MICRUS ENDOVASCULAR CORP
Form 10-Q
August 14, 2006

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2006
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: 000-51323

Micrus Endovascular Corporation
(Exact name of registrant as specified in its charter)

Delaware	**23-2853441**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
821 Fox Lane **San Jose, California**	**95131**
(Address of principal executive offices)	(Zip Code)

(408) 433-1400
(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. R Yes No £

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

Large accelerated filer £ Accelerated filer £ Non-accelerated filer R

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

As of August 1, 2006, there were 14,420,489 shares of common stock, par value $0.01, of the registrant outstanding.

Table of Contents

MICRUS ENDOVASCULAR CORPORATION
INDEX TO FORM 10-Q

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

MICRUS ENDOVASCULAR CORPORATION
Consolidated Balance Sheets
(unaudited)
(in thousands, except share and per share amounts)

	June 30, 2006	March 31, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 30,506	$ 36,104
Short-term investments	990	984
Accounts receivable, net of allowance for doubtful accounts of $384 at June 30, 2006 and $317 at March 31, 2006	8,610	8,267
Inventories, net	5,044	4,479
Prepaid expenses and other current assets	1,380	766
Total current assets	46,530	50,600
Property and equipment, net	2,556	2,488
Goodwill	3,309	3,309
Intangible assets, net	5,289	5,417
Other assets	310	300
Deferred offering costs	442	
Total assets	$ 58,436	$ 62,114
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 1,163	$ 2,088
Accrued payroll and other related expenses	2,838	3,147
Accrued liabilities	4,400	4,308
Total current liabilities	8,401	9,543
Other non-current liabilities	1,273	1,255
Total liabilities	9,674	10,798
Commitments and contingencies (Note 4)		
Stockholders equity:		
Common stock, $0.01 par value; Authorized: 50,000,000 shares Issued and outstanding: 14,222,557 shares at June 30, 2006 and 14,190,287 shares at March 31, 2006	142	142
Additional paid-in capital	101,938	101,430
Deferred stock-based compensation	(340)	(397)
Accumulated other comprehensive loss	(400)	(240)
Accumulated deficit	(52,578)	(49,619)

Total stockholders equity	48,762	51,316
Total liabilities and stockholders equity	$ 58,436	$ 62,114

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

MICRUS ENDOVASCULAR CORPORATION
Consolidated Statements of Operations
(unaudited)
(in thousands, except per share amounts)

	Three months ended June 30,	
	2006	**2005**
Revenues	$ 12,683	$ 7,112
Cost of goods sold	3,262	2,119
Gross profit	9,421	4,993
Operating expenses:		
Research and development	2,754	822
Sales and marketing	5,797	2,772
General and administrative	4,449	2,265
Total operating expenses	13,000	5,859
Loss from operations	(3,579)	(866)
Interest and investment income	379	128
Interest expense		(6)
Other income (expense), net	204	(494)
Loss before benefit from income taxes	(2,996)	(1,238)
Benefit from income taxes	37	
Net loss	(2,959)	(1,238)
Accretion of redeemable convertible preferred stock to redemption value including beneficial conversion feature		(659)
Net loss attributable to common stockholders	$ (2,959)	$ (1,897)
Net loss per share attributable to common stockholders:		
Basic and diluted	$ (0.21)	$ (0.70)
Weighted-average number of shares used in per share calculations:		
Basic and diluted	14,226	2,699

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

MICRUS ENDOVASCULAR CORPORATION
Consolidated Statement of Cash Flows
(unaudited)
(in thousands)

	Three months ended June 30,	
	2006	**2005**
Cash flows from operating activities:		
Net loss	$ (2,959)	$ (1,238)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	364	131
Provision for doubtful accounts	63	19
Provision for impairment of inventory	123	60
Increase in fair value of 2005 common stock warrants		158
Stock-based compensation expense	440	64
Changes in operating assets and liabilities:		
Accounts receivable	(173)	(502)
Inventories	(574)	(110)
Prepaid expenses and other current assets	(597)	(758)
Other assets	(5)	45
Accounts payable	(947)	(1,094)
Accrued payroll and other related expenses	(330)	336
Accrued liabilities	241	(17)
Other non-current liabilities	(10)	(6)
Net cash used in operating activities	(4,364)	(2,912)
Cash flows from investing activities:		
Payment to Biotronik AG for developed technology	(732)	
Acquisition of property and equipment	(201)	(72)
Net cash used in investing activities	(933)	(72)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net of issuance costs		32,499
Proceeds from issuance of convertible preferred stock and warrants		1,007
Proceeds from exercise of stock options	97	80
Payments of issuance costs for issuance of convertible preferred stock and warrants		(11)
Net cash provided by financing activities	97	33,575
Effect of exchange rate changes on cash	(398)	254
Net increase (decrease) in cash and cash equivalents	(5,200)	30,591
Cash and cash equivalents at beginning of period	36,104	15,017
Cash and cash equivalents at end of period	$ 30,506	$ 45,862

Supplemental schedule of noncash investing and financing activities:

Conversion of preferred stock to common stock	$	$ 59,227
Accretion to redemption value of redeemable convertible preferred stock including beneficial conversion feature	$	$ 659
Reclassification of 2005 common stock warrants to equity	$	$ 3,359
Accrued offering cost for issuance of common stock	$ 442	$

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

MICRUS ENDOVASCULAR CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Formation and Business of the Company

Micrus Endovascular Corporation (the Company), formerly Micrus Corporation, was incorporated under the laws of the state of Delaware in June 1996. The Company develops, manufactures and markets both implantable and disposable medical devices used in the treatment of cerebral vascular diseases.

Initial public offering

On June 21, 2005, the Company completed an initial public offering (IPO) in which it sold 3,250,000 shares of common stock at $11.00 per share providing net cash proceeds to the Company of approximately $33,248,000, net of underwriting discounts and commissions. Upon the closing of the IPO, all of the Company s outstanding shares of redeemable convertible preferred stock automatically converted into 7,919,626 shares of common stock. On July 6, 2005, the underwriters purchased an additional 250,000 shares of common stock at $11.00 per share pursuant to their over-allotment option. Together with the over-allotment shares sold by the Company, cash proceeds to the Company in the offering were approximately $33,030,000, net of underwriting discounts and offering expenses.

Interim unaudited financial information

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (generally accepted accounting principles) for interim financial information and in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual financial statements, except for the adoption of SFAS No. 123R during the first quarter of fiscal 2007 (see Note 2). In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation. These financial statements should be read in conjunction with the audited financial statements and notes thereto for the preceding fiscal year contained in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on June 16, 2006.

The results of operations for the three months ended June 30, 2006 may not necessarily be indicative of the results that may be expected for the fiscal year ended March 31, 2007 or any future period.

Note 2 Summary of Significant Accounting Policies

Principles of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Micrus Endovascular SA and Micrus Endovascular UK Limited. All significant intercompany balances and transactions have been eliminated in consolidation.

The Company s international subsidiaries use the local currency as their functional currency. Assets and liabilities are translated at exchange rates in effect at the balance sheet date. Revenue, expense, gains and losses accounts are translated at average exchange rates during the period. Resulting translation adjustments are recorded directly to accumulated other comprehensive income (loss).

Use of estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates. These estimates and assumptions include reserves and write-downs related to accounts receivable and inventories, the recoverability of long-term assets, deferred tax assets and related valuation allowances and valuation of stock based compensation and equity instruments.

Table of Contents

Net loss per common share

Basic net loss per share is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by giving effect to all potential dilutive common shares, including options, warrants and redeemable convertible preferred shares. There is no difference between basic and diluted net loss per share for all periods presented due to the Company s net losses. A reconciliation of the numerator and denominator used in the calculation of basic and diluted net loss per share follows (in thousands):

	Three months ended June 30,	
	2006	**2005**
Numerator:		
Net loss	$ (2,959)	$ (1,238)
Beneficial conversion feature of preferred stock		(383)
Accretion of redeemable convertible preferred stock to redemption value		(276)
Net loss attributable to common stockholders	$ (2,959)	$ (1,897)
Weighted-average number of common shares outstanding used in computing basic and diluted net loss per share	14,226	2,699

Anti-dilutive securities

The following outstanding stock options, restricted stock units and shares issuable under the employee stock purchase plan were excluded from the computation of diluted net loss per common share for the periods presented because their impact would have been anti-dilutive (in thousands):

	Three months ended June 30,	
	2006	**2005**
Shares issuable upon exercise of common stock	3,058	2,412
Shares issuable upon settlement of restricted stock units	10	
Shares issuable under employee stock purchase plan	25	
	3,093	2,412

Stock-based compensation

The Company has adopted various stock plans that provide for the grant of stock awards to employees, non-employee directors and consultants. The Company also has an employee stock purchase plan, which enables employees to purchase the Company s common stock.

During the first quarter of fiscal 2007, the Company adopted the provisions of, and account for stock-based compensation in accordance with, the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards No. 123 revised 2004 (SFAS No. 123R), Share-Based Payment, which replaced Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation and supersedes APB Opinion No. 25 (APB No. 25), Accounting for Stock Issued to Employees. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is generally the vesting period. The effective date of this new standard for the Company s financial statements was April 1, 2006. The Company transitioned to SFAS No. 123R using the modified-prospective method, under which prior periods have not been revised for comparative purposes. The valuation provisions of SFAS No. 123R apply to new grants and to grants

that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost previously estimated for the Company s SFAS No. 123 pro forma disclosures, excluding options granted prior to the Company s initial filing on Form S-1 with the SEC in March 2005 (pre-IPO options), for which the fair value was determined using the minimum value method. For these grants, any remaining unamortized deferred compensation expenses will continue to be accounted for under the intrinsic value method of APB No. 25.

Table of Contents

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Recognized stock-based compensation expense includes compensation expense for share-based payment awards granted prior to, but not yet vested as of April 1, 2006, based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS No. 123 for stock options granted subsequent to the Company s IPO. Stock-based compensation charges also include the amortization of unrecognized deferred compensation charges as deferred under APB No. 25 for all options granted prior to the Company s IPO. Recognized stock-based compensation expense also includes compensation expense for the share-based payment awards granted subsequent to April 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. The estimated fair value of our equity-based awards, less expected forfeitures, is amortized over the awards vesting period on a straight-line basis. In the Company s pro forma information required to be disclosed under SFAS No. 123 for the periods prior to April 1, 2006, the Company accounted for forfeitures as they occurred.

See Note 5 to these consolidated financial statements for further information regarding the Company s stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods as if the Company had recorded stock-based compensation expense.

Recent accounting pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which clarifies the accounting for uncertainty in tax positions. FIN 48 requires that the Company recognize in its financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of the Company s 2008 fiscal year, with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its financial statements.

Note 3 Balance Sheet Components

Inventories

Inventories consisted of the following (in thousands):

	June 30, 2006	March 31, 2006
Raw materials	$ 570	$ 507
Work-in-progress	697	504
Finished goods	1,165	1,294
Consigned inventory	3,411	2,874
Inventory held by Latin American distributors	267	230
Gross inventory	6,110	5,409
Less inventory allowances	(1,066)	(930)
	$ 5,044	$ 4,479

Consigned inventory is held at customer locations, primarily hospitals, and is under the physical control of the customer. The Company retains title to the inventory until used and purchased by the customer, generally when used in a medical procedure.

Table of Contents

Intangible assets

Intangible assets consisted of the following (in thousands):

	June 30, 2006	March 31, 2006
Identifiable intangible assets Neurologic acquisition	$ 3,900	$ 3,900
Licensed technology Biotronik	1,565	1,462
Patents	1,100	1,100
	6,565	6,462
Less accumulated amortization	(1,276)	(1,045)
	$ 5,289	$ 5,417

The identifiable intangible assets are being amortized using the straight-line method over the useful lives ranging from five to six years as follows: customer relationships five years, distribution agreements five years, non compete agreements six years. Amortization expense was $191,000 and $0 for the three months ended June 30, 2006 and 2005, respectively.

The licensed technology will be amortized using the straight-line method over seven years. The amortization period will begin once the Company starts generating revenue from the stent product associated with this licensed technology which is currently estimated to be during the second quarter of fiscal 2007.

The patents are being amortized using the straight-line method over seven years. Amortization expense was $27,500 for the three months ended June 30, 2006 and 2005. Amortization expense through fiscal year 2010 is expected to be $110,000 per year.

The future amortization of the intangible assets is as follows (in thousands):

	Amortization
For years ended March 31,	
2007 (remaining 9 months)	$ 819
2008	1,091
2009	1,091
2010	1,091
2011	643
2012 and beyond	554
	$ 5,289

Accruals

Accrued payroll and other related expenses consisted of the following (in thousands):

	June 30, 2006	March 31, 2006
Accrued bonuses	$ 762	$ 1,157
Accrued salaries	243	478
Accrued vacation	963	804
Accrued commissions	514	392
Accrued payroll taxes	356	316
	$ 2,838	$ 3,147

Table of Contents

Accrued liabilities consisted of the following (in thousands):

	June 30, 2006	March 31, 2006
Accrued professional fees	$ 1,502	$ 709
Raw material inventory receipts not invoiced	482	129
VAT payable	316	78
Marketing related programs	285	144
Accrued employee stock purchase plan contributions	254	
Accrued printer costs SEC filings	152	
Deferred revenue from Japan distribution agreement	150	150
Earn-out payment in connection with Neurologic acquisition		1,403
Biotronik milestone payment		732
Import handling fee Japan product shipments		282
Other	1,259	681
	$ 4,400	$ 4,308

Other non-current liabilities

Other non-current liabilities consisted of the following (in thousands):

	June 30, 2006	March 31, 2006
Deferred tax liability	$ 640	$ 641
Deferred revenue from Japan distribution agreement	488	525
Other non-current liabilities	145	89
	$ 1,273	$ 1,255

On September 30, 2005, the Company entered into a five-year, exclusive distribution agreement with Goodman, CO., LTD (Goodman). Under the terms of the distribution agreement, Goodman will promote and market the Company s products in Japan. In connection with the Distribution Agreement, Goodman paid the Company an up-front cash payment of $750,000 which has been recorded as deferred revenue. The Company is recognizing the deferred revenue on a straight-line basis over the five year term of the agreement.

Note 4 Commitments and Contingencies

Lease commitments

On June 6, 2005, the Company entered into a non-cancelable 7-year lease agreement (the Lease). Pursuant to the Lease, the Company has leased approximately 42,000 square feet of building space which is being used as the Company s headquarters in the United States with both administrative and manufacturing facilities. The Lease commenced in January 2006, with an option for one 5 year extension that may be exercised by the Company.

The Lease provides for a base rent that increases periodically and averages approximately $41,445 monthly over the lease period and is accounted for on a straight-line basis. The Lease also provides for certain additional payments including the Company s share of landlord s operating expenses, including project costs, property taxes and overhead management fees.

Additionally, the Company leases office space for its two wholly-owned subsidiaries, Micrus SA and Micrus UK, under non-cancelable lease agreements with terms through November 2011 and December 2010, respectively. The combined rent expense for the two operating leases is approximately $90,000 annually. The leases also provide for certain additional payments including the Company s share of the landlord s operating expenses.

Table of Contents

Future minimum lease payments are as follows (in thousands):

	Minimum lease payments
For years ended March 31,	
2007 (remaining 9 months)	$ 496
2008	654
2009	641
2010	614
2011 and beyond	1,533
Total minimum lease payments	$ 3,938

Indemnification

In the normal course of business, the Company enters into contracts and agreements that contain a variety of representations and warranties and provide for general indemnification. The Company s exposure under these agreements is unknown because it involves claims that may be made against the Company in the future, but have not yet been made. To date, the Company has not paid any claims or been required to defend any action related to its indemnification obligations, and accordingly, the Company has not accrued any amounts for such indemnification obligations. However, the Company may record charges in the future as a result of these indemnification obligations.

Litigation

The Company is from time to time subject to various lawsuits. The Company does not believe that it is probable that resolution of pending litigation will have a material adverse effect on the Company s consolidated financial statements; however the outcome of litigation is inherently uncertain.

FCPA investigation

In August 2004, the Company identified certain payments made to physicians located in France, Germany, Spain and Turkey that may likely have violated the Foreign Corrupt Practices Act (FCPA) and the laws of certain foreign countries. In September 2004, the Company voluntarily disclosed to the United States Department of Justice (DOJ) factual information obtained in the Company s internal investigation of potential violations of the FCPA. In February 2005, the DOJ and the Company entered into an agreement pursuant to which the DOJ agreed not to prosecute the Company for conduct disclosed to the DOJ, provided that the Company accepted responsibility for the actions of its employees and officers, paid a monetary penalty of $450,000, continues to cooperate with the DOJ in its investigation, including the waiver of legal privileges, establishes policies and procedures to assure compliance with the FCPA and other relevant bribery laws, retains and pays for an independent monitor, which shall report to the DOJ for a period of three years to assure compliance with the agreement with the DOJ and the Company s implementation and adherence to FCPA compliance policies and procedures, and cooperates fully with the DOJ, the independent monitor and the Securities and Exchange Commission (SEC). The Company must remain in compliance with these conditions for a period of two years following February 28, 2005 or face the filing of a criminal complaint by the DOJ. The monetary penalty was accrued in fiscal 2005 and was paid in April 2005. The ongoing cost of compliance with the DOJ agreement will be recorded as an expense as incurred.

The payments made to physicians in France, Germany, Spain and Turkey also may likely have violated the applicable laws in those foreign jurisdictions and may possibly have violated laws in Switzerland. The Company is not able to determine at this time what penalties or other actions, if any, authorities in France, Germany, Spain, Turkey or Switzerland may impose as a result of such violations. Such amounts could be material to the financial position, results of operations or cash flows of the Company.

Patent litigation

In September 2004, Boston Scientific Corporation and Target Therapeutics, Inc., a subsidiary of Boston Scientific Corporation (collectively Boston Scientific), filed a patent infringement suit in the United States District Court for the

Northern District of California, alleging that our coil devices infringe two patents held by Boston Scientific and that this infringement is willful. In November 2004, the Company answered Boston Scientific s complaint and counterclaimed, alleging that Boston Scientific s occlusive products, and their use, infringed three of the Company s patents. Each party is seeking an injunction preventing manufacture, sale, offer for sale, use and importation of the other s detachable coil devices in the United States, damages for past infringement, which may be trebled, and its legal fees and costs. In addition, each party seeks a declaration that the patents of the other are invalid and not infringed and has alleged that certain of the asserted patents of the other are unenforceable due to inequitable conduct.

Table of Contents

Boston Scientific is also a party in two other lawsuits against Cordis Corporation and Micro Therapeutics, Inc. in which the Boston Scientific patents which are the basis of Boston Scientific s suit against Micrus are also at issue. In October 2004, Cordis requested ex parte reexamination of certain claims in those patents. In February 2005, the court granted a stay of the Boston Scientific lawsuit against Micrus until the earlier of twelve months or the outcome of the reexamination by the USPTO in the Cordis case. In March 2006 the Court lifted the stay with respect to any claims that were confirmed in the reexamination proceedings and has permitted discovery in the case to commence with respect to those confirmed claims. The parties have since exchanged preliminary infringement contentions in which Boston Scientific asserted only claims from the first patent. On June 16, 2006, the parties exchanged preliminary invalidity contentions in which each side disclosed various grounds upon which it will argue the invalidity of the other party s presently asserted patents. Boston Scientific has stated that it would supplement its preliminary infringement contentions to include claims from the second Boston Scientific patent still under reexamination upon completion of the reexamination, and that these asserted claims would be from the set of claims which has not yet been deemed in condition to be confirmed by the USPTO. The Company and Boston Scientific have negotiated a schedule that would permit discovery and claim construction proceedings to proceed for the second patent while it is still undergoing reexamination and reissue proceedings. The Court has not yet issued an order stating whether it will accept this schedule.

The Company is unable at this time to determine the outcome of any such litigation. If the litigation is protracted or results in an unfavorable outcome to the Company, the impact to the financial position, results of operations or cash flows of the Company could be material.

Note 5 Stock-based Compensation

Stock option plans

1996 Stock Option Plan

Upon the effectiveness of the Company s IPO, 14,633 shares available for grant under the 1996 Stock Option Plan (the 1996 Plan) became available for grant under the 2005 Plan. There were no options outstanding under the 1996 Plan as of the Company s IPO.

1998 Stock Plan

Upon the effectiveness of the Company s IPO, 158,167 shares available for grant under the 1998 Stock Option Plan (the 1998 Plan) became available for grant under the 2005 Plan. All options previously granted under the 1998 Plan will continue to be administered under the 1998 Plan. As of June 30, 2006, options to purchase 1,842,539 shares of common stock were outstanding under the 1998 Plan.

2005 Equity Incentive Plan

The 2005 Equity Incentive Plan (the 2005 Plan) became effective upon the Company s IPO. The 2005 Plan provides for the issuance of nonstatutory stock options, stock appreciation rights, stock awards and cash awards. The Company initially reserved a total of 2,222,220 shares of its common stock for issuance under the 2005 Plan. In addition, the 2005 Plan provides for an automatic annual increase of the number of shares reserved for issuance thereunder by amount equal to the lesser of (i) 5% of our total number of outstanding shares; (ii) 666,666 shares, or (iii) a number of shares determined by our board of directors. The shares reserved under the 2005 Plan will also be increased as a result of the cancellation of unexercised options under the 1998 Plan. As of June 30, 2006, there were 3,079,604 shares reserved for issuance under the 2005 Plan, of which 1,853,991 were available for grant, 1,215,613 shares were subject to outstanding options and 10,000 shares were subject to outstanding restricted stock units.

Employee stock purchase plan

The 2005 Employee Stock Purchase Plan (the Purchase Plan) became effective upon the Company s IPO. The Purchase Plan provides employees with an opportunity to purchase the Company s common stock through accumulated payroll deductions.

The Company initially reserved a total of 222,222 shares of common stock for issuance under the Purchase Plan. The Purchase Plan provides for annual increases in the total number of shares available for issuance under this plan on April 1 of each year beginning on April 1, 2006, by a number of shares that is equal to the lesser of: (1) 2% of the outstanding shares of the Company s common stock on the immediately preceding March 31; (2) 222,222 shares; or (3) a lesser

12

Table of Contents

number determined by the Company s board of directors. As of June 30, 2006, there were 444,444 shares reserved for issuance under the Purchase Plan, of which 40,154 shares were issued and outstanding.

The Purchase Plan permits participants to purchase the Company s common stock through payroll deductions of up to 15% of the participant s compensation, up to a maximum of $25,000 per year, and up to a maximum of 1,111 shares per purchase period. Amounts deducted and accumulated for the participant s account are used to purchase shares of the Company s common stock on the last trading day of each purchase period at a price of at least 85% of the lesser of the fair market values of the common stock at the beginning of the offering period or at the end of the purchase period.

The Purchase Plan provides for offering periods of 12 months and purchase periods of 6 months or such shorter period as may be established by the Company s board of directors. The offering periods start on April 1 and October 1 of each year.

Stock-based compensation

During the first quarter of fiscal 2007, the Company adopted the provisions of, and accounts for stock-based compensation in accordance with, SFAS No. 123R. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is generally the vesting period. The Company transitioned to SFAS No. 123R using the modified-prospective method, under which prior periods have not been revised for comparative purposes. The valuation provisions of SFAS No. 123R apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost previously estimated for the Company s SFAS No. 123 pro forma disclosures, excluding pre-IPO options, for which the fair value was determined using the minimum value method. For these grants, any remaining unamortized deferred compensation expenses will continue to be accounted for under the intrinsic value method of APB No. 25.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Recognized stock-based compensation expense includes compensation expense for share-based payment awards granted prior to, but not yet vested as of April 1, 2006, based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS No. 123 for options granted after the Company s IPO. Compensation expense for the share-based payment awards granted subsequent to April 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. Stock-based compensation charges also include the amortization of unrecognized deferred compensation charges as deferred under APB No. 25 for all options granted prior to the Company s IPO. The estimated fair value of the Company s equity-based awards, less expected forfeitures, is amortized over the awards vesting periods on a straight-line basis. In the Company s pro forma information required to be disclosed under SFAS No. 123 for the periods prior to April 1, 2006, the Company accounted for forfeitures as they occurred.

The Company uses the Black-Scholes option pricing model to determine the fair value of employee stock options and employee stock purchase plan shares. The determination of the fair value of stock-based payment awards on the date of grant using an option pricing model is affected by the Company s stock price as well as by assumptions regarding a number of complex and subjective variables. These variables include the Company s expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends.

Because there is insufficient historical information available to estimate the expected term of the stock-based awards, the Company adopted the simplified method for estimating the expected term pursuant to Staff Accounting Bulletin No. 107 (SAB No. 107). On this basis, the Company estimated the expected term of options granted by taking the average of the vesting term and the contractual term of the option.

The expected volatility used in the valuation model is based on the Company s peer group in the industry in which it does business and the Company s historical volatility since its IPO.

The risk-free interest rate is based on the yield on zero-coupon U.S. Treasury securities with remaining terms similar to the expected term on the employee stock option and employee stock purchase plan awards.

Table of Contents

The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model.

The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods.

The determination of the fair value of employee stock options and employee stock purchase plan shares has been estimated using the following weighted-average assumptions:

	Stock Plans Three months ended June 30,		Purchase Plan Three months ended
	2006	2005	June 30, 2006
Expected term (in years)	6.0	4.0	0.5
Volatility	46%	46%	39%
Risk-free interest rate	5.04%	3.84%	5.03%
Dividend yield	0%	0%	0%
Weighted average per share fair value of equity-based awards at date of grant	$5.87	$3.95	$ 3.74

Stock-based compensation expense recognized under SFAS No. 123R for the three months ended June 30, 2006 related to employee stock options and employee stock purchase plan shares was $238,000 and $43,000, respectively. Additionally, approximately $28,000 in stock-based compensation expense related to SFAS No. 123R has been capitalized as inventory as of June 30, 2006. The tax benefit, and the resulting effect on cash flows from operations and financial activities, related to stock-based compensation expense was not recognized as the Company currently provides a full valuation allowance for all of its deferred tax assets.

Stock-based compensation expense recognized for the three months ended June 30, 2006 and 2005 related to the amortization of deferred stock-based compensation was $57,000 and $58,000, respectively.

In addition, stock options issued to non-employees, generally for consulting services related to patient studies or marketing analysis, are recorded at their fair value on the date of vesting and recognized over the respective service or vesting period. The fair value of the stock options granted is calculated at each reporting date using the Black-Scholes option pricing model using the following assumptions:

	Three months ended June 30,	
	2006	2005
Expected term (in years)	5	7
Volatility	42%	56%
Risk-free interest rate	5.15%	3.94%
Dividend yield	0%	0%

Stock-based compensation recognized for the three months ended June 30, 2006 and 2005 related to non-employee options was $102,000 and $6,000, respectively. The non-employee stock-based compensation expense will fluctuate as the fair market value of the common stock fluctuates.

Stock-based compensation expense included in the consolidated statement of operations is as follows (in thousands):

	Three months ended June 30,

	2006	2005
Cost of goods sold	$ 27	$ 6
Research and development	43	11
Sales and marketing	216	17
General and administrative	154	30
Total	$ 440	$ 64

As of June 30, 2006, there was approximately $4.1 million of total stock-based compensation expense, after estimated forfeitures, related to unvested employee stock options, which is expected to be recognized over an estimated weighted average amortization period of 3.0 years.

Additionally, the future amortization of deferred compensation is as follows:

Fiscal year 2007 (remaining 9 months)	$ 172,000
Fiscal year 2008	168,000
	$ 340,000

The stock-based compensation expense will be reduced in the period of forfeiture for any accrued but unvested compensation arising from early termination of an option holder s services.

Periods prior to the adoption of SFAS No. 123R

Prior to April 1, 2006, the Company accounted for stock-based employee compensation arrangements in accordance with provisions of APB No. 25 and complied with the disclosure provisions of SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation, Transition and Disclosure* (SFAS No. 148). Under APB No. 25, deferred stock-based compensation is based on the difference, if any, on the date of grant, between the fair value of our common stock and the exercise price of stock option grants to employees. Stock-based compensation expense was recognized under APB No. 25 for options granted prior to the Company s IPO, based upon the intrinsic value method.

Table of Contents

The modified prospective transition method of SFAS No. 123R requires the presentation of pro forma information for periods presented prior to the adoption of SFAS No. 123R regarding net loss and net loss per share as if the Company had accounted for its stock options under the fair value method of SFAS No. 123R. If compensation expense had been determined based upon the fair value at the grant date for employee compensation arrangements, consistent with the methodology prescribed under SFAS No. 123, the Company s pro forma net loss and pro forma net loss per common share under SFAS No. 123 for the period ended June 30, 2005 would have been as shown in the following table. For the purpose of this pro forma disclosure, the estimated value of the stock awards is recognized on an accelerated basis over the vesting periods of the awards (in thousands, except per share data):

		Three months ended June 30, 2005
Net loss attributable to common stockholders (as reported)	$	(1,897)
Add: Stock-based employee compensation expenses included in reported net loss		58
Deduct: Total stock-based employee compensation expenses determined under fair value based method for all awards		(11)
Adjusted net loss	$	(1,850)
Net loss per common shares, basic and diluted:		
As reported	$	(0.70)
Adjusted	$	(0.69)

Pro forma disclosures for the three months ended June 30, 2006 are not presented because stock-based employee compensation was accounted for under SFAS No. 123R s fair-value method during this period. Additionally, the stock-based employee compensation determined under the fair-value method for the three months ended June 30, 2005 has been adjusted to exclude the effect of pre-IPO options, as those options were valued for pro forma disclosure purposes using a minimum value method. The weighted-average fair values of stock options granted during the three months ended June 30, 2005 was $3.95 per stock option. For the three months ended June 30, 2005, the total intrinsic value of options exercised during the period was $0.7 million. The intrinsic value as of June 30, 2005 is calculated as the difference between the market value as of June 30, 2005 of the shares of common stock to be issued upon exercise of the stock option and the exercise price of the stock option. The market value of a share of Company s common stock as of June 30, 2005 was $11.00 per share as reported by the Nasdaq National Stock Market.

Table of Contents

General stock option information

The following table sets forth the summary of option and restricted stock unit activity for the three months ended June 30, 2006:

	Shares	Weighted-average exercise price	Weighted-average remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Options outstanding at March 31, 2006	2,804	$ 6.54		
Options granted	328	$ 13.27		
Restricted stock units issued	10	$ 12.06		
Options exercised	(31)	$ 9.83		
Options forfeited	(42)	$ 9.90		
Options expired	(1)	$ 9.82		
Options outstanding at June 30, 2006	3,068	$ 7.25	8.2	$ 15,402
Options exercisable at June 30, 2006	1,224	$ 4.60	6.9	$ 9,317

The weighted average per share fair value of options granted during the three months ended June 30, 2006 was $5.87 per share. The total intrinsic value of options exercised during the three months ended June 30, 2006 was $0.3 million. The intrinsic value as of June 30, 2006 is calculated as the difference between the market value as of June 30, 2006 of the shares of common stock to be issued upon exercise of the stock option and the exercise price of the share. The market value of a share of the Company s common stock as of June 30, 2006 was $12.06 per share as reported by the Nasdaq National Stock Market.

Net cash proceeds from the exercise of stock options were $97,000 and $80,000 for the three months ended June 30, end 2007 and 2006, respectively.

Table of Contents

The following table sets forth the summary of the Company s nonvested shares activity for the three months ended June 30, 2006:

	Shares
Nonvested at March 31, 2006	1,646
Options granted	328
Restricted stock units awarded	10
Options vested	(97)
Options forfeited and expired	(43)
Nonvested at June 30, 2006	1,844

Information regarding stock option awards outstanding at June 30, 2006 is summarized below:

	Options outstanding			Options exercisable	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable	Weighted average exercise price
$ 0.68 - $ 1.01	489	5.1	$ 0.78	467	$ 0.78
$ 1.13 - $ 1.15	155	6.5	$ 1.14	112	$ 1.14
$ 5.63	885	8.5	$ 5.63	435	$ 5.63
$ 6.51 - $ 8.89	438	9.5	$ 8.50		$
$ 9.01 - $11.20	452	9.4	$ 10.00	17	$ 10.68
$12.03 - $13.39	473	8.8	$ 12.77	193	$ 13.04
$13.58 - $14.62	166	9.9	$ 14.15		$
$ 0.68 - $14.62	3,058	8.2	$ 7.25	1,224	$ 4.60

Note 6 Redeemable Convertible Preferred Stock

The Company s Certificate of Incorporation, as amended, authorized the Company to issue 1,000,000 shares of $0.01 par value preferred stock. As of June 30, 2006, there are no shares of preferred stock issued or outstanding.

Note 7 Common Stock

The Company s Certificate of Incorporation, as amended, authorizes the Company to issue 50,000,000 shares of $0.01 par value common stock. Each holder of common stock has the right to one vote and is also entitled to receive dividends whenever funds are legally available and when declared by the Board of Directors, subject to the prior rights of holders of all classes of stock outstanding having priority rights as to dividends. No dividends have been declared or paid as of June 30, 2006.

2005 Common Stock Warrants

In conjunction with the Series E preferred stock financing in February and March of 2005, the Company issued warrants to purchase common stock of the Company (the 2005 common stock warrants). The 2005 common stock warrants were not initially exercisable, but were to become exercisable for an aggregate of 671,614 shares of common stock at $9.00 per share if the Company had not closed the IPO prior to December 31, 2005, or for an adjusted number of shares (calculated based on the IPO price) with an exercise price of $0.000225 if the IPO closed prior to December 31, 2005 at a price less than $13.50 per share. Based on the IPO price of $11.00 per share, the 2005 common stock warrants became exercisable for an aggregate of 305,272 shares of common stock at an exercise price of $0.000225 per share.

Table of Contents

As of June 30, 2006, warrants to purchase 291,460 shares of common stock have been exercised. All of these warrants have been exercised at an aggregate exercise price of $0.000225 per share. Warrants covering an aggregate of 267,203 shares of common stock were exercised without cash. In most cases the aggregate purchase price was offset by the value of fractional shares payable upon exercise of such warrants; however an aggregate of 2 shares were withheld in payment of the aggregate exercise price of one warrant resulting in a net issue of 267,201 shares. Warrants covering an additional 24,259 shares of common stock were exercised for cash. There were warrants to purchase 13,810 shares of common stock at an exercise price of $0.000225 per share outstanding at June 30, 2006, which will expire on January 1, 2011.

Note 8 Segments

The Company s significant operations outside the United States include two sales subsidiaries in Europe (located in Switzerland and the United Kingdom). Revenues from unaffiliated customers by geographic area, based on the customer s shipment locations were as follows (in thousands):

	Three months ended June 30,	
	2006	**2005**
United States	$ 5,943	$ 3,397
Japan	2,219	
United Kingdom	1,545	1,151
Rest of the world	2,976	2,564
Total revenues	$ 12,683	$ 7,112

The Company identifies its operating segments based on how management views and evaluates the Company s operations, which is primarily based on geographic location. For all periods presented, the Company operated in three business segments, the Americas, Europe and Asia Pacific. The products sold by each segment are substantially the same and the Company evaluates performance and allocates resources primarily based on revenues and gross profit. Revenues and gross profit for these segments were as follows (in thousands):

	Three months ended June 30,	
	2006	**2005**
Revenues:		
Americas	$ 6,585	$ 3,899
Europe	3,728	3,076
Asia Pacific	2,370	137
Total	$ 12,683	$ 7,112
Gross Profit:		
Americas	$ 5,486	$ 2,932
Europe	2,477	2,000
Asia Pacific	1,458	61
Total	$ 9,421	$ 4,993

Table of Contents

The gross profit amounts by geographic segments for the three months ended June 30, 2005 has been revised to correct a misallocation between the Americas and Europe as follows (in thousands):

	As revised June 30, 2005	As previously reported June 30, 2005
Gross Profit:		
Americas	$ 2,932	$ 3,563
Europe	2,000	1,430
Asia Pacific	61	
Total	$ 4,993	$ 4,993

The above revisions had no impact on the consolidated results of operations, cash flows, or the financial position of the Company.

Note 9 Subsequent Events

On July 19, 2006, the Company completed a secondary offering in which certain stockholders sold 1,270,211 shares of common stock at the public offering price of $11.89 per share. The Company did not receive any proceeds from the sale of shares by the selling stockholders. On July 19, 2006, the underwriters purchased 190,531 shares of common stock pursuant to their over-allotment option. The total cash proceeds to the Company were approximately $2,129,000, net of the underwriting discount.

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

The following discussion and analysis of the financial condition and results of operations of the Company should be read in conjunction with the consolidated financial statements and the related notes included elsewhere in this report, and with other factors described from time to time in our other filings with the Securities and Exchange Commission. This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. Actual results and the timing of events may differ materially from those contained in the forward-looking statements due to a number of factors, including those discussed in Part II, Item 1A Risk Factors in this Quarterly Report on Form 10-Q.

Overview

We develop, manufacture and market both implantable and disposable medical devices used in the treatment of cerebral vascular diseases. We also are developing products for the treatment of ischemic disease and have recently launched our first product in this market. Our products are used by interventional neuroradiologists and neurosurgeons to treat cerebral aneurysms responsible for hemorrhagic stroke. Both hemorrhagic and ischemic stroke are significant causes of death worldwide. Our product lines consist of endovascular systems that enable a physician to gain access to the brain in a minimally invasive manner through the vessels of the arterial system. We believe our products provide a safe and reliable alternative to more invasive neurosurgical procedures for treating aneurysms. Our proprietary three-dimensional, embolic coils are unique in that they automatically and rapidly deploy within an aneurysm, forming a scaffold that conforms to a wide diversity of aneurysm shapes and sizes. We also supply accessory devices and products including microcatheters and guidewires used to deliver microcoils and stents for the treatment of cerebral vascular disease. We plan on growing our business by continuing to penetrate our existing markets, bringing new products and technologies to interventional neuroradiologists and neurosurgeons, and by entering new markets such as Asia where we introduced our products in Japan through a distributor. Our products commenced selling in Japan in March 2006.

Our revenues are derived primarily from sales of our microcoils. We also sell access devices, which currently do not account for a significant portion of our revenues. Geographically, our revenues are generally from sales to customers in the Americas, Europe and Asia. Our products are shipped from our facilities in the United States, Switzerland, United Kingdom, and a logistics facility in the Netherlands, to either hospitals or distributors. We invoice

our customers upon shipment. In select hospitals, our products are held on consignment, free of charge and remain on site.

We anticipate that our cost of goods sold will generally increase in absolute dollars during those quarters in which our sales increase or we incur additional manufacturing costs in anticipation of the commercial introduction of new products. Furthermore, our gross margin percentage may decrease in those quarters in which we initiate sales of new products or product lines, or enter new geographic territories.

Our product development efforts are primarily focused on expanding our current line of microcoils and broadening our product offerings. In August 2004, we introduced our Cerecyte microcoil product line and since June 2005 we have launched seven new products, including microcoils, stents, microcatheters and guidewires. We intend to continue this product line expansion with the goal of continuing to increase our per-procedure revenue.

Table of Contents

We also intend to continue to expand our direct sales force in Europe and the United States and enter the Asian markets through distributors. In March 2006, we launched our sales and marketing efforts in Japan through our distribution partner Goodman. We recorded product sales of $2.2 million to Goodman in March 2006 and $2.2 million in the first quarter of fiscal 2007.

As we expect to continue to incur net losses for the foreseeable future as described below, we currently anticipate that the broadening of our product line, the worldwide expansion of our direct sales force and our entry into the Asian market will be primarily funded with our currently available cash.

We introduced our first proprietary, three-dimensional microcoil in May 2000. Our revenues have grown from $1.8 million in fiscal 2001 to $32.8 million in fiscal 2006. Our revenues were $12.7 million in the first quarter of fiscal 2007.

Since inception, we have been unprofitable. We have incurred net losses of $2.0 million in fiscal 2004, $6.7 million in fiscal 2005, $8.3 million in fiscal 2006 and $3.0 million in the first quarter of fiscal 2007. As of June 30, 2006, we had cash and marketable securities of $31.5 million. We believe that our current cash position and the cash expected to be generated from product sales will be sufficient to meet our working capital and capital expenditure requirements for at least the next twelve months. We expect to continue to incur net losses for the foreseeable future as we expand our manufacturing and sales activities and expand geographically. As of June 30, 2006, we had an accumulated deficit of $52.6 million.

Recent Developments

On July 19, 2006, the Company completed a secondary offering in which certain stockholders sold 1,270,211 shares of common stock at the public offering price of $11.89 per share. The Company did not receive any proceeds from the sale of shares by the selling stockholders. On July 19, 2006, the underwriters purchased 190,531 shares of common stock pursuant to their over-allotment option. The total cash proceeds to the Company were approximately $2.1 million, net of the underwriting discount.

Results of Operations

The following table sets forth the results of our operations, expressed as percentages of revenues, for the three months ended June 30, 2006 and 2005:

	Three months ended June 30,	
	2006	2005
	%	%
Consolidated Statement of Operations Data:		
Revenues	100%	100%
Cost of goods sold	26%	30%
Gross profit	74%	70%
Operating expenses:		
Research and development	22%	12%
Sales and marketing	45%	39%
General and administrative	35%	32%
Total operating expenses	102%	82%
Loss from operations	(28)%	(12)%
Interest and investment income	3%	2%
Interest expense	0%	0%
Other income, net	1%	(7)%

Net loss before benefit from income taxes	(24)%	(17)%
Benefit from income taxes	1%	0%
Net loss	(23)%	(17)%
Accretion of redeemable convertible preferred stock to redemption value including beneficial conversion feature	0%	(9)%
Net loss attributable to common stockholders	(23)%	(26)%

Table of Contents

Three Months Ended June 30, 2006 and 2005

Revenues

	Three months ended June 30,		Change	
(Dollars in thousands)	**2006**	**2005**	**$**	**%**
Americas	**$ 6,585**	**$ 3,899**	**$ 2,686**	**69%**
Europe	**3,728**	**3,076**	**652**	**21%**
Asia Pacific	**2,370**	**137**	**2,233**	**1630%**
Total Revenues	**$ 12,683**	**$ 7,112**	**$ 5,571**	**78%**

Our revenues are derived primarily from sales of our microcoils and to a lesser extent sales of accessory devices used in the treatment of cerebral vascular diseases. Our revenues were $12.7 million for the first quarter of fiscal 2007, an increase of $5.6 million or 78% from $7.1 million in first quarter of fiscal 2006. Revenues from the Americas were $6.6 million in the first quarter of fiscal 2007, an increase of $2.7 million or 69% from $3.9 million in the first quarter of fiscal 2006. Revenues from Europe were $3.7 million in the first quarter of fiscal 2007, an increase of $0.6 million or 21% from $3.1 million in the first quarter of fiscal 2006. The increase was primarily due to an increase in the number of microcoil products sold during this period. Factors driving the increase included growth in the overall market for embolic coils, an increase in our share of both the domestic and foreign markets in which we participate and the introduction of new products. Additionally, the increase in revenues was partially due to higher average selling prices as a result of increased Cerecyte product sales in the first quarter of fiscal 2007. Revenues from Asia Pacific were $2.4 million in the first quarter of fiscal 2007. The increase was due to product sales of $2.2 million during the quarter to our distributor in Japan. In February 2006, we received regulatory clearance to sell our products in Japan through our distributor, and the sale of our products in Japan commenced in March 2006.

Gross Profit

	Three months ended June 30,		Change	
(Dollars in thousands)	**2006**	**2005**	**$**	**%**
Cost of goods sold	**$ 3,262**	**$ 2,119**	**$ 1,143**	**54%**
Gross profit	**9,421**	**4,993**	**4,428**	**89%**

Cost of goods sold consists of materials, direct labor, overhead costs associated with manufacturing, impairments of inventory and warranty expenses. Cost of goods sold were $3.3 million for the first quarter of fiscal 2007, an increase of $1.1 million or 54% from $2.1 million in the first quarter of fiscal 2006. The increase in cost of goods sold during the first quarter of fiscal 2007 as compared to the first quarter of fiscal 2006 was primarily due to an increase in personnel and manufacturing costs associated with increased sales of our products as well as increased costs attributable to a general increase in salaries, benefits and overhead costs resulting from increased production, partially offset by increased manufacturing efficiencies.

Gross profit was $9.4 million for the first quarter of fiscal 2007, an increase of $4.4 million or 89% from $5.0 million in the first quarter of fiscal 2006. Gross margin was 74% in the first quarter of fiscal 2007 and 70% in the first quarter of fiscal 2006. The increase was primarily due to an increase in revenue from sales of higher margin products and manufacturing efficiencies, partially offset by higher levels of distributor sales of lower margin products primarily due to our entry into the Japanese market in the fourth quarter of fiscal 2006. We expect our gross margin to fluctuate in future periods based on the mix of our product sales.

Operating Expenses

	Three months ended June 30,	Change

(Dollars in thousands)	2006	2005	$	%
Research and development	$ 2,754	$ 822	$ 1,932	235%

Research and development expenses consist primarily of costs associated with the design, development, and testing of products. Such costs are expensed as they are incurred and include salaries and related personnel costs, fees paid to outside consultants, and other direct and indirect costs related to research and product development. Research and development expenses increased in the first quarter of fiscal 2007 compared to the same period in fiscal 2006 primarily due to a milestone payment to

Table of Contents

Vascular FX in connection with the purchase of intellectual property in the amount of $1.5 million and an increase of $326,000 related to outside services associated with new product development. We have recorded the milestone payment to Vascular FX as research and development expense as there were no regulatory clearances for a product at that time. As a percentage of revenues, research and development expenses were 22% in the first quarter of fiscal 2007 and 12% in the first quarter of fiscal 2006. We expect our research and development expenses to increase in absolute dollars in future periods as we hire additional development personnel, continue work on product improvements, and expand our existing product line.

	Three months ended June 30,		Change	
(Dollars in thousands)	**2006**	**2005**	**$**	**%**
Sales and marketing	**$ 5,797**	**$ 2,772**	**$ 3,025**	**109%**

Sales and marketing expenses consist primarily of compensation costs of our direct sales force and marketing personnel, as well as overhead costs related to these activities. Also included are costs associated with promotional literature and videos, trade show participation, and education and training of physicians. Sales and marketing expenses increased in the first quarter of fiscal 2007 compared to the same period in fiscal 2006 primarily due to an increase of $0.9 million associated with additional sales and marketing personnel in the United States and Europe, higher sales incentive and commission costs of $0.7 million on increased sales in the United States and Europe, higher travel expenses of $318,000, an increase of $233,000 related to graphic design, promotional and printing costs in connection with new product releases, an increase of $199,000 in stock-based compensation expense due primarily to the impact of the adoption of SFAS No. 123R, an increase of $176,000 related to consulting expenses incurred primarily due to outsourced product marketing functions, as well as an increase of $128,000 primarily due to US national sales meeting expenses. As a percentage of revenues, sales and marketing expenses increased to 45% in the first quarter of fiscal 2007 from 39% in the first quarter of fiscal 2006 due to an increase in headcount both in the United States and Europe in the sales force and clinical support group. We anticipate that sales and marketing expenses will increase in absolute dollars in future periods as we continue to increase the size of our direct sales force and clinical support group, increase spending on additional sales and marketing programs and expand into additional geographic territories.

	Three months ended June 30,		Change	
(Dollars in thousands)	**2006**	**2005**	**$**	**%**
General and administrative	**$ 4,449**	**$ 2,265**	**$ 2,184**	**96%**

General and administrative expenses consist primarily of compensation and related costs for finance, human resources, facilities, information technology, insurance, and professional services. Professional services are principally comprised of outside legal, audit and information technology consulting. General and administrative expenses increased in the first quarter of fiscal 2007 compared to the same period in fiscal 2006 primarily due to an increase of $0.8 million in legal fees incurred in connection with the patent litigation with Boston Scientific, an increase of $377,000 related to higher finance and administrative personnel costs, an increase of $191,000 related to the amortization of identifiable intangible assets in connection with the purchase of Neurologic, an increase in audit and tax fees of $191,000 related primarily to the year end audit, an increase of $164,000 in outside services related to compensation analysis and benchmarking, printer costs associated with our SEC filings, regulatory technical file submissions associated with our microcoils and microcatheters, an increase of $124,000 in stock-based compensation expense due primarily to the impact of the adoption of SFAS No. 123R, an increase of $112,000 due to consulting fees related to compliance with Sarbanes-Oxley regulations, partially offset by a decrease of $167,000 related to management bonuses in connection with our IPO incurred in the first quarter of fiscal 2006. As a percentage of revenues, general and administrative expenses were 35% in the first quarter of fiscal 2007 and 32% in the first quarter of fiscal 2006. As we incur additional expenses associated with being a public company and to the extent our business expands, we expect that general and administrative expenses will increase in absolute dollars in future periods.

Table of Contents

Stock-based Compensation Charges

During the first quarter of fiscal 2007, we adopted SFAS No. 123R which replaced SFAS No. 123 and supersedes APB No. 25. Under the fair value provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is generally the vesting period. We transitioned to SFAS No. 123R using the modified-prospective method, under which prior periods have not been revised for comparative purposes. The valuation provisions of SFAS No. 123R apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost previously estimated for our SFAS No. 123 pro forma disclosures, excluding pre-IPO options, for which the fair value was determined using the minimum value method. For these grants, any remaining unamortized deferred compensation expenses will continue to be accounted for under the intrinsic value method of APB No. 25.

We recognized stock-based compensation expense under SFAS No. 123R for employee stock options and employee stock purchase plan shares of $238,000 and $43,000 in the first quarter of fiscal 2007, respectively.

We recognized stock-based compensation expense related to the amortization of deferred stock-based compensation of $57,000 and $58,000 in the first quarter of fiscal 2007 and 2006, respectively.

In addition, stock options issued to non-employees, generally for consulting services related to patient studies or marketing analysis, are recorded at their fair value on the date of vesting and recognized over the respective service or vesting period. In connection with stock options issued to non-employees, we recognized stock-based compensation of $102,000 and $6,000 in the first quarter of fiscal 2007 and 2006, respectively.

Stock-based compensation expense included in the consolidated statement of operations is as follows (in thousands):

	Three months ended June 30,	
	2006	**2005**
Cost of goods sold	$ 27	$ 6
Research and development	43	11
Sales and marketing	216	17
General and administrative	154	30
Total	$ 440	$ 64

Additionally, approximately $28,000 in stock-based compensation expense related to SFAS No. 123R has been capitalized as inventory as of June 30, 2006.

As of June, 2006, there was approximately $4.1 million of stock-based compensation expense, after estimated forfeitures, related to unvested employee stock options, which is expected to be recognized over an estimated weighted average amortization period of 3.0 years.

The future amortization of deferred compensation is as follows:

Fiscal year 2007 (remaining 9 months)	$172,000
Fiscal year 2008	168,000
	$340,000

The stock-based compensation expense will be reduced in the period of forfeiture for any accrued but unvested compensation arising from early termination of an option holder s services.

Other Income, Net

	Three months ended June 30,	Change

(Dollars in thousands)	2006	2005	$	%
Interest and investment income	$ 379	$ 128	$ 251	196%
Interest expense		(6)	6	-100%
Other income (expense), net	204	(494)	698	-141%
Total other income (expense), net	$ 583	$ (372)	$ 955	-257%

Other income, net consists primarily of investment income, interest expense, and foreign currency gains and losses. Total other income, net was $583,000 in the first quarter of fiscal 2007, an increase of $955,000 from other expense, net of $372,000 in the first quarter of fiscal 2006. Total other income (expense), net increased in the first quarter of fiscal 2007 compared to the same period in fiscal 2006 primarily due to foreign exchange gains resulting from differences in exchange rates between the time of the recording of the transaction and settlement of foreign currency denominated receivables and payables, an increase of $251,000 in interest income as a result of higher interest rates and higher average cash and investment balances due primarily from proceeds from our IPO. During the first quarter of fiscal 2006, a non-operating charge of $158,000 was recorded upon the completion of our IPO for the change in fair value of the 2005 common stock warrants.

Table of Contents

Income Taxes

We have incurred net operating losses for both federal and state purposes since inception and, as a result, we have paid no federal or state income taxes. In the first quarter of fiscal 2007, we recorded a noncurrent tax benefit of approximately $37,000 for the tax effect of the current quarter amortization related to the intangible assets acquired in the Neurologic transaction which are not deductible. As of March 31, 2006, we had federal, state and foreign net operating loss carryforwards (NOLs) that are available to reduce future taxable income of approximately $30.8 million, $16.5 million and $2.1 million, respectively. The federal NOLs will expire at various dates beginning in 2012, state NOLs will expire beginning in 2007 and the foreign NOLs will expire beginning in 2009. We also have federal and state tax research and development credit carryforwards of approximately $0.9 million and $0.8 million, respectively. The federal tax credit carryforwards will expire beginning in 2012. The state tax credit carryforwards do not expire. Due to the uncertainty of our ability to generate sufficient taxable income to realize the carryforwards prior to their expiration, we have established a valuation allowance at June 30, 2006 and 2005 to fully offset the deferred tax assets.

Accretion of Redeemable Convertible Preferred Stock to Redemption Value

Our convertible preferred stock that was outstanding prior to the closing of our initial public offering in June 2005 was redeemable at the request of the holder on or after the sixth anniversary of the original issuance date based upon certain circumstances. This right expired upon the automatic conversion of all of our preferred stock into common stock upon the closing of the IPO. Prior to the closing of the IPO, we were accreting the carrying value of the preferred stock to the mandatory redemption amount on the sixth anniversary using the effective interest method through periodic charges to additional paid-in capital. We recorded a non-cash charge of $276,000 for the accretion on our redeemable convertible preferred stock in the first quarter of fiscal 2006.

Beneficial Conversion Feature

The difference between the proceeds allocated to the Series E preferred stock and the estimated fair value of the common stock issuable upon conversion resulted in a beneficial conversion feature on the Series E preferred stock which was recorded as a reduction to the Series E preferred stock and an increase to additional paid-in-capital. The total beneficial conversion feature was $383,000 which, prior to the completion of the IPO, was being amortized as a reduction of net income available to common stockholders over the period of redemption of the Series E preferred stock. Upon completion of the IPO, we recorded a non-cash charge of $383,000 for the beneficial conversion feature on our Series E preferred stock in the first quarter of fiscal 2006.

Liquidity and Capital Resources

	Three months ended June 30,	
	2006	**2005**
Cash flow activities:		
Net cash used in operating activities	$ (4,364)	$ (2,912)
Net cash used in investing activities	$ (933)	$ (72)
Net cash provided by financing activities	$ 97	$ 33,575

Since our inception, we have funded our operations primarily through issuances of convertible preferred stock and related warrants, which provided us with aggregate gross proceeds of $61.7 million. On June 21, 2005, we completed an IPO in which we sold 3,250,000 shares of our common stock at $11.00 per share for net cash proceeds to us of approximately $33.2 million, net of underwriting discounts and commissions. On July 6, 2005, we sold an additional 250,000 shares of common stock at $11.00 per share pursuant to the over-allotment option granted to the underwriters. Together with the over-allotment shares sold by us, cash proceeds to us in the offering were approximately $33.0 million, net of underwriting discounts and offering expenses.

As of June 30, 2006, we had cash and marketable securities of $31.5 million, compared to $37.1 million at March 31, 2006. We believe that our current cash position and the cash expected to be generated from product sales will be sufficient to meet our working capital and capital expenditure requirements for at least the next twelve months.

Net cash used in operating activities was $4.4 million during the first quarter of fiscal 2007, compared to $2.9 million during the first quarter of fiscal 2006. Net cash used in operating activities during the first quarter of fiscal 2007 resulted primarily from operating losses, an increase in accounts receivable due to an increase in the number of microcoil products sold, an increase in inventory primarily due to an increase in the number of consignment locations, an increase in prepaid expenses and other current assets primarily related to the payment of directors and officers insurance premiums, a decrease in accounts payable due to timing

Table of Contents

of payments made to our vendors. These factors were partially offset by an increase in stock-based compensation expense primarily due to the adoption of SFAS No. 123R, an increase in depreciation and amortization, and an increase provision for impairment of inventory. Net cash used in operating activities during the first quarter of fiscal 2006 resulted from operating losses and net changes in operating assets and liabilities resulting from the growth of our business.

Net cash used in investing activities was $0.9 million during the first quarter of fiscal 2007, compared to $72,000 during the first quarter of fiscal 2006. Net cash used in investing activities during the first quarter of fiscal 2007 was primarily related to the milestone payment to Biotronik which has been capitalized as licensed technology. Net cash used in investing during the first quarter of fiscal 2006 was related to the purchase of capital equipment.

Net cash provided by financing activities was $97,000 during the first quarter of fiscal 2007, compared to $33.6 million during the first quarter of fiscal 2006. Net cash provided by financing activities during the first quarter of fiscal 2007 consisted of proceeds from the exercise of stock options. Net cash provided by financing activities during the first quarter of fiscal 2006 consisted primarily of net proceeds of $33.2 million (after deducting underwriters commission) from the sale of common stock during our IPO, partially offset by the expenditure of $0.7 million incurred in preparation for the IPO, proceeds of $1.0 million from the exercise of preferred and common stock warrants, and proceeds of $80,000 from the exercise of stock options.

To the extent that existing cash and marketable securities and cash from operations are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing. Although we are currently not a party to any definitive agreement with respect to potential investments in, or acquisitions of, complementary businesses, services or technologies, we may enter into such agreements in the future, which could require us to seek additional funds through public or private equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Recent Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, or FIN 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, which clarifies the accounting for uncertainty in tax positions. FIN 48 requires that we recognize in our financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of the Company s 2008 fiscal year, with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on our financial statements.

Contractual Obligations

We have obligations under non-cancelable operating leases with various expiration dates through 2012 and purchase commitments for inventory, capital equipment and operating expenses, such as materials for research and development and consulting.

As of June 30, 2006, our contractual commitments were as follows:

		Payments Due by Period			
Contractual obligations:	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**Beyond 5 years**
Non-cancelable operating lease obligations	$3,938	$ 626	$1,904	$1,118	$290
Purchase commitments	3,401	3,401			
Total	$7,339	$4,027	$1,904	$1,118	$290

We are required to pay future earn-out amounts associated with the purchase of Neurologic. The future earn-out payments will be one-third of Neurologic s product sales during specified periods.

Item 3. ***Quantitative and Qualitative Disclosures About Market Risk.***

Foreign Currency Market Risks. Historically, we have been exposed to risks from fluctuations in currency exchange rates due to intercompany loans made to Micrus SA, our Swiss subsidiary, in 2001 in connection with its incorporation. These loans are denominated in Swiss francs and will fluctuate in value against the U.S. dollar, causing us to recognize foreign exchange gains and losses. The functional currency of our Swiss subsidiary is the Swiss franc. The functional currency of our UK subsidiary is the pound sterling. In Europe, our revenues are denominated in Swiss francs, euros, pounds sterling and other currencies. Accordingly, we are exposed to market risk related to changes between the Swiss franc and these other currencies. If the Swiss

Table of Contents

franc appreciates against the currencies in which our receivables are denominated, we will recognize foreign currency losses. For the preparation of our consolidated financial statements, the financial results of our Swiss subsidiary are translated into U.S. dollars based on average exchange rates during the applicable period. A hypothetical 10% decline in the value of the Swiss franc versus the U.S. dollar would cause us to recognize a loss of $163,000 related to our loan with Micrus SA and a $410,000 decrease in our comprehensive loss from our investment in Micrus SA. A hypothetical 10% decline in the value of the pound sterling versus the U.S. dollar would cause us to recognize a $225,000 decrease in our comprehensive loss from our investment in Micrus UK. A hypothetical 10% decline in the value of the euro versus the Swiss franc would cause us to recognize a loss of $384,000 based on our foreign denominated receivables as of June 30, 2006.

In fiscal 2006, approximately 32% of our revenues was denominated in currencies other than the U.S. dollar. In future periods, we believe a greater portion of our revenues could be denominated in currencies other than the U.S. dollar, thereby increasing our exposure to exchange rate gains and losses on non-U.S. currency transactions. We do not currently enter into forward exchange contracts to hedge exposure denominated in foreign currencies or any other derivative financial instruments for trading or speculative purposes. In the future, if we believe our currency exposure merits, we may consider entering into transactions to help mitigate that risk.

Interest Rate Market Risk. Our cash is invested in bank deposits and money market funds denominated in U.S. dollars. The carrying value of these cash equivalents approximates fair market value. Our investments in marketable securities are subject to interest rate risk, which is the risk that our financial condition and results of operations could be adversely affected due to movements in interest rates.

Item 4. Controls and Procedures

Our President and Chief Executive Officer, John T. Kilcoyne, and our Executive Vice President, Chief Financial Officer and Secretary, Robert A. Stern, evaluated the effectiveness of our disclosure controls and procedures as of the end of fiscal 2006. Based on their evaluation, they concluded that our disclosure controls are effective in providing reasonable assurance that material information relating to our company is made known to management on a timely basis during the period when our periodic reports are being prepared.

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II OTHER INFORMATION

Item 1. ***Legal Proceedings.***

FCPA Investigation

In August 2004, while reviewing our sales and payment procedures, we identified certain payments we made to physicians located in France, Germany, Spain and Turkey that may have likely violated the FCPA and the laws of such countries as well as possibly the laws of Switzerland, where our Swiss subsidiary is located. Our audit committee immediately directed our legal counsel to conduct an internal investigation into these payments. In September 2004, we voluntarily disclosed to the United States Department of Justice (DOJ) the factual information obtained in our internal investigation of potential violations of the FCPA.

Soon after reaching the preliminary conclusions of the investigation, our Board of Directors adopted a Foreign Corrupt Practices Act Policy and appointed a senior executive to fill the newly created position of Compliance Officer. The Compliance Officer has with the assistance of our general counsel and outside legal counsel developed a number of other corporate policies that will govern payments to and contractual agreements with physicians and other consultants. In addition, the employment of our then Chief Executive Officer and our then Vice President of Sales and Marketing was terminated in November 2004.

After reviewing the results of the internal investigation and the compliance procedures implemented by us, the DOJ entered into an agreement (the DOJ Agreement) with us in February 2005 pursuant to which it will not prosecute us for the conduct disclosed to the DOJ, and we agreed to: (i) accept responsibility for the actions of our employees and officers, (ii) pay a monetary penalty of $450,000, (iii) continue to cooperate with the DOJ in its investigation, including the waiver of legal privileges, (iv) establish policies and procedures to assure compliance with the FCPA and other relevant bribery laws, (v) retain and pay for an independent law firm to act as a monitor, for purposes of reporting to the DOJ for a period of three years as to our compliance with the DOJ Agreement and monitoring our

implementation and adherence to FCPA compliance policies and procedures, and

Table of Contents

(vi) cooperate fully with the DOJ, the independent monitor and the SEC. We must remain in complete compliance with these conditions for a period of two years, or face the filing of a criminal complaint against us. Moreover, the terms of the DOJ Agreement will bind our successors, or merger partners, as long as the agreement is in effect.

The payments we made to physicians located in France, Germany, Spain and Turkey also may have likely violated the applicable laws in those foreign jurisdictions and may possibly have violated laws in Switzerland. We are not able to determine at this time what penalties or other actions, if any, authorities in France, Germany, Spain, Turkey or Switzerland may impose on us, or our Swiss subsidiary, as a result of such violations. Such amounts could be material to the financial position, results of operations or cash flows of the Company.

Patent Litigation

In September 2004, Boston Scientific Corporation and Target Therapeutics, Inc., a subsidiary of Boston Scientific Corporation (collectively Boston Scientific), filed a patent infringement suit in the United States District Court for the Northern District of California, alleging that our coil devices infringe two patents held by Boston Scientific and that this infringement is willful. Sales of our microcoil devices currently represent virtually all of our revenues. Boston Scientific is a large, publicly-traded corporation with significantly greater financial resources than us. In November 2004, we answered Boston Scientific s complaint and counterclaimed, alleging that Boston Scientific s occlusive products, and their use, infringe three of our patents. Each party seeks an injunction preventing manufacture, offer for sale, use and importation of the other s detachable coil devices in the United States, damages for past infringement, which may be trebled, and payment of its legal fees and costs. In addition, each party seeks a declaration that the patents of the other are invalid and not infringed and has alleged that certain of the asserted patents of the other are unenforceable due to inequitable conduct.

Boston Scientific is also a party in two other lawsuits against Cordis Corporation and ev3/Micro Therapeutics, Inc. in which the Boston Scientific patents which are the basis of Boston Scientific s suit against us are also at issue. An outcome of either of these lawsuits adverse to Cordis Corporation or ev3/ Micro Therapeutics, and related to the same patents Boston Scientific asserts against us, could have an adverse impact on certain of our defenses in our litigation with Boston Scientific.

In October 2004, Cordis requested *ex parte* reexamination of certain claims in those patents. In February 2005, the court granted a stay of the Boston Scientific lawsuit against Micrus until the earlier of twelve 12 months or the outcome of the reexamination by the U.S. Patent and Trademark Office (USPTO) in the Cordis case. In February 2006, the USPTO issued a Notice of Intent to Issue Ex Parte Reexamination Certificate for one of the two patents, apparently confirming all of the claims of that patent. In February 2006, the USPTO also issued an Office Action in which it apparently confirmed the patentability of certain of the claims in the second patent, but rejected the remainder. Boston Scientific has stated to the USPTO and to the court that the rejected claims from the second patent can be reissued and certified as patentable upon reexamination if a correction is made to the priority chain for the second patent. In March 2006, the court lifted the stay with respect to any claims that were confirmed as patentable in the reexamination proceedings and has permitted discovery in the case to commence with respect to those claims. The parties have since exchanged preliminary infringement contentions in which Boston Scientific asserted only claims from the first patent. On June 16, 2006, the parties exchanged preliminary invalidity contentions in which each side disclosed various grounds upon which it will argue the invalidity of the other party s presently asserted patents. Boston Scientific has stated that it would supplement its preliminary infringement contentions to include claims from the second Boston Scientific patent still under reexamination upon completion of the reexamination, and that these asserted claims would be from the set of claims which has not yet been deemed in condition to be confirmed by the USPTO. The Company and Boston Scientific have negotiated a schedule that would permit discovery and claim construction proceedings to proceed for the second patent while it is still undergoing reexamination and reissue proceedings. The Court has not yet issued an order stating whether it will accept this schedule. Based on our current understanding of the reexamination, we believe that the claims of the second Boston Scientific patent also will be confirmed. The confirmation of asserted claims in one, and potentially both, of Boston Scientific s asserted patents may negatively impact our chances of mounting a successful invalidity defense against this patent.

We are unable at this time to determine the likely outcome of the patent litigation. Patent lawsuits involve complex legal and factual issues which can take a number of years and a great deal of expense and management attention to

resolve. We may also be subject to potentially negative publicity due to the litigation. In the because of an event it is determined that we infringe patent claims asserted by Boston Scientific and that those claims are not invalid and not unenforceable we may, among other things, be required to do one or more of the following:

pay damages, including up to treble damages and Boston Scientific s attorney s fees and costs, which may be substantial;

Table of Contents

cease, because of an injunction, the making, using, selling, offering to sell, importing into the U.S. or exporting from the U.S. of our microcoil devices, which currently represent virtually all of our revenues, found to infringe the patent claims asserted by Boston Scientific;

expend significant resources to redesign our technology so that it does not infringe the patent claims asserted by Boston Scientific, which may not be possible;

discontinue manufacturing or other processes that incorporate technology that infringes the patent claims asserted by Boston Scientific;

become subject to a compulsory license order under which we would be required to pay Boston Scientific a royalty on future sales of our products; and/or

obtain a license from Boston Scientific to use the relevant patents, which may not be available to us on acceptable terms, or at all.

If our microcoil devices were found to infringe, any development or acquisition of products or technologies that do not infringe the patent claims asserted by Boston Scientific could require the expenditure of substantial time and other resources and could have a material adverse effect on our business and financial results. If we were to be required to, but could not obtain, a license under the patent claims asserted by Boston Scientific, we would likely be prevented from commercializing or further commercializing the relevant products. We believe that it is unlikely that we would be able to obtain a license under the patent claims being asserted by Boston Scientific. If we need to redesign our products to avoid the patent claims being asserted by Boston Scientific, we may suffer significant regulatory delays associated with conducting additional studies or submitting technical, manufacturing or other information related to the redesigned products and, ultimately, in obtaining approval.

As a result of Boston Scientific s answer to our counterclaim that Boston Scientific infringes three of our patents, the validity of those patents is now at issue in the lawsuit. The court could find that those patents are invalid, which would prevent us from asserting those patents against third parties.

An unfavorable outcome for us in this patent litigation would significantly harm our business and may cause us to materially change our business model.

From time to time, we may be involved in other litigation relating to claims arising out of our ordinary course of business. We are not currently a party to any other material legal proceedings.

Item 1A. Risk Factors.

Certain Factors that May Affect Our Business and Future Results

Some of the information included herein contains forward-looking statements as defined in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements are based on the beliefs of, estimates made by and information currently available to our management and are subject to certain risks, uncertainties and assumptions. Any statements contained herein (including, without limitation, statements to the effect that the Company, we, or management may, will, expects, anticipates, estimates, continues, plans, believes, or projects, or statements concerning potential or oppor any variations thereof, comparable terminology or the negative thereof) that are not statements of historical fact should be construed as forward-looking statements. Our actual results may vary materially from those expected in these forward-looking statements. The realization of such forward-looking statements may be impaired by risks including, but not limited to the following:

Our future success is dependent on the continued growth in embolic coiling procedures and our ability to convince a concentrated customer base of neurointerventionalists to use our products as an alternative to other available products.

Our future success and revenue growth are significantly dependent upon an increase in the use of embolic coiling as a procedure to treat cerebral aneurysms. If the number of embolic coiling procedures does not increase or if a new procedure that does not employ our products becomes a more acceptable alternative among neurointerventionalists,

our business would be seriously harmed.

Table of Contents

The number of interventional neuroradiologists and neurosurgeons trained to conduct embolic coiling procedures is relatively small, both in the United States and abroad. There are currently approximately 300 neurointerventionalists in the United States who perform embolic coiling procedures. We believe less than one-third of these physicians perform a substantial majority of the total number of embolic coiling procedures per year. In the three months ended June 30, 2006, a substantial portion of our product sales were to approximately 60 hospitals in the United States. The growth in the number of interventional neuroradiologists and neurosurgeons in the United States is constrained by the lengthy training programs required to educate these physicians. Accordingly, our revenue growth will be primarily dependent on our ability to increase sales of our products to our existing customers and to increase sales of products to trained neurointerventionalists that currently use products offered by our competitors. We believe that neurointerventionalists who do not currently use our products will not widely adopt our products unless they determine, based on experience, clinical data and published peer reviewed journal articles, that our products provide benefits or an attractive alternative to the clipping of aneurysms or the use of competitors products. We believe neurointerventionalists base their decision to use an alternative procedure or product on the following criteria, among others:

extent of clinical evidence supporting patient benefits;

their level of experience with the alternative product;

perceived liability risks generally associated with the use of new products and procedures;

availability of reimbursement within healthcare payment systems; and

costs associated with the purchase of new products and equipment.

In addition, we believe that recommendations and support of our products by influential physicians are essential for market acceptance and adoption. If we do not receive continued support from such influential physicians, neurointerventionalists and hospitals may not use our products. In such circumstances, we may not achieve expected revenue levels and our business will suffer.

We are currently involved in a patent litigation action involving Boston Scientific Corporation and, if we do not prevail in this action, we could be liable for past damages and be prevented from making, using, selling, offering to sell, importing into the U.S. or exporting from the U.S., our microcoils, our primary product line.

In September 2004, Boston Scientific Corporation and Target Therapeutics, Inc., a subsidiary of Boston Scientific Corporation, (collectively Boston Scientific), filed a patent infringement suit in the United States District Court for the Northern District of California, alleging that our microcoil devices infringe two patents held by Boston Scientific and that this infringement is willful. Sales of our microcoil devices currently represent virtually all of our revenues. Boston Scientific is a large, publicly-traded corporation with significantly greater financial resources than us. In November 2004, we answered Boston Scientific s complaint and counterclaimed, alleging that Boston Scientific s occlusive products, and their use, infringe three of our patents. Each party seeks an injunction preventing the making, using, selling, offering to sell, importing into the U.S. or exporting from the U.S., of the other s detachable coil devices in the United States, damages for past infringement, which may be trebled, and payment of its legal fees and costs. In addition, each party seeks a declaration that the patents of the other are invalid and not infringed and has alleged that certain of the asserted patents of the other are unenforceable due to inequitable conduct.

Boston Scientific is also a party in two other lawsuits against Cordis, a division of Johnson & Johnson (Cordis) and ev3/Micro Therapeutics, Inc. in which the Boston Scientific patents, which are the basis of Boston Scientific s suit against us, are also at issue. An outcome of either of these lawsuits adverse to Cordis or ev3/Micro Therapeutics, Inc., and related to the same patent claims Boston Scientific asserts against us, could have an adverse impact on certain of our defenses in our litigation with Boston Scientific.

In October 2004, Cordis requested *ex parte* reexamination of certain claims in those patents. In February 2005, the court granted a stay of the Boston Scientific lawsuit against Micrus until the earlier of 12 months or the outcome of the reexamination by the U.S. Patent and Trademark Office (USPTO) in the Cordis case. In February 2006, the

USPTO issued a Notice of Intent to Issue Ex Parte Reexamination Certificate for one of the two patents, apparently confirming all of the claims of that patent. In February 2006, the USPTO also issued an Office Action in which it apparently confirmed the patentability of certain of the claims in the second patent, but rejected the remainder. Boston Scientific has stated to the USPTO and to the court that the rejected claims from the second patent can be reissued and certified as patentable upon reexamination if a correction is made to the priority chain for the second patent. In March 2006, the court lifted the stay with respect to any claims that were confirmed as patentable in the reexamination proceedings and has permitted discovery in the case to commence with respect to those claims.

Table of Contents

The parties have since exchanged preliminary infringement contentions in which Boston Scientific asserted only claims from the first patent. On June 16, 2006, the parties exchanged preliminary invalidity contentions in which each side disclosed various grounds upon which it will argue the invalidity of the other party s presently asserted patents. Boston Scientific has stated that it would supplement its preliminary infringement contentions to include claims from the second Boston Scientific patent still under reexamination upon completion of the reexamination, and that these asserted claims would be from the set of claims which has not yet been deemed in condition to be confirmed by the USPTO. The Company and Boston Scientific have negotiated a schedule that would permit discovery and claim construction proceedings to proceed for the second patent while it is still undergoing reexamination and reissue proceedings. The Court has not yet issued an order stating whether it will accept this schedule. Based on our current understanding of the reexamination, we believe that the claims of the second Boston Scientific patent also will be confirmed. The confirmation of asserted claims in one, and potentially both, of Boston Scientific s asserted patents may negatively impact our chances of mounting a successful invalidity defense against this patent.

We are unable at this time to determine the likely outcome of the patent litigation. Patent lawsuits involve complex legal and factual issues which can take a number of years and a great deal of expense and management attention to resolve. We may also be subject to negative publicity due to the litigation. In the event it is determined that we infringe patent claims asserted by Boston Scientific and that those claims are not invalid and not unenforceable we may, among other things, be required to do one or more of the following:

pay damages, including up to treble damages and Boston Scientific s attorney s fees and costs, which may be substantial;

cease, because of an injunction, the making, using, selling, offering to sell, importing into the U.S. or exporting from the U.S. of our microcoil devices, which currently represent virtually all of our revenues, found to infringe the patent claims asserted by Boston Scientific;

expend significant resources to redesign our technology so that it does not infringe the patent claims asserted by Boston Scientific, which may not be possible;

discontinue manufacturing or other processes that incorporate technology that infringes the patent claims asserted by Boston Scientific;

become subject to a compulsory license order under which we would be required to pay Boston Scientific a royalty on future sales of our products; and/or

obtain a license from Boston Scientific to use the relevant patents, which may not be available to us on acceptable terms, or at all.

If our microcoil devices were found to infringe, any development or acquisition of products or technologies that do not infringe the patent claims asserted by Boston Scientific could require the expenditure of substantial time and other resources and could have a material adverse effect on our business and financial results. If we were required to but could not obtain a license under the patent claims asserted by Boston Scientific, we would likely be prevented from commercializing or further commercializing the relevant products. We believe that it is unlikely that we would be able to obtain a license under the patent claims being asserted by Boston Scientific. If we need to redesign our products to avoid the patent claims being asserted by Boston Scientific, we may suffer significant regulatory delays associated with conducting additional studies or submitting technical, manufacturing or other information related to the redesigned product and, ultimately, in obtaining approval.

As a result of Boston Scientific s answer to our counterclaim that Boston Scientific infringes three of our patents, the validity of those patents is now at issue in the lawsuit. The court could find that those patents are invalid, which would prevent us from asserting those patents against third parties.

An unfavorable outcome for us in this patent litigation would significantly harm our business and may cause us to materially change our business model.

We have a limited operating history, have incurred significant operating losses since inception, and expect to continue to incur losses, and we cannot assure you that we will achieve profitability.

We were incorporated in the State of Delaware in 1996, and began commercial sales of our microcoil products in 2000. We have yet to demonstrate that we can generate sufficient sales of our products to become profitable. The extent of our future operating losses and the timing of profitability are highly uncertain, and we may never achieve profitability. We have incurred

Table of Contents

significant net losses since our inception, including losses of approximately $8.3 million in fiscal 2006, $6.7 million in fiscal 2005, $2.0 million in fiscal 2004 and $3.0 million in the first quarter of fiscal 2007. At June 30, 2006, we had an accumulated deficit of $52.6 million. It is possible that we will never generate sufficient revenues from product sales to achieve profitability. Even if we do achieve significant revenues from our product sales, we expect that increased operating expenses will result in significant operating losses in the near term as we, among other things:

- grow our internal and third-party sales and marketing forces to expand the sales of our products in the United States and internationally;
- increase our research and development efforts to improve upon our existing products and develop new products;
- perform clinical research and trials on our existing products and product candidates;
- expand our regulatory resources in order to obtain governmental approvals for our existing product enhancements and new products;
- acquire and/or license new technologies; and
- expand manufacturing.

As a result of these activities, we may never become profitable. Even if we do achieve profitability, we may not be able to sustain or increase profitability on an ongoing basis.

Our quarterly operating and financial results and our gross margins are likely to fluctuate significantly in future periods.

Our quarterly operating and financial results are difficult to predict and may fluctuate significantly from period to period. The level of our revenues, gross margins and results of operations at any given time will be based primarily on the following factors:

- neurointerventionalist and patient acceptance of our products;
- changes in the number of embolic coiling procedures performed to treat cerebral aneurysms;
- the seasonality of our product sales;
- the mix of our products sold;
- stocking patterns for distributors;
- the development of new procedures to treat cerebral aneurysms;
- results of clinical research and trials on our existing products and products in development;
- demand for, and pricing of, our products;
- levels of third-party reimbursement for our products;
- timing of new product offerings, acquisitions, licenses or other significant events involving us or our competitors;
- increases in the costs of manufacturing and selling our products;

the amount and timing of our operating expenses;

litigation expenses;

fluctuations in foreign currency exchange rates;

regulatory approvals and legislative changes affecting the products we may offer or those of our competitors;

Table of Contents

the effect of competing technological and market developments;

changes in our ability to obtain and maintain FDA approval or clearance for our products.

inventory adjustments we may have to make in any quarter;

interruption in the manufacturing or distribution of our products;

our ability to maintain and expand our sales force and operational personnel;

the ability of our suppliers to timely provide us with an adequate supply of materials and components; and

amount and timing of capital expenditures and other costs relating to any potential expansion of our operations.

Many of the products we may seek to develop and introduce in the future will require FDA approval or clearance and meet similar regulatory requirements in other countries where we seek to market our products, without which we cannot begin to commercialize them. Forecasting the timing of sales of our products is difficult due to the delay inherent in seeking FDA and other clearance or approval, or the failure to obtain such clearance or approval. In addition, we will be increasing our operating expenses as we build our commercial capabilities. Accordingly, we may experience significant, unanticipated quarterly losses. Because of these factors, our operating results in one or more future quarters may fail to meet the expectations of securities analysts or investors, which could cause our stock price to decline significantly.

We may not be able to develop new products or product enhancements that will be accepted by the market.

Our success will depend in part on our ability to develop and introduce new products and enhancements to our existing products. We cannot assure you that we will be able to successfully develop or market new products or that any of our future products will be accepted by the neurointerventionalists who use our products or the payors who reimburse for many of the procedures performed with our products. The success of any new product offering or enhancement to an existing product will depend on several factors, including our ability to:

properly identify and anticipate interventionalist and patient needs;

develop new products or enhancements in a timely manner;

obtain the necessary regulatory approvals for new products or product enhancements;

provide adequate training to potential users of our products;

receive adequate reimbursement for our procedures; and

develop an effective marketing and distribution network.

If we do not develop new products or product enhancements in time to meet market demand or if there is insufficient demand for our products or enhancements, we may not achieve expected revenue levels and our business will suffer.

Our international operations and our relationships with physicians and other consultants require us to comply with a number of U.S. and international regulations.

We are required to comply with a number of international regulations related to sales of medical devices and contractual relationships with physicians in countries outside of the United States. In addition, we must comply with the Foreign Corrupt Practices Act (FCPA) which prohibits U.S. companies or their agents and employees from providing anything of value to a foreign official for the purposes of influencing him or her to help obtain or retain business, direct business to any person or corporate entity, or obtain any unfair advantage.

In August 2004 while reviewing our sales and payment procedures, we identified certain payments we made to physicians outside the United States that may have violated the FCPA and the laws of certain foreign countries. Following an internal investigation, we voluntarily disclosed to the United States Department of Justice (DOJ) the factual information obtained in our internal investigation of potential violations of the FCPA.

Table of Contents

After reviewing the results of the internal investigation and the compliance procedures implemented by us, the DOJ entered into an agreement (the DOJ Agreement) with us in February 2005. Pursuant to that agreement, the DOJ will not prosecute us for the conduct disclosed to the DOJ, and we agreed to various conditions, including establishing policies and procedures to assure compliance with the FCPA and other relevant anti-bribery laws, retaining an independent law firm to act as a monitor for purposes of reporting to the DOJ for a period of three years as to our compliance with the DOJ Agreement and to monitor our implementation of and adherence to FCPA compliance policies and procedures, and fully cooperating with the DOJ, the independent monitor, and the SEC. We must remain in complete compliance with these conditions for a period of two years, or face the filing of a criminal complaint against us. The terms of the DOJ Agreement will bind our successors, or any merger partners, as long as the DOJ Agreement is in effect.

The payments we made to physicians in France, Germany, Spain and Turkey also may have likely violated the applicable laws in those foreign jurisdictions and may possibly have violated laws in Switzerland, where our Swiss subsidiary is located. We are not able to determine at this time what penalties or other sanctions, if any, authorities in France, Germany, Spain, Turkey or Switzerland may impose on us as a result of such violations.

Though we have adopted a number of compliance procedures, including adoption of a Foreign Corrupt Practices Act Policy and related procedures, and appointed a Compliance Officer, we cannot assure you that we will be able to comply with the various regulations in foreign jurisdictions, which vary from country to country. Implementing and monitoring such compliance procedures in a number of foreign jurisdictions can be very expensive and time-consuming. Any failure by us to adopt appropriate compliance procedures and ensure that our employees and agents comply with applicable laws and regulations in foreign jurisdictions could result in substantial penalties and/or restrictions in our ability to sell products in certain foreign jurisdictions.

We are in a highly competitive market segment, face competition from large, well-established medical device manufacturers with significant resources, and may not be able to increase penetration in our markets or otherwise compete effectively.

The market for medical devices for treatment of cerebral vascular diseases is intensely competitive, subject to rapid change and significantly affected by new product introductions and other market activities of industry participants. We compete primarily with the Target Therapeutics division of Boston Scientific Corporation, the market leader, as well as the Cordis division of Johnson & Johnson, ev3/Micro Therapeutics and Terumo/MicroVention. At any time, other companies may develop alternative treatments, products or procedures for the treatment of cerebral aneurysms that compete directly or indirectly with our products. If alternative treatments prove to be superior to our microcoil or other products, continued use or adoption of our products could be negatively affected and our future revenues could suffer.

In addition, most of our current and potential competitors are either large publicly traded or divisions or subsidiaries of large publicly traded companies, and enjoy several competitive advantages over us, including:

- greater financial and personnel resources;
- significantly greater name recognition;
- established relationships with neurointerventionalists;
- established distribution networks;
- greater experience in obtaining and maintaining FDA, and other regulatory approvals for products and product enhancements, and greater experience in developing compliance programs for compliance with numerous federal, state, local and similar laws in non-U.S. jurisdictions;
- greater resources for product research and development;
- greater experience in, and resources for, launching, marketing, distributing and selling products; and

broader product lines.

Except for our distribution agreement with Goodman, none of our customers has long-term purchase agreements with us and may at any time switch to the use of our competitors products.

Table of Contents

For these reasons, we may not be able to compete successfully against our current or potential future competitors and sales of our products and our revenues may decline.

Our sales in international markets subject us to foreign currency exchange and other risks and costs that could harm our business.

A substantial portion of our revenues are derived from outside the U.S. For the fiscal years ended March 31, 2004, 2005 and 2006, revenues from customers outside the U.S. represented approximately 50%, 48% and 53% respectively, of our revenues. For the three months ended June 30, 2007, revenues from customers outside the United States represented 53% or our revenues. We anticipate that revenues from international customers will continue to represent a substantial portion of our revenues as we expand in new international markets including China and Japan. Because we generate revenues in foreign currencies, we are subject to the effects of exchange rate fluctuations. For the three months ended June 30, 2007, approximately 32% of our revenues were denominated in currencies other than the U.S. dollar. The functional currency of our Swiss subsidiary is the Swiss franc. In Europe, our revenues are denominated in Swiss francs, euros, pounds sterling and U.S. dollars. Accordingly, we are exposed to market risk related to changes between the Swiss franc and these other currencies in which we conduct business. If the Swiss franc appreciates against the currencies in which our receivables are denominated, we will recognize foreign currency losses. For the preparation of our consolidated financial statements, the financial results of our Swiss and UK subsidiaries are translated into U.S. dollars based on average exchange rates during the applicable period. If the U.S. dollar appreciates against the Swiss franc and pounds sterling, the revenues we recognize from sales by our European subsidiaries will be adversely impacted. Historically, we have also been exposed to risks from fluctuations in currency exchange rates due to intercompany loans made to Micrus SA, our Swiss subsidiary, in 2001 in connection with its incorporation. These loans are denominated in Swiss francs and will fluctuate in value against the U.S. dollar, causing us to recognize foreign exchange gains and losses. Foreign exchange gains or losses as a result of exchange rate fluctuations in any given period could harm our operating results and negatively impact our revenues. Additionally, if the effective price of our products were to increase as a result of fluctuations in foreign currency exchange rates, demand for our products could decline and adversely affect our results of operations and financial condition.

We are subject to various additional risks as a consequence of doing business internationally, and, in particular in Argentina, Brazil, Chile, Columbia, Costa Rica, Mexico, Peru, Venezuela, Greece and Turkey, each of which could harm our business, including the following:

- local economic and political instability or other potentially adverse conditions;
- lack of experience in certain geographical markets;
- unexpected delays or changes in regulatory requirements;
- increased difficulty in collecting accounts receivables in certain foreign countries;
- delays and expenses associated with tariffs and other trade barriers;
- difficulties and costs associated with attracting and maintaining third party distributors;
- compliance with foreign laws and regulations; and
- adverse tax consequences or overlapping tax structures.

If we fail to increase our direct sales force in a timely manner, our business could suffer.

We have a limited domestic and international direct sales force. We also have a distribution network for sales in the major markets in Europe, Latin America, Asia and the Middle East. As we launch new products and increase our marketing efforts with respect to existing products, we will need to significantly expand the number of our direct sales personnel on a worldwide basis. The establishment and development of a more extensive sales force will be expensive and time consuming. There is significant competition for sales personnel experienced in interventional medical device

sales. If we are unable to attract, motivate and retain qualified sales personnel and thereby increase our sales force, we may not be able to increase our revenues.

Table of Contents

If we fail to properly manage our anticipated growth, our business could suffer.

We have experienced, and may continue to experience, periods of rapid growth and expansion, which have placed, and will likely continue to place, a significant strain on our limited personnel and other resources. In particular, the expansion of our fabrication facility and the continuing expansion of our direct sales force will require significant management, technical and administrative resources. Any failure by us to manage our growth effectively, could have an adverse effect on our ability to achieve our development and commercialization goals.

To achieve our revenue goals, we must successfully increase production in our fabrication facility as required by customer demand. We may in the future experience difficulties in increasing production, including problems with production yields and quality control and assurance and in satisfying and maintaining compliance with regulatory requirements. These problems could result in delays in product availability and increases in expenses. Any such delay or increased expense could adversely affect our ability to generate revenues.

Future growth will also impose significant added responsibilities on management, including the need to identify, recruit, train and integrate additional employees. In addition, rapid and significant growth will place a strain on our administrative and operational infrastructure. In order to manage our operations and growth we will need to continue to improve our operational, financial and management controls, reporting systems and procedures. If we are unable to manage our growth effectively, it may be difficult for us to execute our business strategy and our operating results and business could suffer.

We can provide no assurance regarding our, or our independent registered public accounting firm s, conclusions at March 31, 2007 with respect to the effectiveness of our internal controls over financial reporting.

Section 404 of the Sarbanes-Oxley Act of 2002 (the Act) will require us to include an internal controls report from management in our Annual Report on Form 10-K for the fiscal year ended March 31, 2007 and in subsequent Annual Reports. The internal control report must include a statement:

- about management s responsibility for establishing and maintaining adequate internal controls over financial reporting;
- identifying the framework used by management to conduct the required evaluation of the effectiveness of our internal control over financial reporting;
- concerning management s assessment of the effectiveness of our internal control over financial reporting as of March 31, 2007, including a statement as to whether or not internal control over financial reporting is effective; and
- that our independent registered public accounting firm has issued an attestation report on management s assessment and the effectiveness of internal control over financial reporting.

We have and will be required to continue to expend significant resources in developing the necessary documentation and testing procedures required by Section 404. We have not completed our assessment as required by Section 404, and our independent registered accounting firm has not been engaged to express and has not expressed, an opinion on our internal controls over financial reporting. However, in connection with its audit of our 2006 fiscal year our independent registered accounting firm identified significant deficiencies in our internal controls. A significant deficiency is a control deficiency, or a combination of control deficiencies, that results in more than a remote likelihood that a misstatement of the Company s financial statements that is more than inconsequential will not be prevented or detected. We are in the process of hiring additional accounting personnel, and management believes that the identified significant deficiencies will be remedied by the hiring of such personnel.

Through fiscal 2007 we anticipate significant growth in our business, including international expansion. As a result, given the risks inherent in the design and operation of internal controls over financial reporting, we can provide no assurance as to our, or our independent registered public accounting firm s, conclusions at March 31, 2007 with respect to the effectiveness of our internal controls over financial reporting. If our internal controls are not designed or operating effectively, we would be required to disclose at such time that our internal control over financial reporting is not effective. In addition, our registered public accounting firm may either disclaim an opinion as it relates to

management s assessment of the effectiveness of our internal controls or may issue an adverse opinion on the effectiveness of our internal controls over financial reporting. Investors may lose confidence in the reliability of our financial statements, which could cause the market price of our common stock to decline and which could affect our ability to run our business as we otherwise would like to.

Table of Contents

Our future capital needs are uncertain and we may need to raise additional funds in the future, and such funds may not be available on acceptable terms or at all.

We believe that our current cash position, together with the cash to be generated from expected product sales will be sufficient to meet our projected operating requirements for at least the next 12 months. However, after such period we may be required to seek additional funds from public and private stock offerings, borrowings under lease lines or other sources. Our capital requirements will depend on many factors, including:

the revenues generated by sales of our products;

the costs associated with expanding our sales and marketing efforts;

the expenses we incur in manufacturing and selling our products;

the costs of developing and or acquiring new products or technologies;

the cost of obtaining and maintaining U.S Food and Drug Administration (FDA) approval or clearance of our products and products in development;

costs associated with our litigation with Boston Scientific;

the expenses we incur related to compliance with the U.S. Foreign Corrupt Practices Act (FCPA) and laws and regulations in non-U.S. jurisdictions;

costs associated with compliance with the Sarbanes-Oxley Act of 2002 and rules and regulations affecting public companies recently promulgated by the Securities and Exchange Commission and the Nasdaq National Market;

the costs associated with our facilities expansion, if any; and

the costs associated with increased capital expenditures.

As a result of these factors, we may need to raise additional funds, and such funds may not be available on favorable terms, or at all. Furthermore, if we issue equity or debt securities to raise additional funds, our existing stockholders may experience dilution, and the new equity or debt securities may have rights, preferences and privileges senior to those of our existing stockholders. In addition, if we raise additional funds through collaboration, licensing or other similar arrangements, it may be necessary to relinquish valuable rights to our potential products or proprietary technologies, or grant licenses on terms that are not favorable to us. If we cannot raise funds on acceptable terms, we may not be able to develop or enhance our products, execute our business plan, take advantage of future opportunities, or respond to competitive pressures or unanticipated customer requirements. In these events, our ability to achieve our development and commercialization goals would be adversely affected.

If we choose to acquire new and complementary businesses, products or technologies instead of developing them ourselves, we may be unable to complete these acquisitions or to successfully integrate them in a cost effective and non-disruptive manner.

Our success depends on our ability to continually enhance and broaden our product offerings in response to changing customer demands, competitive pressures and technologies. We may in the future pursue the acquisition of additional complementary businesses, products or technologies instead of developing them ourselves. We do not know if we will be able to successfully complete any such acquisitions, or whether we will be able to successfully integrate any acquired business, product or technology or retain any key employees. Integrating any business, product or technology we acquire could be expensive and time consuming, disrupt our ongoing business and distract our management. If we are unable to integrate any acquired businesses, products or technologies effectively, our business will suffer. In addition, any amortization or charges resulting from the costs of acquisitions could harm our business

and operating results.

We are dependent on single source suppliers for components and materials used in our devices, and the loss of any of these suppliers, or their inability to supply us with an adequate supply of materials, could harm our business.

We rely on third-party suppliers for components and materials used in our products and rely on single sources for many of the microcoil and delivery system components, including tubing, connectors and sterilization services. Our dependence on third-party suppliers involves several risks, including limited control over pricing, availability, quality, delivery schedules and supplier compliance with regulatory requirements. Any delays in delivery of such components or provision of such services or shortages of such components could cause delays in the shipment of our products, which could significantly harm our business. We

Table of Contents

generally acquire our single source components pursuant to purchase orders placed in the ordinary course of business, and we have no guaranteed supply arrangements with any of our single source suppliers. Because of our reliance on these vendors, we may also be subject to increases in component costs. These increases could significantly harm our business. For us to be successful, our third-party suppliers must also be able to provide us with the materials and components of our products in substantial quantities, in compliance with regulatory requirements, in accordance with agreed upon specifications, at acceptable cost and on a timely basis. Our anticipated growth may strain the ability of suppliers to deliver an increasingly large supply of materials and components. If we are unable to obtain sufficient quantities of high quality components and materials to meet customer demand on a timely basis, we could lose customers, our reputation may be harmed and our business could suffer. If any one or more of our third-party suppliers cease to provide us with sufficient quantities of our materials or components in a timely manner or on terms acceptable to us, we would have to seek alternative sources of supply. We could incur delays while we locate and engage alternative qualified suppliers and we might be unable to engage alternative suppliers on favorable terms. Any such disruption or increased expenses could harm our commercialization efforts and adversely affect our ability to generate revenues.

We rely on independent contract manufacturers for the manufacture and assembly of certain of our products and components. Reliance on independent contract manufacturers involves several risks, including the potential inadequacy of capacity, the unavailability of or interruptions in access to certain process technologies and reduced control over product quality, compliance with regulatory requirements, delivery schedules, manufacturing yields and costs. Such manufacturers have possession of and at times title to molds for certain manufactured components of our products. Shortages of raw materials, production capacity constraints or delays by our contract manufacturers could negatively affect our ability to meet our production obligations and result in increased prices for affected parts. Any such reduction, constraint or delay may result in delays in shipments of our products or increases in the prices of components, either of which could have a material adverse effect on our business, operating results and financial condition. We have no supply agreements with our current contract manufacturers and utilize purchase orders which are subject to supplier acceptance. The unanticipated loss of any of our contract manufacturers could cause delays in our ability to deliver product while we identify and qualify a replacement manufacturer. If our current or future independent contract manufacturers are unable to meet our requirements for manufactured components, our business could suffer.

Our operations are currently conducted at a single location that may be at risk from earthquakes or other natural disasters.

We currently conduct all of our manufacturing, development and management activities at a single location in Silicon Valley, California, near known earthquake fault zones. We have taken precautions to safeguard our facilities, including insurance, health and safety protocols, and off-site storage of computer data. However, any future natural disaster, such as an earthquake, could cause substantial delays in our operations, damage or destroy our equipment or inventory, and cause us to incur additional expenses. A disaster could seriously harm our business and results of operations.

If we are unable to effectively manage our inventory held on consignment by our intended customers, we will not achieve our expected results.

A significant portion of our inventory is held on consignment by hospitals that purchase the inventory as they use it. In these consignment locations, we do not have physical possession of the consigned inventory. We therefore have to rely on information from our customers as well as periodic inspections by our sales personnel to determine when our products have been used. We have in the past experienced problems managing appropriate consigned inventory levels and as a result we recorded an impairment of inventory for anticipated obsolescence in fiscal 2004 and an impairment of excess inventory in both fiscal 2004 and 2005. If we are not able to effectively manage appropriate consigned inventory levels, we may suffer inventory losses that will reduce our gross profit levels. There can be no assurance that any efforts to strengthen our monitoring and management of consigned inventory will be adequate to meaningfully reduce the risk of inventory loss.

We are dependent on our senior management team, key clinical advisors and scientific personnel, and the loss of any of them could harm our business.

Our continued success depends in part upon the continued availability and contributions of our senior management team and the continued participation of our key clinical advisors. We have entered into letter agreements with certain members of our senior management team, but none of these agreements guaranty the services of the individual for a specified period of time. We also rely on the skills and talents of our scientific personnel because of the complexity of our products. The loss of members of our senior management, key clinical advisors or scientific personnel, or our inability to attract or retain other qualified personnel or advisors could have a material adverse effect on our results of operations and financial condition.

Table of Contents

The medical device industry is characterized by patent litigation, which could be costly, result in the diversion of management s time and efforts and require us to pay damages.

The medical device industry is characterized by extensive litigation and administrative proceedings over patent and other intellectual property rights. Accordingly, we may in the future be subject to further litigation and administrative proceedings over such rights with other companies in our industry. As we have discussed above with respect to our current litigation with Boston Scientific, whether a product or method infringes a patent involves complex legal and factual issues rendering the outcome of any patent dispute largely unpredictable. In the future, other competitors may assert that at least one of our products, its components, or the methods we employ in the use or manufacture of our products are covered by and infringe the competitors U.S. or foreign patents held by them. In addition, should our patents or applications have claims that encompass the same scope as claims pending or issued to a third party competitor, that third party may claim that its claims have priority over ours because they invented the claimed subject matter first. Because patent applications generally take many years to issue, there may be third party applications presently pending of which we are unaware, that may in the future result in issued patents that at least one of our products, its components, or the methods we employ in the use or manufacture of our product(s) may infringe. There could also be issued patents that one or more components of our products may inadvertently be infringing, of which we are unaware. As the number of participants in the market for cerebral vascular treatments and the number of issued patents in this technology area grows, the possibility of being charged with patent infringement increases.

As we have discussed above with respect to our litigation with Boston Scientific, any infringement claims against us may cause us to incur substantial costs, could place a significant strain on our financial resources, divert the attention of management from our core business and harm our reputation. If the relevant patent claims are upheld as valid and enforceable and we are found to infringe, we could be required to pay substantial damages and/or royalties and could be prevented from selling our products unless we could obtain a license or were able to redesign our products to avoid infringement. Any such license may not be available on reasonable terms, if at all. If we fail to obtain any required licenses or make any necessary changes to our products or technologies, we may be unable to commercialize one or more of our products or practice the methods we employ in the use or manufacture of our products.

Our ability to protect our intellectual property and proprietary technology through patents and other means is uncertain.

Our success depends significantly on our ability to procure proprietary rights to the technologies used in our products. We rely on patent protection, as well as a combination of copyright, trade secret and trademark laws, and nondisclosure, confidentiality and other contractual restrictions to protect our proprietary technology. However, these legal means afford only limited protection and may not be sufficient to adequately protect our intellectual property or permit us to gain or keep any competitive advantage. For example, any of our pending U.S. or foreign patent applications may ultimately not issue as a patent or, alternatively, may issue with claims that are of little or no value to us. In addition, once issued, a valuable patent may be challenged successfully by third parties and invalidated, such as is being attempted by Boston Scientific in our presently ongoing litigation. In addition, our patent protection for material aspects of our products and methods is presently being pursued with applications that have been filed but not issued, such that these material aspects are not presently protected by patents. Competitors may further be able to get around having to license our technology in order to avoid infringement by designing around our issued and published patent claims, thereby staying clear of our proprietary rights. Similarly, competitors may develop products and methods that are equivalent or superior to ours. Our confidentiality agreements and intellectual property assignment agreements with our employees, consultants and advisors may not be enforceable or may not provide meaningful protection for our trade secrets or other proprietary information in the event of unauthorized use or disclosure or other breaches of the agreements. Furthermore, the laws of some foreign countries may not protect our intellectual property rights to the same extent as do the laws of the United States. Both the process of procuring patent rights and the process of managing patent disputes can be time consuming and expensive.

In the event a competitor infringes upon our patent or other intellectual property rights, enforcing those rights may be difficult and time consuming. Even if successful, litigation to enforce our intellectual property rights or to defend our patents against challenge could be prolonged, costly and could divert our management s attention. We may not

have sufficient resources to enforce our intellectual property rights or to defend our patents against a challenge.

If we fail to obtain, or experience significant delays in obtaining, FDA clearances or approvals for our future products or product enhancements, or to comply with similar regulatory requirements in other countries where we market our products, our ability to commercially distribute and market our products could suffer.

Our medical devices are subject to rigorous regulation by the FDA and numerous other federal, state and foreign governmental authorities. Our failure to comply with such regulations could lead to the imposition of injunctions, suspensions or

Table of Contents

loss of regulatory clearances or approvals, product recalls, termination of distribution or product seizures or the need to invest substantial resources to comply with various existing or new requirements. In the more egregious cases, criminal sanctions, civil penalties, disgorgement of profits or closure of our manufacturing facilities are possible. The process of obtaining regulatory clearances or approvals to market a medical device, particularly from the FDA, can be costly and time consuming, and there can be no assurance that such clearances or approvals will be granted on a timely basis, if at all. In particular, the FDA permits commercial distribution of most new medical devices only after the device has received 510(k) clearance or is the subject of an approved pre-market approval application, or PMA. The FDA will clear marketing of a medical device through the 510(k) process if it is demonstrated that the new product has the same intended use, is substantially equivalent to another legally marketed device, including a 510(k)-cleared product, and otherwise meets the FDA s requirements. The PMA approval process is more costly, lengthy and uncertain than the 510(k) clearance process and requires the development and submission of clinical studies supporting the safety and effectiveness of the device. Product modifications may also require the submission of a new 510(k) clearance, or the approval of a PMA before the modified product can be marketed. Changes in labeling and manufacturing site for a PMA approved device may require the submission and approval of a PMA supplement. Any products we develop that require regulatory clearance or approval may be delayed, if approved at all. In addition, we believe that some of our new products will require an approved PMA before we can commercially distribute the device and we cannot assure you that any new products or any product enhancements we develop will be subject to the shorter 510(k) clearance process instead of the more lengthy PMA requirements. Additionally, certain of our products under development may involve both device and drug or biologic regulation and we will need to comply with drug and biologic regulations in addition to medical device requirements. Accordingly, we anticipate that the regulatory review and approval process for some of our future products or product enhancements may take significantly longer than anticipated or that we have experienced in the past. We will also be required to pay a medical device user fee and may also be required to pay a drug or biologic user fee. There is no assurance that the FDA will not require that a certain new product or product enhancement go through the lengthy and expensive PMA approval process. We have no experience in obtaining PMA approval. We also have no experience in obtaining drug or biologic approval, and will need to rely on third party assistance in navigating the regulatory approval pathway for future combination products.

Further, pursuant to FDA regulations, we can only market our products for cleared or approved uses. Certain of our products may be used by physicians for indications other than those cleared or approved by the FDA, but we cannot promote the products for such off-label uses.

Modifications to our marketed products may require new 510(k) clearances or pre-market approvals, or may require us to cease marketing or recall the modified products until clearances are obtained.

Any modification to a 510(k)-cleared device that could significantly affect its safety or effectiveness, or that would constitute a change in its intended use, requires a new 510(k) clearance or, possibly, PMA approval. The FDA requires every manufacturer to make this determination in the first instance, but the FDA may review a manufacturer s decision. The FDA may not agree with any of our past or future decisions regarding whether new clearances or approvals are necessary. If the FDA requires us to seek 510(k) clearance or PMA approval for any modification to a previously cleared product, we may be required to cease marketing and/or to recall the modified product until we obtain clearance or approval, and we may be subject to significant regulatory fines or penalties. Further, our products could be subject to recall if the FDA determines, for any reason, that our products are not safe, including but not limited to new safety data from use of the product, or manufacturing defects. Any recall or FDA requirement that we seek additional approvals or clearances could result in delays, fines, costs associated with modification of a product, loss of revenue and potential operating restrictions imposed by the FDA.

If we or our suppliers fail to comply with the FDA s quality system regulations, the manufacture of our products could be delayed.

We and our suppliers are required to comply with the FDA s quality system regulations, which cover the methods and documentation of the design, testing, production, control, quality assurance, labeling, packaging, storage and shipping of our products. The FDA enforces these quality system regulations through unannounced inspections. If we or one of our suppliers fail a quality system regulations inspection or if any corrective action plan is not sufficient, or

is very expensive or time consuming to implement, the manufacture of our products could be delayed until satisfactory corrections are made, or in the event we are unable to correct the problems we may not be able to continue manufacturing and distributing the particular device or devices. Such a delay potentially could disrupt our business, harm our reputation and adversely affect our sales and revenues.

Table of Contents

If interventionalists are unable to obtain sufficient reimbursement for procedures performed with our products, it is unlikely that our products will be widely used.

Successful sales of our products will depend on the availability of adequate reimbursement from third-party payors. Healthcare providers that purchase medical devices for treatment of their patients, generally rely on third-party payors to cover the use of the product for the particular procedure and reimburse all or part of the costs and fees associated with the procedures performed with these devices. Currently, the costs of our products distributed domestically are being reimbursed by third party payors. There is no guarantee that coverage and adequate reimbursement will be available in the future for our existing and/or new products. Both public and private insurance reimbursement plans are central to new product acceptance. Neurointerventionalists are unlikely to use our products if they do not receive reimbursement adequate to cover the cost of our products and related procedures.

In international markets, market acceptance may depend, in part, upon the availability of reimbursement within prevailing healthcare payment systems. Reimbursement and healthcare payment systems in international markets vary significantly by country, and include both government sponsored healthcare and private insurance. Currently, the costs of our products distributed internationally, other than in some Latin American countries, are being reimbursed by public and private healthcare insurers. We may not obtain international reimbursement approvals in a timely manner, if at all, our failure to receive international reimbursement approvals would negatively impact market acceptance of our products in the international markets in which those approvals are sought.

In addition, in certain countries, such as France, Germany and Japan, we are required to obtain regulatory clearance for our products to be eligible for reimbursements by third party payors, even though reimbursement for embolic coiling procedures is already in place.

Future reimbursement may be subject to increased restrictions both in the United States and in international markets. Third-party reimbursement and coverage may not be available or adequate in either the United States or international markets. Future legislation, regulation or reimbursement policies of third-party payors may adversely affect the demand for our existing products or our products currently under development and limit our ability to sell our products on a profitable basis.

The adoption of Statement of Financial Accounting Standard No. 123R and changes to existing accounting pronouncements or taxation rules or practices may affect how we conduct our business and affect our reported results of operations.

During the first quarter of fiscal 2007, we adopted the provisions of, and account for stock-based compensation in accordance with, the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards No. 123 revised 2004 (SFAS No. 123R), Share-Based Payment, which replaced Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation and supersedes APB Opinion No. 25 (APB No. 25), Accounting for Stock Issued to Employees. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is generally the vesting period. The effective date of this new standard under these new rules for our financial statements was April 1, 2006. Adoption of this statement has had a significant impact on our consolidated financial statements, as we are now required to expense the fair value of our stock option grants and stock purchases under our employee stock purchase plan rather than disclose the impact on our net loss within our footnotes. The impact of SFAS No. 123R on our consolidated financial statements and related disclosures is, and is expected to continue to be, material to our results of operations. Our actual stock-based compensation expense in fiscal 2007 will be dependent on a number of factors, including the amount of awards granted and the fair value of those awards at the time of grant, as well as any changes in variables or underlying assumptions used to determine fair value under our pricing model. In addition, a change in accounting pronouncements or taxation rules or practices can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. Other new accounting pronouncements or taxation rules and varying interpretations of accounting pronouncements or taxation practice have occurred and may occur in the future. Changes to existing rules, future changes, if any, or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business.

We may become subject to product liability claims which could require us to pay damages that exceed our insurance coverage.

Our business exposes us to potential product liability claims that are inherent in the testing, manufacture and sale of medical devices for neurointerventional procedures. These procedures involve significant risk of serious complications, including intracranial bleeding, brain injury, paralysis and even death. Any product liability claim brought against us, with or without merit, could result in the increase of our product liability insurance rates or the inability to secure coverage in the future. In addition, we could have to pay an amount in excess of policy limits, which would have to be paid out of cash reserves. If longer-term patient

Table of Contents

results and experience indicate that our products or any component cause tissue damage, motor impairment or other adverse effects, we could be subject to significant liability. Finally, even a meritless or unsuccessful product liability claim could harm our reputation in the industry, lead to significant legal fees and could result in the diversion of management s attention from managing our business.

We may be subject to damages resulting from claims that we or our employees have wrongfully used or disclosed alleged trade secrets of their former employers.

Many of our employees were previously employed at other medical device companies, including our competitors or potential competitors. Although no claims against us are currently pending, we may be subject to claims that these employees or we have inadvertently or otherwise used or disclosed trade secrets or other proprietary information of their former employers. Litigation may be necessary to defend against these claims. Even if we are successful in defending against these claims, litigation could result in substantial costs and be a distraction to management. If we fail in defending such claims, in addition to paying monetary damages, we may lose valuable intellectual property rights or personnel. A loss of key research personnel or their work product could hamper or prevent our ability to commercialize product candidates, which could severely harm our business.

The price of our common stock has fluctuated and we expect will continue to fluctuate substantially and you may not be able to sell your shares at or above your purchase price.

The market price of our common stock has been and we expect will continue to be highly volatile and may fluctuate substantially due to many factors, including:

volume and timing of orders for our products;

the introduction of new products or product enhancements by us or our competitors;

disputes or other developments with respect to intellectual property rights;

our ability to develop, obtain regulatory clearance for, and market, new and enhanced products on a timely basis;

product liability claims or other litigation;

quarterly variations in our or our competitors results of operations;

sales of large blocks of our common stock, including sales by our executive officers and directors;

changes in governmental regulations or in the status of our regulatory approvals or applications;

changes in the availability of third-party reimbursement in the United States or other countries;

changes in earnings estimates or recommendations by securities analysts; and

general market conditions and other factors, including factors unrelated to our operating performance or the operating performance of our competitors.

Furthermore, to the extent there is an inactive market for our common stock, the value of your shares and your ability to sell your shares at the time you wish to sell them may be impaired. An inactive market may also impair our ability to raise capital by selling shares and may impair our ability to acquire other companies, products or technologies by using our shares as consideration.

Because of their significant stock ownership, our executive officers, directors and principal stockholders will be able to exert control over us and our significant corporate decisions.

Based on shares outstanding at August 1, 2006, our executive officers, directors, and stockholders holding more than 5% of our outstanding common stock and their affiliates will, in the aggregate, beneficially own approximately

37% of our outstanding common stock. As a result, these persons, acting together, may have the ability to determine the outcome of all matters submitted to our stockholders for approval, including the election and removal of directors and any merger, consolidation, or sale of all or

Table of Contents

substantially all of our assets. This concentration of ownership may harm the market price of our common stock by, among other things:

delaying, deferring or preventing a change in control of our company;

impeding a merger, consolidation, takeover or other business combination involving our company; or

causing us to enter into transactions or agreements that are not in the best interests of all stockholders.

Further, three of our eight current directors were designated by our principal stockholders which may increase such stockholders influence relating to matters submitted to the Board of Directors.

Future sales of our common stock may depress our stock price.

Our current stockholders hold a substantial number of shares of our common stock that they are able to sell in the public market A significant portion of these shares are held by a small number of stockholders. Sales by our current stockholders of a substantial number of shares could significantly reduce the market price of our common stock. Moreover certain holders of our common stock have the right to require us to file registration statements covering their shares or to include their shares in registration statements that we may file for ourselves or other stockholders.

We have registered 4,972,187 shares of common stock that we may issue under our 1998 Stock Plan, 2005 Equity Incentive Plan and 2005 Employee Stock Purchase Plan. These shares can be freely sold in the public market upon issuance. The sale by any of these holders of a large number of securities in the public market could reduce the trading price of our common stock and impede our ability to raise future capital.

We may incur increased costs as a result of recently enacted and proposed changes in laws and regulations.

Recently enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules proposed by the Securities and Exchange Commission (SEC) and by the Nasdaq National Market, could result in increased costs to us. The new rules could make it more difficult or more costly for us to obtain certain types of insurance, including directors and officers liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, our board committees or as executive officers. We are presently evaluating and monitoring developments with respect to new and proposed rules and cannot predict or estimate the amount of the additional costs we may incur or the timing of such costs.

We may become involved in securities class action litigation that could divert management s attention and harm our business.

The stock market in general, the Nasdaq National Market and the market for medical device companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Further, the market prices of securities of medical device companies have been particularly volatile. These broad market and industry factors may materially harm the market price of our common stock, regardless of our operating performance. In the past, following periods of volatility in the market price of a particular company s securities, securities class action litigation has often been brought against that company. We may become involved in this type of litigation in the future. Litigation often is expensive and diverts management s attention and resources, which could materially harm our financial condition and results of operations.

We do not intend to pay cash dividends.

We have never declared or paid cash dividends on our capital stock. We currently intend to retain all available funds and any future earnings for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future. In addition, the terms of any future debt or credit facility may preclude us from paying any dividends. As a result, capital appreciation, if any, of our common stock will be your sole source of potential gain for the foreseeable future.

Table of Contents

Anti-takeover provisions in our organizational documents and Delaware law may discourage or prevent a change of control, even an acquisition which would be beneficial to our stockholders, and thereby affect our stock price adversely and prevent attempts by our stockholders to replace or remove our current management.

Our amended and restated certificate of incorporation and amended bylaws contain provisions that could delay or prevent a change of control of our company or changes in our board of directors that our stockholders might consider favorable. Some of these provisions:

- authorize the issuance of preferred stock which can be created and issued by the board of directors without prior stockholder approval, with rights senior to those of the common stock;
- provide for a classified board of directors, with each director serving a staggered three-year term;
- prohibit our stockholders from filling board vacancies, calling special stockholder meetings, or taking action by written consent;
- prohibit our stockholders from making certain changes to our amended and restated certificate of incorporation or bylaws except with 66 2/3% stockholder approval; and
- require advance written notice of stockholder proposals and director nominations.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law, which may prohibit certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our amended and restated certificate of incorporation, restated bylaws and Delaware law could make it more difficult for stockholders or potential acquirers to obtain control of our board of directors or initiate actions that are opposed by our then-current board of directors, including delaying or impeding a merger, tender offer, or proxy contest involving our company. Any delay or prevention of a change of control transaction or changes in our board of directors could cause the market price of our common stock to decline.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

In June 2006, a holder exercised 2005 common stock warrants covering 1,666 shares of common stock. As a result of the adjustment of the 2005 common stock warrants in connection with our initial public offering, no cash proceeds were received by the Company in connection with the exercise. We did not sell any other unregistered shares of our common stock during the first quarter of fiscal 2007.

Use of Proceeds

Our Registration Statement on Form S-1 (File No. 333-123154) related to our IPO was declared effective by the SEC on June 16, 2005. The public offering commenced on June 17, 2005. All 3,250,000 shares of common stock offered in the final prospectus were sold at the initial closing on June 21, 2005, and an additional 250,000 shares of common stock subject to the underwriters over-allotment option, were sold at a third closing on July 6, 2005, in each case at a price to public of $11.00 per share (before deducting underwriting discounts and commissions) through a syndicate of underwriters managed by A.G. Edwards and Needham & Company, LLC. The aggregate gross proceeds of the shares offered and sold was $38.5 million, out of which we paid an aggregate of $2.7 million in underwriting discounts and commissions to the underwriters. In addition, as of March 31, 2006, we incurred additional expenses of approximately $2.8 million in connection with the offering, which when added to the underwriting discounts and commissions paid by us, amounts to total expenses of approximately $5.5 million.

We have used and intend to continue to use the net proceeds of the public offering primarily for general corporate purposes, including costs associated with our entry into the Japanese market, expansion of our sales force, research and development activities, facilities expansion and other working capital and capital expenditures. The amounts and timing of our actual expenditures will depend upon numerous factors, including the growth of our sales and marketing activities, status of our research and development efforts and the amount of cash generated by our operations, if any. We have used and may in the future also use a portion of the proceeds for the acquisition of, or investment in, companies, technologies, products or assets that complement our business.

We have not determined the amount of net proceeds to be used specifically for the foregoing purposes. As a result, management will have broad discretion over the proceeds from the IPO. Pending these uses, we intend to invest the net proceeds of the IPO in United States government and short-term investment grade securities.

Table of Contents

Issuer Purchases of Equity Securities

We do not have a stock repurchase program and did not repurchase any of our equity securities during the quarter ended June 30, 2006.

Item 3. ***Defaults Upon Senior Securities.***

None

Item 4. ***Submission of Matters to a Vote of Security Holders.***

None

Item 5. ***Other Information.***

None

Item 6. Exhibits.

See the Index to Exhibits on Page 46 of this report

Table of Contents

SIGNATURES

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

Date: August 14, 2006

By: /s/ John T. Kilcoyne
John T. Kilcoyne
President and Chief Executive Officer

Date: August 14, 2006

By: /s/ Robert A. Stern
Robert A. Stern
Executive Vice President, Chief Financial Officer and Secretary

Table of Contents

INDEX TO EXHIBITS

Exhibit Number	Description
3.1	Certificate of Incorporation (incorporated by reference to Exhibit 3.2 of Amendment No. 3 to the Registrant s Registration Statement on Form S-1 filed on May 17, 2005 Registration No. 333-123154) (Amendment No. 3)
3.2	Bylaws (incorporated by reference to Exhibit 3.4 of Amendment No. 3)
4.1	Specimen Stock Certificate (incorporated by reference to Exhibit 4.1 of the Registrant s Registration Statement on Form S-1 filed on March 4, 2005 (Registration No. 333-123154) (Form S-1)
4.2	Warrant dated as of December 11, 2000 among the Registrant and Roberts Mitani Capital, LLC (incorporated by reference to Exhibit 4.2 of Form S-1)
4.3	Amended and Restated Stockholders Rights Agreement dated as of February 21, 2005 among the Registrant and the parties listed therein (incorporated by reference to Exhibit 4.3 of Form S-1)
4.4	Form of Common Stock Warrant issued in connection with the Series E Preferred Stock and Warrant Purchase Agreement dated February 21, 2005, among the Registrant and the purchasers of the Registrant s Series E Preferred Stock (incorporated by reference to Exhibit 4.4 of Form 10-Q filed on February 14, 2006)
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002