | | | |
| Selling, general and administrative | 43,932 | 35,477 | 84,049 | 70,978 |
| Research and development | 26,511 | 23,048 | 52,628 | 46,387 |
| Total operating expenses | 70,443 | 58,525 | 136,677 | 117,365 |
| Income from operations | 18,352 | 25,231 | 36,297 | 52,062 |
| Other income and (expense): | | | | |
| Interest expense | (13) | (2) | (13) | (2) |
| Interest income and other | 687 | 559 | 1,504 | 806 |
| Income before income taxes | 19,026 | 25,788 | 37,788 | 52,866 |
| Income tax expense | (5,778) | (8,375) | (13,760) | (17,214) |
| Net income | $ 13,248 | $ 17,413 | $ 24,028 | $ 35,652 |
| | | | | |
| Net Income per share: | | | | |
| Basic | $ 0.24 | $ 0.31 | $ 0.44 | $ 0.63 |
| Diluted | $ 0.24 | $ 0.30 | $ 0.44 | $ 0.62 |
| Shares used to compute income per share: | | | | |
| Basic | 54,481 | 56,723 | 54,246 | 56,781 |
| Diluted | 55,261 | 57,188 | 55,155 | 57,538 |

See notes to the unaudited condensed consolidated financial statements.

**THORATEC CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(unaudited)**

**(in thousands)**

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| Net income | $ 13,248 | $ 17,413 | $ 24,028 | $ 35,652 |
| Unrealized gains (losses) on investments (net of taxes (benefits) of $(188) and $(2) for the three months ended July 4, 2015 and June 28, 2014, respectively, and $(183) and $(284) for the six months ended July 4, 2015 and June 28, 2014, respectively) | (282) | 4 | (274) | (1,407) |
| Foreign currency translation adjustments | 1,667 | (781) | 4,396 | 678 |
| Total other comprehensive income (loss) | 1,385 | (777) | 4,122 | (729) |
| Comprehensive income | $ 14,633 | $ 16,636 | $ 28,150 | $ 34,923 |

See notes to the unaudited condensed consolidated financial statements.

**THORATEC CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(unaudited)**

**(in thousands)**

| | Six Months Ended | |
|---|---|---|
| | **July 4, 2015** | **June 28, 2014** |
| **Cash flows from operating activities:** | | |
| Net Income | $ 24,028 | $ 35,652 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 6,943 | 8,207 |
| Fixed assets write-down | 172 | |
| Investment premium amortization, net | 1,810 | 2,176 |
| Allowance (reduction in) for bad debt | 463 | (995) |
| Foreign currency re-measurement and other | 5,149 | 232 |
| Tax benefit related to stock options | 992 | 875 |
| Change in fair value of contingent consideration | 818 | (1,436) |
| Share-based compensation expense | 18,850 | 14,615 |
| Excess tax benefits from share-based compensation | (1,941) | (989) |
| Loss on disposal of assets | 96 | 613 |
| Change in net deferred tax liability | (428) | (226) |
| Changes in assets and liabilities: | | |
| Receivables | (8,858) | 3,697 |
| Inventories | (9,958) | (8,104) |
| Other current and non-current assets | 3,136 | 559 |
| Accounts payable | 8,771 | 1,167 |
| Income taxes, net | (11) | (7,410) |
| Other current and non-current liabilities | 5,692 | (7,799) |
| Net cash provided by operating activities | 55,724 | 40,834 |
| | | |
| **Cash flows from investing activities:** | | |
| Purchases of available-for-sale investments | (90,937) | (86,877) |
| Sales and maturities of available-for-sale investments | 116,891 | 94,232 |
| Purchases of property, plant and equipment | (2,820) | (5,330) |
| Note receivable from Apica | | (2,019) |
| Net cash provided by investing activities | 23,134 | 6 |
| | | |
| **Cash flows from financing activities:** | | |
| Payment of contingent consideration | (7,699) | (6,107) |
| Proceeds from stock option exercises | 23,463 | 2,867 |
| Proceeds from stock issued under employee stock purchase plan | 2,499 | 2,800 |
| Excess tax benefits from share-based compensation | 1,941 | 989 |
| Repurchase and retirement of common shares | (32,268) | (46,030) |
| Net cash used in financing activities | (12,064) | (45,481) |
| Effect of exchange rate changes on cash and cash equivalents | 5,317 | 271 |
| Net increase (decrease) in cash and cash equivalents | 72,111 | (4,370) |
| Net cash and cash equivalents at beginning of period | 72,814 | 139,099 |
| Net cash and cash equivalents at end of period | $ 144,925 | $ 134,729 |

| | | | | |
|---|---|---|---|---|
| **Supplemental disclosure of consolidated cash flow information:** | | | | |
| Cash paid for taxes | $ | 13,239 | $ | 24,206 |
| **Supplemental disclosure of consolidated non-cash investing and financing activities:** | | | | |
| Transfers of equipment from inventory | $ | 605 | $ | 1,012 |
| Repurchases and retirement of common shares through other accrued liabilities | $ | 312 | $ | 2,266 |
| Purchases of property, plant and equipment through accounts payable and accrued liabilities | $ | 221 | $ | 583 |

See notes to the unaudited condensed consolidated financial statements.

**THORATEC CORPORATION**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1. Operations and Significant Accounting Policies**

***Basis of Presentation***

The interim unaudited condensed consolidated financial statements of Thoratec Corporation ( we, our, us, or the Company ) have been prepared and presented in accordance with accounting principles generally accepted in the U.S. ( GAAP ) and the rules and regulations of the Securities and Exchange Commission ( SEC ), without audit, and reflect all adjustments necessary (consisting only of normal recurring adjustments) to present fairly our financial position, results of operations and cash flows as of and for the periods presented. Certain information and footnote disclosures normally included in our annual financial statements, prepared in accordance with GAAP, have been condensed or omitted. The accompanying financial statements should be read in conjunction with our consolidated financial statements, and the accompanying notes thereto, filed with the SEC in our Annual Report on Form 10-K for the fiscal year ended January 3, 2015 (the 2014 Annual Report ). The operating results for any interim period are not necessarily indicative of the results that may be expected for any future period.

The preparation of our unaudited condensed consolidated financial statements necessarily requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities on the unaudited condensed consolidated balance sheet dates and the reported amounts of revenues and expenses for the periods presented. Significant items subject to management s estimates include revenue recognition, the useful lives of property and equipment, allowance for doubtful accounts, valuation allowance for deferred tax assets, stock-based compensation, income tax uncertainties, valuation of goodwill and intangible assets, warranty accrual and contingent consideration. The actual amounts could differ from those estimated amounts.

***Recent Accounting Pronouncements***

In May 2014, the Financial Accounting Standards Board ( FASB ) issued Accounting Standard Update ( ASU ) No. 2014-09, *Revenue from Contracts with Customers* (Topic 606), which provides guidance for revenue recognition. This ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets. The guidance in this ASU supersedes the revenue recognition requirements in Topic 605, *Revenue Recognition*, and most industry-specific guidance. This ASU also supersedes some cost guidance included in Subtopic 605-35, *Revenue Recognition-Construction-Type and Production-Type Contracts*. On July 9, 2015, FASB voted to defer the effective date of this standard by one year to December 15, 2017. This standard will be effective for the Company starting in the fiscal year 2018. We are currently evaluating the impact of the adoption of this ASU on our condensed consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02, *Amendments to the Consolidation Analysis*. The new standard amends the guidelines for determining whether certain legal entities should be consolidated and reduces the number of consolidation models. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted. We are currently evaluating the impact, if any, of adopting this new accounting guidance on our condensed consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-11, *Simplifying the Measurement of Inventory.* The new standard amends the guidelines for the measurement of inventory from lower of cost or market to the lower of cost and net realizable value (NRV). NRV is defined as the estimated selling prices in the ordinary course of business less reasonably predictable costs of completion, disposal, and transportation. Under existing standards, inventory is measured at lower of cost or market, which requires the consideration of replacement cost, NRV, and NRV less an amount that approximates a normal profit margin. This ASU eliminates the requirement to determine and consider replacement cost or NRV less an approximately normal profit margin for inventory measurement. The new standard is effective prospectively beginning January 1, 2017, with early adoption permitted. We are currently evaluating the impact, if any, of adopting this new accounting guidance on our condensed consolidated financial statements.

**Note 2. Acquisitions**

We have accounted for our acquisitions as business combinations. In accordance with authoritative guidance on business combination accounting, the assets and liabilities of the acquired companies were recorded as of the acquisition date, at their respective fair values, and are consolidated within our condensed consolidated financial statements. The results of operations related to each company acquired have been included in our condensed consolidated statements of operations since the date each company was acquired. All acquisition-related costs are expensed and recorded in selling, general and administrative expenses in our condensed consolidated statement of operations for the periods presented.

Apica Acquisition in 2014

On July 2, 2014, we acquired all of the outstanding equity interests of Apica Cardiovascular Limited ( Apica ) and certain related subsidiaries from the former stockholders of Apica (the Apica Acquisition ). Under the terms of the Apica Acquisition, the initial purchase consideration was approximately $35.1 million (net of acquired cash and inclusive of the settlement of existing debt and Apica s direct acquisition-related transaction costs), and we will be obligated to make potential future milestone payments, based on regulatory approvals and commercial sales, of up to $40.0 million. Total purchase price allocation was estimated at $60.8 million at the acquisition date, including the initial purchase consideration of approximately $35.1 million and the estimated fair values for contingent consideration totaling $25.7 million, which was recorded as a non-current liability because such contingent consideration is expected to be settled no earlier than the third quarter of 2016. Prior to the acquisition, Apica was developing a surgical implantation system ( SIS ) to improve the apical access and attachment of the Left Ventricular Assist Device ( LVAD ) to the apex of the heart. We plan to couple the SIS with our HeartMate product line with the intention to obtain regional regulatory approvals for commercialization. In addition, Apica had developed the apical access, stabilization, and closure ( ASC ) device, which is commercially sold in Europe and is used for transapical valve procedures. We incurred $2.3 million of acquisition-related costs in connection with the Apica Acquisition in 2014.

The purchase price allocation as of the acquisition date (as adjusted) is summarized as follows (in thousands):

| | | |
|---|---|---|
| Current assets (excluding cash) | $ | 548 |
| Identifiable intangible assets: | | |
| Developed technology (ASC) | | 5,300 |
| IPR&D asset (SIS) | | 26,500 |
| Goodwill | | 31,491 |
| Total assets | | 63,839 |
| Less: Liabilities assumed | | 463 |
| Deferred tax liability | | 2,562 |
| Total estimated purchase price consideration | | 60,814 |
| Less: Contingent consideration | | 25,700 |
| Cash paid or payable at the acquisition closing | $ | 35,114 |

We recorded an IPR&D asset of $26.5 million, which represents an estimate of the fair value of the in-process technology related to the SIS device. The fair value of the IPR&D asset was determined using the multi-period excess earnings method which is equal to the present value of the incremental after-tax cash flows attributable to that intangible asset, using a discount rate of 23% based on our best estimate of a market participant s after-tax weighted average cost of capital. We also recorded an ASC intangible asset of $5.3 million, which represents the estimated fair value of the technology associated with the ASC device. The fair value of the ASC intangible asset was determined using the replacement cost method, which represents what a market participant s estimated cost would be to obtain or develop the technology in its current state. The replacement cost method was utilized because of limited market opportunities associated with the ASC technology. In the fourth quarter of 2014, we discontinued the commercialization of the ASC device and impaired the unamortized net book value associated with the ASC intangible asset.

Goodwill is calculated as the difference between the acquisition date fair value of the consideration transferred and the fair values assigned to the assets acquired, liabilities assumed, and primarily represents the expected synergies of Apica with our technologies. The goodwill of $31.5 million was allocated to our sole operating segment (Cardiovascular group) and is not deductible for income tax purposes.

The following pro forma information presents the combined results of operations for the six months ended June 28, 2014 as if we had completed the Apica acquisition at the beginning of 2013. The pro forma financial information is provided for comparative purposes only and is not

necessarily indicative of what actual results would have been had the acquisition occurred on the date indicated, nor does it give effect to synergies, cost savings, fair market value adjustments, immaterial depreciation expense and other changes expected to result from the acquisition. Accordingly, the pro forma financial results do not purport to be indicative of condensed consolidated results of operations as of the date hereof, for any period ended on the date hereof, or for any other future date or period.

| | Six months Ended June 28, 2014 |
|---|---|
| Product sales | $ 243,760 |
| Income before taxes | 49,793 |
| Net income | 33,579 |

Contingent Consideration

Our acquisition of Apica includes payments of future contingent consideration upon the achievement of certain regulatory approvals and commercial sales milestones. We determined the initial fair value of the contingent consideration in connection with the regulatory and commercial sales milestones using various estimates, including probabilities of success, discount rates and the estimated amount of time until the conditions of the milestone payments are met. This fair value measurement was based on significant inputs not observable in the market, representing a Level 3 measurement within the fair value hierarchy (see Note 3 for more information about fair value measurements). The key assumptions used to determine the fair value of the contingent consideration associated with the regulatory milestones at the acquisition dates included a discount rate and probability-adjusted milestone payment date ranges. The key assumptions used to determine the fair value of the contingent consideration associated with the commercial sales milestones at the acquisition dates included a discount rate and probability-weighted expected milestone payment date ranges based on the aggregate number of commercial units sold.

The fair value of recorded contingent consideration is re-measured at each reporting period with the change in fair value recognized within operating expense in our condensed consolidated statements of operations. We measure the liabilities on a recurring basis using Level 3 inputs. See Note 3 for further information regarding fair value measurements.

- In the first six months of 2015, the fair value of the Apica contingent consideration increased by $0.3 million, in which $0.31 million was reported as research and development ( R&D ) expense and ($0.01) million was reported as selling, general and administrative ( SG&A ) expense. The increase was primarily a result of accretion associated with the passage of time.

- We acquired certain assets and assumed certain liabilities from Terumo Corporation related to the DuraHeart II Left Ventricular Assist System product line ( DuraHeart II ) in June 2013. Under the terms of the DuraHeart II acquisition, the initial purchase consideration was $13.0 million and we will be obligated to make potential future milestone payments, based on regulatory approvals and product sales, of up to $43.5 million. In the first six months of 2015, the fair value of the DuraHeart II contingent consideration increased by $0.3 million (primarily reported as SG&A expense) as a result of a change in the discount rate and accretion associated with the passage of time. In the first six months of 2014, the fair value decreased by $3.2 million ($2.2 million reported as a reduction to R&D expense and $1.0 million reported as a reduction to SG&A expense) as a result of the changes in the probabilities of success and timing of when milestones were expected to be met.

- Our acquisition of the medical business of Levitronix LLC ( Levitronix Medical ) in August 2011 requires payments of future contingent consideration annually through August 2015, which is calculated as 36% of annual revenues above agreed upon revenue targets. In the first six months of 2015 and 2014, we paid $9.4 million and $7.0 million, respectively, related to the Levitronix Medical contingent consideration. In the first six months of 2015 and 2014, we recorded a re-measurement adjustment (increase) of $0.2 million and $1.7 million, respectively, which was reported as SG&A expense.

**Note 3. Fair Value Measurements**

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

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

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

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

We review the fair value hierarchy classification on a quarterly basis. Changes in the ability to observe valuation inputs may result in a reclassification of levels of certain securities within the fair value hierarchy. We recognize transfers into and out of levels within the fair value hierarchy in the period in which the actual event or change in circumstances caused the transfers to occur. There were no transfers between Level 1, Level 2 and Level 3 during either of the six months ended July 4, 2015 or June 28, 2014.

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

| | Total Fair Value | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| | | (in thousands) | | |
| **At July 4, 2015:** | | | | |
| Cash equivalents: | | | | |
| Money market funds | $ 131,198 | $ 131,198 | $ | $ |
| Corporate bonds | 2,006 | | 2,006 | |
| Municipal bonds | 3,063 | | 3,063 | |
| Short-term investments: | | | | |
| Municipal bonds | 86,358 | | 86,358 | |
| U.S. government agency securities | 6,900 | | 6,900 | |
| Corporate bonds | 22,419 | | 22,419 | |
| Commercial paper | 12,792 | | 12,792 | |
| Asset-backed securities | 573 | | 573 | |
| Prepaid expenses and other assets: | | | | |
| Foreign exchange contracts | 188 | | 188 | |
| Long-term investments: | | | | |
| Auction rate securities | 4,212 | | | 4,212 |
| Other long-term assets: | | | | |
| Investments included in our deferred compensation plan | 1,870 | | 1,870 | |
| Marketable equity securities | 1,451 | 1,451 | | |
| Other accrued liabilities: | | | | |
| Foreign exchange contracts | 611 | | 611 | |
| Contingent consideration (current and long-term portions) | $ 38,019 | $ | $ | $ 38,019 |

| | Total Fair Value | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| | | (in thousands) | | |
| **At January 3, 2015:** | | | | |
| Cash equivalents: | | | | |
| Money market funds | $ 34,742 | $ 34,742 | $ | $ |
| Commercial paper | 5,000 | | 5,000 | |
| Corporate bonds | 1,006 | | 1,006 | |
| Municipal bonds | 2,691 | | 2,691 | |
| Short-term investments: | | | | |
| Municipal bonds | 117,681 | | 117,681 | |
| U.S. government agency securities | 8,340 | | 8,340 | |
| Corporate bonds | 19,632 | | 19,632 | |
| Commercial paper | 10,297 | | 10,297 | |
| Asset-backed securities | 1,714 | | 1,714 | |
| Prepaid expenses and other assets: | | | | |
| Foreign exchange contracts | 3,759 | | 3,759 | |
| Long-term investments: | | | | |
| Auction rate securities | 4,239 | | | 4,239 |
| Other long-term assets: | | | | |
| | 1,552 | | 1,552 | |

| | | | | |
|---|---|---|---|---|
| Investments included in our deferred compensation plan | | | | |
| Marketable equity securities | 1,836 | 1,836 | | |
| Other accrued liabilities: | | | | |
| Foreign exchange contracts | 913 | | 913 | |
| Contingent consideration (current and long-term portions) | $ 46,558 | $ | $ | $ 46,558 |

Financial assets and liabilities are considered Level 2 when their fair values are determined using inputs that are observable in the market or can be derived principally from or corroborated by observable market data such as pricing for similar securities, recently executed transactions, cash flow models with yield curves, and benchmark securities. Our Level 2 financial assets and liabilities include short-term investments, foreign exchange instruments and certain of our deferred compensation plan securities. In addition, Level 2 financial instruments are valued using comparisons to like-kind financial instruments and models that use readily observable market data as their basis.

Financial assets and liabilities are considered Level 3 when their fair values are determined using pricing models, discounted cash flow methodologies, or similar techniques, and at least one significant model assumption or input is unobservable. Level 3 financial assets and liabilities include the following:

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

**Contingent liabilities** The fair value of the contingent consideration related to the acquisitions of Levitronix Medical, DuraHeart II and Apica requires significant management judgment and estimates. The fair value of each contingent consideration is re-measured at the end of each reporting period with the change in fair value recorded in operating expense on our condensed consolidated statements of operations. Actual amounts paid may differ from the obligations recorded. The fair value of the Levitronix Medical contingent consideration is calculated using the income approach, using various revenue assumptions and applying a probability to each scenario. The fair value of the DuraHeart II contingent consideration is calculated using the income approach, using various estimates, including probabilities of success, discount rate and the estimated amount of time until the conditions of the milestone payments are met. Refer to Note 2 for a discussion of the fair value of the contingent consideration associated with the Apica acquisition and further information regarding fair value measurements associated with the DuraHeart II acquisition.

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | | (in thousands) | | |
| **At July 4, 2015:** | | | | |
| Short-term investments: | | | | |
| Municipal bonds | $ 86,339 | $ 49 | $ (30) | $ 86,358 |
| U.S. government agency securities | 6,901 | | (1) | 6,900 |
| Corporate bonds | 22,440 | | (21) | 22,419 |
| Commercial paper | 12,792 | | | 12,792 |
| Asset-backed securities | 573 | | | 573 |
| Total short-term investments | $ 129,045 | $ 49 | $ (52) | $ 129,042 |
| Long-term investments: | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Auction rate securities | $ | 4,900 | $ | | $ | (688) | $ | 4,212 |
| Other long-term assets: | | | | | | | | |
| Marketable equity securities | | 2,996 | | | | (1,545) | | 1,451 |
| Total long-term | $ | 7,896 | $ | | $ | (2,233) | $ | 5,663 |
| **At January 3, 2015**: | | | | | | | | |
| Short-term investments: | | | | | | | | |
| Municipal bonds | $ | 117,614 | $ | 83 | $ | (16) | $ | 117,681 |
| U.S. government agency securities | | 8,341 | | | | (1) | | 8,340 |
| Corporate bonds | | 19,655 | | 1 | | (24) | | 19,632 |
| Commercial paper | | 10,297 | | | | | | 10,297 |
| Asset-backed securities | | 1,715 | | | | (1) | | 1,714 |
| Total short-term investments | $ | 157,622 | $ | 84 | $ | (42) | $ | 157,664 |
| Long-term investments: | | | | | | | | |
| Auction rate securities | $ | 4,900 | $ | | $ | (661) | $ | 4,239 |
| Other long-term assets: | | | | | | | | |
| Marketable equity securities | | 2,996 | | | | (1,160) | | 1,836 |
| Total long-term | $ | 7,896 | $ | | $ | (1,821) | $ | 6,075 |

As of July 4, 2015, our marketable equity securities have been in a continuous unrealized loss position for more than twelve months. We believe that the decline in fair value of the marketable equity securities below our cost basis is temporary and we intend to retain the securities for a sufficient period of time to allow for recovery in the market value of these investments.

Our deferred compensation plan includes our corporate owned life insurance policies and mutual fund investments. The underlying mutual fund investments are deemed trading securities. The mutual fund investments fair value and the cash surrender value of our corporate-owned life insurance policies are classified in the condensed consolidated balance sheets in Other long-term assets. The aggregate value of our deferred compensation plan assets as of July 4, 2015 and January 3, 2015 was $6.4 million and $6.0 million, respectively. The unrealized gain before tax from the change in the value of the deferred compensation plan was not significant in the six months ended July 4, 2015 and June 28, 2014.

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

| | Amortized Cost | Fair Value |
|---|---|---|
| | (in thousands) | |
| **At July 4, 2015:** | | |
| Maturing within 1 year | $ 80,742 | $ 80,746 |
| Maturing after 1 year through 5 years | 48,303 | 48,296 |
| Short-term available-for-sale investments | 129,045 | 129,042 |
| Maturing after 5 years | 4,900 | 4,212 |
| | $ 133,945 | $ 133,254 |

The following table provides a roll forward of the fair value, as determined by Level 3 inputs, of the auction rate securities during the first six months of 2015:

| | Auction Rate Securities (in thousands) |
|---|---|
| Balance as of January 3, 2015 | $ 4,239 |
| Unrealized holding loss on auction rate securities, included in other comprehensive income | (27) |
| Balance as of July 4, 2015 | $ 4,212 |

The following table provides a roll forward of the fair value, as determined by Level 3 inputs, of contingent consideration during the first six months of 2015:

| | Contingent Consideration (in thousands) |
|---|---|
| Balance as of January 3, 2015 | $ 46,558 |
| Payments | (9,357) |
| Change in fair value | 818 |
| Balance as of July 4, 2015 | $ 38,019 |

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The following table presents quantitative information about the inputs and valuation methodologies used for our fair value measurements classified in Level 3 of the fair value hierarchy at July 4, 2015 and January 3, 2015:

| | Fair Value at July 4, 2015 (in thousands) | Valuation Methodology | Significant Unobservable Input | Weighted Average (range, if applicable) |
|---|---|---|---|---|
| Auction rate securities | $ 4,212 | Discounted cash flow | Discount rate | 1.64% |
| | | | Market credit spread | 2.95% |
| | | | Liquidity factor | 0% |
| Levitronix Medical Contingent consideration | $ 5,782 | Multiple outcome discounted cash flow | Revenue | $30.0 million |
| DuraHeart II Contingent consideration | $ 5,501 | Multiple outcome discounted cash flow | Milestone dates | 2017 to 2026 |
| | | | Discount rate | 5.26% to 25% |
| | | | Percent probabilities assigned to scenarios | 5% to 67% |
| Apica Contingent consideration | $ 26,736 | Multiple outcome discounted cash flow | Milestone dates | 2016 to 2020 |
| | | | Discount rate | 5.26% |
| | | | Percent probabilities assigned to scenarios | 7.5% to 30% |

| | Fair Value at January 3, 2015 (in thousands) | Valuation Methodology | Significant Unobservable Input | Weighted Average (range, if applicable) |
|---|---|---|---|---|
| Auction rate securities | $ 4,239 | Discounted cash flow | Discount rate | 1.61% |
| | | | Market credit spread | 2.83% |
| | | | Liquidity factor | 0% |
| Levitronix Medical Contingent consideration | $ 14,902 | Multiple outcome discounted cash flow | Revenue | $29.4 million for fiscal year 2015; $50.0 million for fiscal year 2014 |
| DuraHeart II Contingent consideration | $ 5,189 | Multiple outcome discounted cash flow | Milestone dates | 2017 to 2026 |
| | | | Discount rate | 4.63% to 22.5% |
| | | | Percent probabilities assigned to scenarios | 5% to 67% |
| Apica Contingent consideration | $ 26,467 | Multiple outcome discounted cash flow | Milestone dates | 2016 to 2020 |
| | | | Discount rate | 4.63% |
| | | | Percent probabilities assigned to scenarios | 7.5% to 30% |

*Auction Rate Securities*

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

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

*Contingent Consideration*

The fair values of contingent consideration are measured using projected payment dates, discount rates, probabilities of payments, and projected revenues (for revenue-based considerations). Projected contingent payment amounts are discounted back to the current period using a discounted cash flow model. A significant increase (decrease) in the projected revenue in isolation could result in a significantly higher (lower) fair value measurement; a significant delay (acceleration) in the product development (including projected regulatory milestone) achievement date in isolation could result in a significantly lower (higher) fair value measurement; a significant increase (decrease) in the discount rate in isolation could result in a significantly lower (higher) fair value measurement; and the changes in the probability of occurrence between the outcomes in isolation could result in a significant change in fair value measurement.

The fair values of the contingent consideration are calculated on a quarterly basis by management based on a collaborative effort of our regulatory, research and development, operations, finance and accounting groups, as appropriate. Potential valuation adjustments are made as additional information becomes available, including the progress toward achieving revenue and milestone targets as compared to initial projections, the impact of market competition and changes in actual and projected product mix and average selling price, with the impact of such adjustments being recorded in the consolidated statements of operations.

*Assets and Liabilities That Are Measured at Fair Value on a Nonrecurring Basis*

Non-marketable equity investments and non-financial assets, such as goodwill, intangible assets, and property, plant, and equipment (measured at fair value if a write-down is recognized) are evaluated for impairment annually or when indicators of impairment exist. Non-financial assets such as identified intangible assets acquired in connection with our acquisitions are measured at fair value using Level 3 inputs, which include discounted cash flow methodologies, or similar techniques, when there is limited market activity and the determination of fair value requires significant judgment and estimates. In addition, in evaluating the fair value of goodwill impairment, further corroboration is obtained using our market capitalization. No impairment was recorded in either the six months ended July 4, 2015 or June 28, 2014.

**Note 4. Foreign Exchange Instruments**

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

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

| | July 4, 2015 | January 3, 2015 |
|---|---|---|
| Forward contracts: | | |
| Euro (sell) | 11.4 million | 15.8 million |

| | | | | |
|---|---|---|---|---|
| British Pound Sterling (sell) | £ | 1.3 million | £ | 1.5 million |
| U.S. Dollar (sell) | $ | 40.8 million | $ | 21.2 million |
| U.S. Dollar (buy) | $ | 76.8 million | $ | 59.0 million |

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

| | As of July 4, 2015 | | As of January 3, 2015 | |
|---|---|---|---|---|
| | Prepaid expenses and other assets | Other accrued liabilities | Prepaid expenses and other assets | Other accrued liabilities |
| | (in thousands) | | | |
| Derivatives not designated as hedging instruments (forward contracts) | $ 188 | $ 611 | $ 3,759 | $ 913 |

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| | (in thousands) | | | |
| Foreign currency exchange gain (loss) on foreign contracts | $ (1,547) | $ (420) | $ 7,943 | $ (67) |
| Foreign currency transactions gain (loss) | 1,887 | 291 | (7,383) | (119) |

**Note 5. Balance Sheet and Statement of Operations Information**

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

Inventories consisted of the following:

| | July 4, 2015 | January 3, 2015 |
|---|---|---|
| | (in thousands) | |
| Finished goods | $ 27,457 | $ 24,871 |
| Work in process | 22,944 | 18,135 |
| Raw materials | 20,458 | 19,198 |
| Total | $ 70,859 | $ 62,204 |

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

| | July 4, 2015 | January 3, 2015 |
|---|---|---|
| | (in thousands) | |
| Land, building and improvements | $ 20,600 | $ 20,600 |
| Equipment and capitalized software | 57,295 | 56,696 |
| Furniture and leasehold improvements | 26,473 | 25,710 |
| Total | 104,368 | 103,006 |
| Less accumulated depreciation | (54,997) | (51,775) |
| Total | $ 49,371 | $ 51,231 |

As of July 4, 2015, we have $1.6 million of equipment from the DuraHeart II acquisition which is expected to be placed in service in 2015 and is included in the Equipment and capitalized software line in the table above.

Depreciation expense was $2.3 million and $4.6 million for the three and six months ended July 4, 2015, respectively, and $2.3 million and $4.4 million for the three and six months ended June 28, 2014, respectively.

Warranty and related costs are accrued for based on our best estimates when management determines that it is probable a charge or liability has been incurred and the amount of loss can be reasonably estimated. Warranty and related accruals and the changes in the balances for the six months ended July 4, 2015 and June 28, 2014 were as follows:

| | July 4, 2015 | June 28, 2014 |
|---|---|---|
| | (in thousands) | |
| Balance, beginning of the period | $ 10,639 | $ 9,899 |
| Additions | 2,480 | 1,710 |
| Change in estimate | 614 | |
| Settlements | (5,085) | (2,258) |
| Balance, end of the period | $ 8,648 | $ 9,351 |

Changes in Accumulated Other Comprehensive Loss by component during the six months ended July 4, 2015:

| | Foreign currency items (A) | Unrealized gain (loss) on available-for-sale securities (A) | Total |
|---|---|---|---|
| | | (in thousands) | |
| Balance as of January 3, 2015 | $ (20,781) | $ (1,241) | $ (22,022) |
| Other comprehensive loss before reclassification | 4,396 | (274) | 4,122 |
| Net current period other comprehensive loss | 4,396 | (274) | 4,122 |
| Balance as of July 4, 2015 | $ (16,385) | $ (1,515) | $ (17,900) |

(A) All amounts are net of tax.

Items included in Other accrued liabilities on our consolidated balance sheets that are in excess of 5% of total current liabilities are as follows:

| | July 4, 2015 | January 3, 2015 |
|---|---|---|
| | (in thousands) | |
| Deferred revenue | $ 7,066 | $ 5,063 |

Interest income and other consisted of the following:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| | (in thousands) | | | |
| Interest income | $ 177 | $ 201 | $ 325 | $ 425 |
| Foreign currency, net | 340 | (130) | 560 | (187) |
| Other | 170 | 488 | 619 | 568 |
| Total interest income and other | 687 | 559 | 1,504 | 806 |

**Note 6. Goodwill and Purchased Intangible Assets, net**

The carrying amount of goodwill and the changes in the balance for the six months ended July 4, 2015 were as follows (in thousands):

| | |
|---|---|
| Balance as of January 3, 2015 | $ 225,293 |
| Foreign currency translation impact | 1,285 |
| Balance as of July 4, 2015 | $ 226,578 |

Intangible assets (net of accumulated amortization and impairment) were as follows:

| | At July 4, 2015 | | | |
|---|---|---|---|---|
| | Gross Amount | Accumulated Amortization | Accumulated Impairment | Net Amount |
| | (in thousands) | | | |
| *Intangible assets subject to amortization:* | | | | |
| Patents and trademarks | $ 43,532 | $ (36,782) | $ | $ 6,750 |
| Core technology | 37,180 | (24,063) | (12,642) | 475 |
| Developed technology | 133,373 | (86,721) | (42,079) | 4,573 |
| Customer based relationships and other | 7,243 | (6,046) | | 1,197 |
| Pre-existing license agreement | 2,300 | (1,287) | | 1,013 |
| Foreign currency translation impact | 95 | | | 95 |
| | 223,723 | (154,899) | (54,721) | 14,103 |
| *Intangible assets not yet subject to amortization:* | | | | |
| DuraHeart II IPR&D | 12,400 | | (7,700) | 4,700 |
| Apica VAD Tool IPR&D | 26,500 | | | 26,500 |

| | | | | |
|---|---|---|---|---|
| Foreign currency translation impact | | | | (4,990) |
| Total intangible assets | $ 257,633 | $ (154,899) | $ (62,421) | $ 40,313 |

| | At January 3, 2015 | | | |
|---|---|---|---|---|
| | **Gross Amount** | **Accumulated Amortization** | **Accumulated Impairment** | **Net Amount** |
| *Intangible assets subject to amortization:* | | | | |
| Patents and trademarks | $ 43,532 | $ (36,095) | $ | $ 7,437 |
| Core technology | 37,180 | (23,854) | (12,642) | 684 |
| Developed technology | 133,373 | (85,613) | (42,079) | 5,681 |
| Customer based relationships and other | 7,243 | (5,569) | | 1,674 |
| Pre-existing license agreement | 2,300 | (1,123) | | 1,177 |
| Foreign currency translation impact | (411) | | | (411) |
| | 223,217 | (152,254) | (54,721) | 16,242 |

| | | | | |
|---|---|---|---|---|
| *Intangible assets not yet subject to amortization:* | | | | |
| DuraHeart II IPR&D | 12,400 | | (7,700) | 4,700 |
| Apica VAD Tool IPR&D | 26,500 | | | 26,500 |
| Foreign currency translation impact | (2,954) | | | (2,954) |
| Total intangible assets | $ 259,163 | $ (152,254) | $ (62,421) | $ 44,488 |

Amortization expense related to identifiable intangible assets was $1.2 million and $2.4 million for the three and six months ended July 4, 2015, respectively, and $1.9 million and $3.8 million for the three and six months ended June 28, 2014, respectively.

Estimated amortization expenses for the next five fiscal years and all years thereafter, excluding intangible assets not yet subject to amortization are as follows:

| | (in thousands) |
|---|---|
| **Fiscal year:** | |
| Remainder of 2015 | $ 2,306 |
| 2016 | 3,392 |
| 2017 | 2,520 |
| 2018 | 2,106 |
| 2019 | 1,712 |
| Thereafter | 2,067 |
| Total | $ 14,103 |

**Note 7. Credit Facility**

On December 19, 2011, we signed an unsecured revolving credit facility agreement that provides for up to $50.0 million revolving credit that will expire on December 19, 2016. The interest rate charged on the amounts borrowed is LIBOR plus a margin (ranging from 0.75% to 1.25%). The agreement contains financial covenants with which we were in compliance as of July 4, 2015. The credit agreement permits us to use the facility for working capital and general corporate purposes. We did not have any borrowings under this credit facility during the six months ended July 4, 2015 or June 28, 2014.

**Note 8. Legal Proceeding**

*Legal Proceedings*

From time to time we are involved in litigation arising out of claims in the normal course of business. Based on the information presently available, management believes that there are no claims or actions pending or threatened against us, the ultimate resolution of which will have a material effect on our financial position, liquidity or results of operations, although the results of litigation are inherently uncertain.

*Purported Shareholder Class Action, filed January 2014*

On January 24, 2014, we and three of our present and former officers were named as defendants in a putative shareholder class action entitled Cooper v. Thoratec Corp., Case No. 4:14-cv-00360, filed in the United States District Court for the Northern District of California. The action asserts violations of Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act ), and Rule 10b-5 promulgated thereunder, as well as Section 20(a) of the Exchange Act. On April 21, 2014, the Court appointed Bradley Cooper as Lead Plaintiff. On June 20, 2014, Mr. Cooper filed an amended class action complaint ( Amended Complaint ), adding a former officer of the Company as a defendant. The Amended Complaint alleged that during proposed class period (April 29, 2010 to November 27, 2013, inclusive), Defendants made false or misleading statements in various SEC filings, press releases, earnings calls, and healthcare conferences regarding the Company s business and outlook, focusing primarily on Defendants alleged failure to disclose that there was a purported, known increase in the rate of pump thrombosis for patients using the HeartMate II Left Ventricular Assist Device during the proposed class period. Plaintiff sought unspecified damages, among other relief. Defendants filed a motion to dismiss the Amended Complaint for failure to state a claim on August 19, 2014, which the Court granted in its entirety with leave to amend on November 26, 2014. Plaintiff filed a second amended complaint on January 20, 2015 (the Second Amended Complaint ). In the Second Amended Complaint, Plaintiff amended the class period from May 11, 2011 to August 6, 2014, inclusive, dropped a former officer of the Company as a defendant, and added Plaintiff Todd Labak, who is intended to replace Mr. Cooper as the Lead Plaintiff because Mr. Cooper no longer has Thoratec stock purchases within the proposed class period, among other changes. On March 23, 2015, Defendants filed a motion to dismiss the Second Amended Complaint for failure to state a claim. The motion to dismiss is now fully briefed and the parties are awaiting a ruling by the Court.

*Purported Shareholder Class Action Lawsuit, filed July 2015*

On July 23, 2015, the Company and its directors were named as defendants in a purported class action shareholder lawsuit entitled Solak v. Grossman, which was filed in the Superior Court of California, County of Alameda in connection with our entrance into the Merger Agreement (as defined below) with St. Jude Medical, Inc. and certain other parties named therein. The lawsuit generally alleges that the members of our Board of Directors breached their fiduciary duties in negotiating and approving the Merger Agreement, that the Merger Agreement undervalues the Company, that our stockholders will not receive adequate or fair value for their common stock in the Merger (as defined below), and that the terms of the Merger Agreement impose improper deal protection terms that preclude competing offers.

Plaintiffs seek, among other things, to declare that the action is properly maintainable as a class action and to enjoin the Company from consummating the proposed Merger in the manner provided for by the Merger Agreement. Plaintiffs further seek unspecified money damages, costs and attorneys and experts fees. See also Note 14 titled *Subsequent Events* for a more detailed discussion of the Merger Agreement.

Although the results of litigation are inherently uncertain, based on the information currently available, we do not believe the ultimate resolution of the above named actions will have a material effect on our financial position, liquidity or results of operations.

**Note 9. Share-Based Compensation**

Our Amended and Restated 2006 Incentive Stock Plan ( 2006 Plan ) permits the issuance of stock options ( options ), restricted stock units ( RSUs ), performance share units ( PSUs ) and other types of awards to employees, directors, and consultants. As of July 4, 2015, approximately 3.2 million shares remained available for future issuance under the 2006 Plan, which assumes that PSUs will convert at 100% of target.

Share-based compensation consisted of the following:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| | (in thousands) | | | |
| Cost of product sales | $ 675 | $ 756 | $ 1,458 | $ 1,377 |
| Selling, general and administrative expenses | 6,198 | 4,794 | 12,855 | 8,819 |
| Research and development | 2,580 | 2,283 | 4,537 | 4,419 |
| Total share-based compensation expense before taxes | 9,453 | 7,833 | 18,850 | 14,615 |
| Tax benefit for share-based compensation expense | 3,141 | 2,731 | 6,101 | 5,003 |
| Total share-based compensation (net of taxes) | $ 6,312 | $ 5,102 | $ 12,749 | $ 9,612 |

***Stock Options***

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 | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| Risk free interest rate (weighted average) | 1.50% | 2.21% | 1.52% | 2.19% |
| Expected volatility | 35% | 35% | 37% | 37% |
| Expected option term (years) | 5.60 | 5.88 | 5.14 to 5.82 | 4.54 to 5.04 |
| Dividends | None | None | None | None |

Stock option activity is summarized as follows:

| | Number of Options (in thousands) | | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contract Life (years) |
|---|---|---|---|---|
| Outstanding options as of January 3, 2015 | 2,737 | $ | 31.04 | 6.95 |
| Granted | 211 | | 41.22 | |
| Exercised | (802) | | 29.25 | |
| Forfeited or expired | (62) | | 35.83 | |
| Outstanding options as of July 4, 2015 | 2,084 | | 32.61 | 7.31 |
| Outstanding options exercisable as of July 4, 2015 | 933 | | 29.82 | 5.77 |
| Outstanding options vested as of July 4, 2015 and expected to vest | 1,992 | $ | 32.48 | 7.24 |

As of July 4, 2015, there was $8.3 million of unrecognized compensation expense, net of estimated forfeitures, related to options, which expense we expect to recognize over a weighted average period of 1.59 years. The weighted average grant-date fair value of options granted in the first six months of 2015 was $14.22 per share.

***Restricted Stock Units***

Restricted stock unit activity is summarized as follows:

| | Number of Units (in thousands) | Weighted Average Grant-Date Fair Value | Weighted Average Remaining Contract Life (in years) |
|---|---|---|---|
| Outstanding units as of January 3, 2015 | 1,573 | $ 33.31 | 1.36 |
| Granted | 654 | 41.06 | |
| Released | (500) | 33.33 | |
| Forfeited or expired | (127) | 34.82 | |
| Outstanding units as of July 4, 2015 | 1,600 | $ 36.35 | 1.68 |

As of July 4, 2015, there was $48.8 million of unrecognized compensation expense, net of estimated forfeitures, related to RSUs, which amount we expect to recognize over 2.74 years.

***Performance Share Units***

We issue PSUs representing hypothetical shares of our common stock. Each PSU reflects multiple shares that may be issued to the award recipient, with the number of shares to be issued determined based on performance and market conditions (referred to as either a Performance Condition PSU or a Market Condition PSU ). The actual number of shares the recipient receives at the end of a performance period may range from 0% up to 200% of the target shares granted. Recipients generally must remain employed by us on a continuous basis through the end of the applicable performance period in order to receive shares subject to that award. The stock-based compensation costs for these PSUs, net of estimated forfeitures, are recorded over the three- or four-year vesting period based on a graded accelerated vesting method.

With respect to Performance Condition PSUs, any change in estimates affecting the number of shares to be issued upon vesting of the PSUs would be accounted for as a cumulative adjustment to the compensation expense in the period in which the change occurs. In 2014, we issued approximately 69,000 Performance Condition PSUs and we expect that no shares will be issuable under such PSU s based on a change in management s estimate in 2014. There was no change in estimate in first six months of 2015.

On September 22, 2014, we granted approximately 188,000 Market Condition PSUs to our President and Chief Executive Officer. In the first quarter of 2015, we granted approximately 115,000 Market Condition PSUs to certain employees of the Company. Share-based compensation expense related to all Market Condition PSUs was $1.3 million and $1.9 million in the three and six months ended July 4, 2015, respectively. As of July 4, 2015, we had $9.9 million of unrecognized compensation expense, net of estimated forfeitures, which we expect to recognize over a weighted average period of 2.07 years.

**Note 10. Common and Preferred Stock**

On December 5, 2013, the Board of Directors authorized a program to repurchase up to $200.0 million of our shares of common stock ( December 2013 program ), which will expire on December 31, 2015. In the three and six months ended July 4, 2015, we repurchased $4.6 million and $22.9 million, respectively, of shares of our common stock under the December 2013 program, of which $0.3 million was unsettled and accrued in our condensed consolidated balance sheet as of July 4, 2015. As of July 4, 2015, $72.1 million was available for repurchases of shares of our common stock under the December 2013 program. The December 2013 program may be accelerated, suspended, delayed or discontinued at any time.

We are incorporated in California, and as California law does not recognize treasury stock, the shares repurchased decreased the common shares outstanding. We recorded the $22.9 million of shares repurchased in the six months ended July 4, 2015 by reducing the additional paid-in capital ( APIC ) balance by the average value per share reflected in the account prior to the repurchase and allocating the excess as a reduction of retained earnings. Based on this allocation, APIC decreased by $8.0 million and retained earnings decreased by $14.9 million.

We also purchased shares of our common stock that were not part of our publicly announced repurchase program, which represent the surrender value of shares of restricted stock units withheld in order to satisfy tax withholding obligations upon vesting. The shares purchased do not reduce the dollar value that may yet be purchased under our publicly announced repurchase programs. The aggregate value of shares purchased in the six months ended July 4, 2015 was $6.0 million, which decreased APIC and retained earnings by $1.9 million and $4.1 million, respectively, based on the same allocation methodology discussed above.

**Note 11. Income Taxes**

During the first quarter of fiscal 2015, we recorded a $2.3 million out-of-period adjustment to income tax expense related to the overstatement of certain tax benefits from 2011 to 2014. The adjustment was not considered material to the financial statements for the six month period ended July 4, 2015, or any previously issued interim or annual consolidated financial statements.

Our effective income tax rates for the three months ended July 4, 2015 and June 28, 2014 were 30.4% and 32.5%, respectively. Our effective income tax rates for the six months ended July 4, 2015 and June 28, 2014 were 36.4% and 32.6%, respectively. For the three months ended July 4, 2015, the decrease is primarily due to a higher mix of income generated in lower tax rate jurisdictions. For the first six months of 2015, the increase is primarily due to the out-of-period adjustment discussed above and was partially offset by a higher mix of income generated in lower tax rate jurisdictions.

During the next 12 months, it is reasonably possible that audit resolutions and the expiration of statutes of limitations could reduce our unrecognized tax benefits by up to $1.5 million. However, this amount may be subject to change as a result of final determinations by taxing authorities throughout the year.

**Note 12. Segment and Geographic Information**

We have one operating segment and, and therefore, one reportable segment which develops, manufactures and markets proprietary medical devices used for mechanical circulatory support for the treatment of heart failure patients. Our chief operating decision-maker reviews financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance, accompanied by disaggregated revenue information by product line. We do not assess the performance of our individual product lines on measures of profit or loss, or asset-based metrics. Therefore, the information below is presented only for revenues by product line, geography, and certain revenue category.

Product sales attributed to a country or region include product sales to hospitals, physicians and distributors and are based on final destinations where the products are sold. No individual customer or individual country outside of the U.S. accounted for more than 10% of product sales during the three and six months ended July 4, 2015 or during the three and six months ended June 28, 2014.

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| | (in thousands) | | | |
| Product sales by geographic location: | | | | |

| | | | | |
|---|---|---|---|---|
| Domestic | $ 104,293 | $ 94,172 | $ 200,386 | $ 189,777 |
| International | 24,399 | 23,891 | 49,614 | 53,983 |
| Total | $ 128,692 | $ 118,063 | $ 250,000 | $ 243,760 |

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| | (in thousands) | | | |
| Product sales by product line: | | | | |
| HeartMate | $ 113,684 | $ 101,975 | $ 218,740 | $ 211,986 |
| CentriMag | 13,373 | 13,111 | 27,215 | 26,105 |
| PVAD and IVAD | 815 | 2,497 | 2,546 | 4,749 |
| Other | 820 | 480 | 1,499 | 920 |
| Total | $ 128,692 | $ 118,063 | $ 250,000 | $ 243,760 |

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| | (in thousands) | | | |
| Product sales by category: | | | | |
| Pump | $ 93,042 | $ 81,583 | $ 179,938 | $ 170,883 |
| Non-Pump | 34,830 | 36,000 | 68,563 | 71,957 |
| Other | 820 | 480 | 1,499 | 920 |
| Total | $ 128,692 | $ 118,063 | $ 250,000 | $ 243,760 |

**13. Net Income Per Share**

We calculate basic earnings per share ( EPS ) using net earnings and the weighted-average number of shares outstanding during the reporting period. Diluted EPS includes any dilutive effect of outstanding options and RSUs. PSUs are excluded from the shares used to compute diluted EPS until the performance conditions associated with the PSUs are met.

The reconciliations of the numerators and denominators of each of the basic and diluted EPS calculations were as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| | (in thousands, except per share data) | | | |
| Numerator: | | | | |
| Net Income | $ 13,248 | $ 17,413 | $ 24,028 | $ 35,652 |
| | | | | |
| Denominator: | | | | |
| Weighted average shares used to compute basic EPS | 54,481 | 56,723 | 54,246 | 56,781 |
| Dilutive effect of share-based compensation plans | 780 | 465 | 909 | 757 |
| Weighted average shares used to compute diluted EPS | 55,261 | 57,188 | 55,155 | 57,538 |
| | | | | |
| Net income per share: | | | | |
| Basic | $ 0.24 | $ 0.31 | $ 0.44 | $ 0.63 |
| Diluted | $ 0.24 | $ 0.30 | $ 0.44 | $ 0.62 |

Potential common share equivalents excluded where the inclusion would be anti-dilutive are as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| | (in thousands) | | | |
| Options to purchase shares not included in the computation of diluted net income per share because their inclusion would be anti-dilutive | 184 | 461 | 257 | 749 |

**14. Subsequent Event**

On July 21, 2015, the Company, St. Jude Medical, Inc., a Minnesota corporation ( St. Jude Medical ), and Spyder Merger Corporation, a California corporation and a wholly-owned subsidiary of St. Jude Medical ( Merger Sub ), entered into an Agreement and Plan of Merger (the Merger Agreement ), pursuant to which Merger Sub will, subject to the satisfaction or waiver of the conditions set forth in the Merger Agreement, merge with and into the Company, and the Company will survive the merger and continue as a wholly-owned subsidiary of St. Jude Medical (the Merger ). All issued and outstanding shares of Company stock immediately prior to the effective time of the Merger (the Effective Time ) will be cancelled and converted into the right to receive the merger consideration specified therein, in each case upon the terms and subject to the conditions set forth in the Merger Agreement.

Under the terms of the Merger Agreement, the Company s shareholders will receive $63.50 in cash, without interest, for each share of the Company s common stock they own at the Effective Time. The transaction is conditioned upon, among other things, Company shareholder approval, regulatory approvals and other customary closing conditions. The Merger Agreement includes customary representations, warranties and covenants of the Company and St. Jude Medical. The Company has agreed to operate its business and the business of its subsidiaries in the ordinary course of business consistent with past practices through the Effective Time. The transaction is expected to be completed in the fourth quarter of 2015.

The Merger Agreement includes a go-shop period, during which the Company will actively solicit alternative proposals from third parties for a period of 30 days from the date of the Merger Agreement continuing through August 20, 2015. The Merger Agreement provides for the Company to pay a termination fee of approximately $30 million to St. Jude Medical if the Company terminates the Merger Agreement in connection with a superior proposal that arises during the go-shop period and a termination fee of approximately $111 million if the Company terminates the Merger Agreement in connection with a superior proposal that arises following the go-shop period. See also Note 8 titled *Legal Proceedings* *Purported Shareholder Class Action Lawsuit, filed July 2015* for a discussion on litigation related to the proposed Merger.

**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, believes, intends, should, estimate, will, would, 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 2014 Annual Report on Form 10-K 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 a 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 mechanical circulatory support ( MCS ) for the treatment of heart failure ( HF ) patients. For chronic circulatory support for HF patients, our primary product lines are our ventricular assist devices ( VADs ): HeartMate II Left Ventricular Assist System ( HeartMate II ), HeartMate III Left Ventricular Assist System ( HeartMate III ), and Thoratec Paracorporeal Ventricular Assist Device ( PVAD ). We refer to HeartMate II and HeartMate III collectively as the HeartMate product line and PVAD as the Thoratec product line. For acute circulatory support, our product lines are CentriMag Acute Circulatory System ( CentriMag ) and for pediatric patients PediMag/PediVAS Acute Circulatory System ( PediMag/PediVAS ). HeartMate II, PVAD, IVAD, CentriMag and PediMag/PediVAS are approved by the U.S. Food and Drug Administration ( FDA ), and have received Conformité Européene ( CE ) Mark approval in Europe.

MCS devices supplement the pumping function of the heart in patients with 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 MCS devices. Some of our devices can also provide support for the right side of the heart.

HeartMate III, a centrifugal-flow, chronic, left ventricular assist system, is currently in U.S. Investigational Device Exemption ( IDE ) and Conformité Européene Mark clinical trials and has not yet been approved for commercial sales. The HeartMate III U.S. clinical trial is a randomized non-inferiority study comparing HeartMate III with HeartMate II and includes a primary endpoint of survival free of device replacement and debilitating stroke. In 2014, the trial began enrollment in a safety phase under conditional approval from the FDA for 30 patients at five sites. In early 2015, enrollment broadened up to 60 sites following full approval from the FDA based on 30-day follow-up data from the initial safety phase. The trial provides that the first 294 randomized patients will be followed for six months to evaluate a short-term

indication such as Bridge-to-Transplantation. The first 366 randomized patients will be followed for 24 months to evaluate a long-term indication such as Destination Therapy. The trial also allows for approximately 600 additional randomized patients to be enrolled beyond the pivotal cohort in order to assess secondary endpoints. In 2014, fifty patients were enrolled in the CE Mark trial at ten locations in Europe, Central Asia, Canada and Australia. The CE Mark trial evaluates patient six month survival, which was reached in May 2015. HeartMate III, which incorporates a fully magnetically levitated technology foundation, is designed to lower adverse event rates through improved hemocompatibility and to enhance the ease of surgical placement through a compact size.

Our product portfolio of commercially approved implantable and external MCS devices is described below.

***HeartMate II***

HeartMate II is an implantable, electrically powered, continuous flow, left ventricular assist device ( LVAD ) consisting of a rotary blood pump designed to provide intermediate and long-term MCS. HeartMate II is designed to improve survival and quality of life for a broad range of advanced HF patients. Significantly smaller than our previous generation device and with only one moving part, HeartMate II is simpler and designed to operate more quietly than pulsatile devices.

HeartMate II received FDA approval in April 2008 for bridge-to-transplantation ( BTT ) and received FDA approval for use in HF patients who are not eligible for heart transplantation ( Destination Therapy or DT ) in January 2010. In November 2005, we completed the required conformity assessment procedure and design dossier reviews to be given authority from our Notified Body to affix the CE Mark to the HeartMate II for marketing in Europe. HeartMate II is the world s most widely used LVAD.

***CentriMag***

The CentriMag is an extracorporeal circulatory support device that provides hemodynamic stabilization in patients in need of cardiopulmonary support. The CentriMag Pump is electronically driven, centrifugal pump based on bearingless motor technology. CentriMag is 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 an FDA humanitarian device exemption ( HDE ) 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. The device is marketed in Europe to provide support for up to thirty days for both cardiac and respiratory failure.

***PediMag/PediVAS***

PediMag and PediVAS are identical, extracorporeal full-flow acute surgical support platforms incorporating a polycarbonate pump, based on magnetically levitated bearingless motor technology, designed to provide acute surgical support to pediatric patients. The brand names differ according to indication for use, duration of support, and regulatory approval. PediMag is cleared by the FDA for use, in conjunction with the CentriMag console and motor, for support periods of up to six hours. Outside the U.S., the device is branded as PediVAS. This device has been CE Marked for marketing in Europe to provide support for up to 30 days for both cardiac and respiratory failure.

***PVAD***

PVAD is an external, pulsatile VAD, FDA-approved for BTT and post-cardiotomy myocardial recovery. PVAD is a paracorporeal device that is less invasive than implantable VADs since only the cannulae are implanted. The paracorporeal nature of PVAD provides several benefits including shorter implantation times and the ability to use the device in smaller patients.

PVAD is designed for short-to-intermediate duration for post-cardiotomy myocardial recovery following cardiac surgery and BTT. PVAD and IVAD, described below, offer left, right or biventricular support for use for BTT. This characteristic is significant because the vast majority of

BTT patients treated with PVAD and IVAD require right as well as left-side ventricular assistance. PVAD and IVAD are also the only devices approved for both BTT and recovery following cardiac surgery. PVAD incorporates our proprietary biomaterial, Thoralon, which has high tissue and blood compatibility and is resistant to blood clots.

PVAD received FDA approval for BTT in December 1995 and for recovery (post-cardiotomy) in May 1998. In June 1998, we completed the required conformity assessment procedure and design dossier reviews to be given authority from our Notified Body to affix the CE Mark to the PVAD, allowing for its commercial sale in Europe.

**Critical Accounting Policies and Estimates**

Our unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Preparation of these statements requires management to make judgments and estimates. Some accounting policies have a significant impact on amounts reported in these financial statements. A summary of significant accounting policies and a description of accounting policies that are considered critical may be found in our 2014 Annual Report on Form 10-K, in the Notes to the Consolidated Financial Statements (Note 1) and the Critical Accounting Policies and Estimates section in Management s Discussion and Analysis of Financial Condition and Results of Operations. There have been no changes in these significant accounting policies during the six months ended July 4, 2015.

**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 | | | | Six Months Ended | | | |
|---|---|---|---|---|---|---|---|---|
| | July 4, 2015 | | June 28, 2014 | | July 4, 2015 | | June 28, 2014 | |
| | (in thousands, except for percentage data) | | | | | | | |
| Product sales | $ 128,692 | 100.0% | 118,063 | 100.0% | $ 250,000 | 100.0% | $ 243,760 | 100.0% |
| Cost of product sales | 39,897 | 31.0 | 34,307 | 29.1 | 77,026 | 30.8 | 74,333 | 30.5 |
| Gross profit | 88,795 | 69.0 | 83,756 | 70.9 | 172,974 | 69.2 | 169,427 | 69.5 |
| Operating expenses: | | | | | | | | |
| Selling, general and administrative | 43,932 | 34.1 | 35,477 | 30.1 | 84,049 | 33.6 | 70,978 | 29.1 |
| Research and development | 26,511 | 20.6 | 23,048 | 19.5 | 52,628 | 21.1 | 46,387 | 19.0 |
| Total operating expenses | 70,443 | 54.7 | 58,525 | 49.6 | 136,677 | 54.7 | 117,365 | 48.1 |
| Income from operations | 18,352 | 14.3 | 25,231 | 21.3 | 36,297 | 14.5 | 52,062 | 21.4 |
| Other income and (expense): | | | | | | | | |
| Interest expense | (13) | | (2) | | (13) | | (2) | |
| Interest income and other | 687 | 0.5 | 559 | 0.5 | 1,504 | 0.6 | 806 | 0.3 |
| Income before income taxes | 19,026 | 14.8 | 25,788 | 21.8 | 37,788 | 15.1 | 52,866 | 21.7 |
| Income tax expense | (5,778) | (4.5) | (8,375) | (7.1) | (13,760) | (5.5) | (17,214) | (7.1) |
| Net income | $ 13,248 | 10.3 | $ 17,413 | 14.7 | $ 24,028 | 9.6 | $ 35,652 | 14.6 |

**Three and six months ended July 4, 2015 and June 28, 2014**

***Product Sales***

Product sales consisted of the following:

| | Three Months Ended | | | Six Months Ended | | |
|---|---|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | % Change | July 4, 2015 | June 28, 2014 | % Change |
| | (in thousands) | | | (in thousands) | | |
| Total product sales | $ 128,692 | $ 118,063 | 9.0% | $ 250,000 | $ 243,760 | 2.6% |

In the second quarter of 2015 as compared to the second quarter of 2014, product sales increased by $10.6 million or 9.0%, driven by increased sales volume of our HeartMate II, which was partially offset by a decrease in sales volume of our PVAD products. HeartMate II contributed $11.7 million to the increase due primarily to higher sales activity in the U.S. We also experienced an increase of $0.6 million in sales of the CentriMag and other product lines, while the PVAD product line declined by $1.7 million. From a regional perspective, U.S. sales increased by

$10.1 million and international sales increased by $0.5 million in 2015 as compared to 2014, respectively.

In the first six months of 2015 as compared to the first six months of 2014, product sales increased by $6.2 million or 2.6%, driven by increased sales volume of our HeartMate II and our CentriMag products. HeartMate II contributed $6.7 million to the increase due primarily to higher sales activity in the U.S. We also experienced an increase of $1.7 million in sales of the CentriMag and other product lines, while the PVAD product line declined by $2.2 million. From a regional perspective, U.S. sales increased by $10.6 million and international sales decreased by $4.4 million in 2015 as compared to 2014, respectively.

Sales originating outside of the U.S. and U.S. export sales collectively accounted for approximately 19% and 20% of our total product sales for each of the second quarter of 2015 and the second quarter of 2014, respectively, and approximately 20% and 22% of our total product sales for each of the first six months of 2015 and the first six months of 2014, respectively.

***Gross Profit***

Gross profit and gross margin were as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | July 4, 2015 | June 28, 2014 |
| | (in thousands, except percentages) | | | |
| Total gross profit | $ 88,795 | $ 83,756 | $ 172,974 | $ 169,427 |
| Total gross margin | 69.0% | 70.9% | 69.2% | 69.5% |

In the second quarter of 2015 as compared to the second quarter of 2014, gross margin percentage decreased by 1.9 percentage points primarily due to unfavorable manufacturing variances, higher inventory reserve charges, and unfavorable foreign exchange rate fluctuation, in part offset by lower intangible amortization expense. During the first six months of 2015 as compared to the first six months of 2014, gross margin percentage was relatively unchanged.

***Selling, General and Administrative Expenses***

Selling, general and administrative expenses were as follows:

| | Three Months Ended | | | Six Months Ended | | |
|---|---|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | % Change | July 4, 2015 | June 28, 2014 | % Change |
| | (in thousands) | | | (in thousands) | | |
| Total selling, general and administrative expenses | $ 43,932 | $ 35,477 | 23.8% | $ 84,049 | $ 70,978 | 18.4% |

In the second quarter of 2015 as compared to the second quarter of 2014, selling, general and administrative expenses (SG&A) increased by $8.5 million primarily due to $6.5 million of higher personnel and stock-based compensation expenses and $1.5 million of incremental legal expenses. The increase of $13.1 million in SG&A expense in the first six months of 2015 as compared to the first six months of 2014 was primarily due to $12.3 million of higher personnel and stock-based compensation expenses and $0.8 million in other administrative expenses.

***Research and Development Expenses***

Research and development expenses were as follows:

| | Three Months Ended | | | Six Months Ended | | |
|---|---|---|---|---|---|---|
| | July 4, 2015 | June 28, 2014 | % Change | July 4, 2015 | June 28, 2014 | % Change |
| | (in thousands) | | | (in thousands) | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Total research and development expenses | $ 26,511 | $ 23,048 | 15.0% | $ 52,628 | $ 46,387 | 13.5% |

Research and development ( R&D ) expenses are largely project-driven, and fluctuate based on the level of project activity planned and subsequently approved and conducted.

In the second quarter of 2015 as compared to the second quarter of 2014, R&D expenses increased by $3.5 million primarily due to $2.3 million of higher personnel and stock-based compensation expenses, the remeasurement of our estimated contingent consideration of $0.4 million associated with our acquisitions, and other expenses of $0.8 million. In the first six months of 2015 as compared to the first six months of 2014, R&D expenses increased by $6.2 million primarily due to $3.1 million of higher personnel and stock-based compensation expenses, the remeasurement of our estimated contingent consideration of $2.5 million associated with our acquisitions, and other expenses of $0.6 million.