CRYOLIFE INC
Form 10-Q
August 01, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 30, 2007

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Period from to

Commission File Number 1-13165

CRYOLIFE, INC.

(Exact name of registrant as specified in its charter)

Florida	**59-2417093**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1655 Roberts Boulevard, NW

Kennesaw, Georgia 30144

(Address of principal executive offices)

(zip code)

(770) 419-3355

(Registrant s telephone number, including area code)

Not Applicable

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES x NO ¨

Indicate by check mark whether the registrant 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 x Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in the Rule 12b-2 of the Exchange Act).

YES ¨ NO x

The number of shares of common stock, par value $0.01 per share, outstanding on July 27, 2007 was 27,481,926.

Part I FINANCIAL INFORMATION

Item 1. Financial Statements

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Unaudited)		(Unaudited)	
Revenues:				
Human tissue preservation services	$ 11,711	$ 10,181	$ 24,672	$ 19,520
Products	11,156	10,569	22,551	20,621
Other	144	4	312	62
Total revenues	23,011	20,754	47,535	40,203
Costs and expenses:				
Human tissue preservation services (Including write-downs of $307 for the three months and $453 for the six months ended June 30, 2007 and $379 for the three months and $753 for the six months ended June 30, 2006)	6,976	7,034	14,608	13,797
Products	1,881	2,082	3,829	4,005
General, administrative, and marketing	10,842	10,245	23,177	21,557
Research and development	978	837	2,036	1,746
Interest expense	187	188	340	335
Interest income	(105)	(103)	(202)	(210)
Change in valuation of derivative	866	11	821	67
Other expense, net	13	357	102	344
Total costs and expenses	21,638	20,651	44,711	41,641
Earnings (loss) before income taxes	1,373	103	2,824	(1,438)
Income tax expense (benefit)	82	(114)	179	125
Net income (loss)	$ 1,291	$ 217	$ 2,645	$ (1,563)
Effect of preferred stock dividends		(244)	(243)	(487)
Net income (loss) applicable to common shares	$ 1,291	$ (27)	$ 2,402	$ (2,050)
Income (loss) per common share:				
Basic	$ 0.05	$ 0.00	$ 0.10	$ (0.08)
Diluted	$ 0.05	$ 0.00	$ 0.09	$ (0.08)
Weighted average common shares outstanding:				
Basic	25,480	24,807	25,234	24,783
Diluted	26,333	24,807	25,969	24,783

See accompanying notes to summary consolidated financial statements.

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Item 1. Financial Statements

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS)

	June 30, 2007 (Unaudited)	December 31, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 5,519	$ 4,133
Marketable securities, at market	5,926	3,965
Restricted securities		571
Trade receivables, net	13,295	12,553
Other receivables	1,390	1,403
Deferred preservation costs, net	22,705	19,278
Inventories	5,834	5,153
Prepaid expenses and other assets	3,332	2,329
Total current assets	58,001	49,385
Property and equipment, net	19,803	21,390
Patents, net	4,038	4,226
Trademarks and other intangibles, net	3,361	3,362
Deferred income taxes	1,244	
Other long-term assets	1,230	1,502
TOTAL ASSETS	$ 87,677	$ 79,865
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 2,814	$ 2,475
Accrued compensation	2,069	2,599
Accrued procurement fees	4,706	4,734
Accrued expenses and other current liabilities	7,214	7,100
Deferred income	1,884	1,223
Derivative liability		235
Line of credit	4,501	4,507
Notes payable	1,325	
Current maturities of capital lease obligations	41	40
Total current liabilities	24,554	22,913
Capital lease obligations, less current maturities	103	124
Deferred income taxes	2,182	200
Other long-term liabilities	4,229	4,540
Total liabilities	31,068	27,777
Shareholders Equity:		
Preferred stock (325 issued shares in 2006)		3
Common stock (28,397 issued shares in 2007 and 25,813 in 2006)	284	258
Additional paid-in capital	119,615	115,678
Retained deficit	(57,537)	(59,177)

Deferred compensation	(677)	(73)
Accumulated other comprehensive income	98	160
Treasury stock at cost (942 shares in 2007 and 906 in 2006)	(5,174)	(4,761)
Total shareholders equity	56,609	52,088
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 87,677	$ 79,865

See accompanying notes to summary consolidated financial statements.

Item 1. Financial Statements

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

	Six Months Ended June 30,	
	2007	2006
	(Unaudited)	
Net cash from operating activities:		
Net income (loss)	$ 2,645	$ (1,563)
Adjustments to reconcile net income (loss) to net cash from operating activities:		
Loss on sale or disposal of assets	89	380
Depreciation and amortization	2,235	2,468
Provision for doubtful accounts	48	48
Write-down of deferred preservation costs	451	753
Other non-cash adjustments	(89)	146
Non-cash compensation	967	687
Change in valuation of derivative	821	67
Changes in operating assets and liabilities:		
Receivables	(878)	(1,826)
Income taxes	(103)	(112)
Deferred preservation costs and inventories	(4,559)	(4,331)
Prepaid expenses and other assets	(901)	(1,234)
Accounts payable, accrued expenses, and other liabilities	700	619
Net cash provided by (used in) operating activities	1,426	(3,898)
Net cash from investing activities:		
Capital expenditures	(414)	(992)
Net proceeds from sale of assets	9	13
Other assets	(52)	(46)
Purchases of marketable securities	(9,415)	(9,469)
Sales and maturities of marketable securities	8,155	11,062
Net cash (used in) provided by investing activities	(1,717)	568
Net cash from financing activities:		
Proceeds from debt issuance	282	251
Principal payments of debt	(288)	(281)
Payment of obligations under capital leases	(20)	(281)
Proceeds from financing of insurance policies	1,912	2,349
Principal payments on short-term notes payable	(587)	(711)
Proceeds from exercise of stock options and issuance of common stock	920	244
Payment of preferred stock dividends	(486)	(487)
Purchase of treasury stock		(50)
Net cash provided by financing activities	1,733	1,034
Increase (decrease) in cash and cash equivalents	1,442	(2,296)
Effect of exchange rate changes on cash	(56)	(33)
Cash and cash equivalents, beginning of period	4,133	6,631
Cash and cash equivalents, end of period	$ 5,519	$ 4,302

See accompanying notes to summary consolidated financial statements.

CRYOLIFE, INC. AND SUBSIDIARIES

NOTES TO SUMMARY CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Note 1 Basis of Presentation

The accompanying Summary Consolidated Balance Sheet as of December 31, 2006 has been derived from audited financial statements and the accompanying unaudited summary consolidated financial statements for the periods as of and ending June 30, 2007 and 2006 have been prepared in accordance with (i) accounting principles generally accepted in the United States for interim financial information and (ii) the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the United States Securities and Exchange Commission (SEC). Accordingly, the statements do not include all of the information and disclosures required by accounting principles generally accepted in the United States for a complete presentation of financial statements. In the opinion of management, all adjustments (of normal, recurring nature) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These summary consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in CryoLife s Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

The Company believes that its existing cash, cash equivalents, marketable securities, and availability under the Credit Agreement, as defined in Note 7, will enable the Company to meet its liquidity needs for normal operations through at least June 30, 2008.

Despite the Company s increased revenues in the second quarter of 2007 compared to the second quarter of 2006, the Company has experienced in the first six months of 2007 and could continue to experience during the remainder of 2007 an adverse impact on revenues and cash flows due to decreases in orthopaedic revenue as a result of the exchange and service agreement, (the RTI Agreement), with Regeneration Technologies, Inc. Orthopaedic revenues are expected to reach minimal levels as orthopaedic tissues on hand are depleted. These lost revenues will need to be offset by anticipated increases in cardiovascular and vascular revenues at least partially derived as a result of the RTI Agreement. See Note 3 for a discussion of the RTI Agreement.

The Company believes the following should continue to have a favorable impact on cash flow from operations during the remainder of 2007, although there can be no assurance that these events will occur as and when currently anticipated:

- Expected increases in BioGlue® revenues over levels experienced in 2006 due to increases in BioGlue list prices implemented in July 2006 and January 2007 and anticipated volume increases,
- Expected increases in total preservation service revenues over levels experienced in 2006 due to fee increases for certain tissues implemented in July 2006 and January 2007, to reflect the higher cost of processing these tissues, and anticipated volume increases for cardiovascular and vascular tissues, and
- Anticipated decreases in cash payments related to the defense and resolution of lawsuits and claims from the levels seen in 2003 through 2006.

However, the Company s long term liquidity and capital requirements will depend upon numerous factors, including:

- The continued success of BioGlue and other products using related technology,

The Company s ability to increase the level of tissue procurement and demand for its tissue preservation services,

The Company s ability to maintain sufficient margins on its tissue preservation services,

The Company s spending levels on its research and development activities, including research studies, to develop and support its service and product pipeline,

The timing and cost of resolving product liability lawsuits and other claims (as discussed in Note 14),

To a lesser degree, the Company s success at resolving the issues with the U.S. Food and Drug Administration (FDA) regarding processing of human tissue using the SynerGraft® technology (as discussed in Note 2), and

The Company s success in implementing its identified strategic initiatives.

If the Company is unable to address these issues and experiences negative cash flows in the future, or if additional funding needs arise, the Company may require additional financing or seek to raise additional funds through bank facilities, debt or equity offerings, or other sources of capital to meet operating and other liquidity and capital requirements beyond June 30, 2008. Additional funds may not be available when needed or on terms acceptable to the Company, which could have a material adverse effect on the Company's business, financial condition, results of operations, and cash flows.

Note 2 FDA Correspondence

July 2005 483

An FDA Form 483 Notice of Observations (483) was issued in August 2005 in connection with the FDA inspections of the Company s facilities in July 2005 (July 2005 483). The Company responded to the July 2005 483 multiple times and most recently in June 2006. In April 2007 the FDA responded to the Company s June 2006 letter and questioned the adequacy of the Company s response. The FDA may require the Company to implement additional corrective actions or perform additional testing. The Company has cooperated and will continue to cooperate with the FDA to review process improvements and address any outstanding observations.

SynerGraft

On February 20, 2003 the Company received a letter from the FDA stating that a 510(k) premarket notification should be filed for the Company s SynerGraft processed human cardiac tissues (CryoValve® SG) and that premarket approval marketing authorization should be obtained for the Company s SynerGraft processed human vascular tissues (CryoVein® SG) when marketed or labeled as an arteriovenous (A-V) access graft. The agency s position is that use of the SynerGraft technology in the processing of allograft heart valves represents a modification to the Company's legally marketed CryoValve allograft and that vascular allografts labeled for use as A-V access grafts are medical devices that require premarket approval.

On November 3, 2003 the Company filed a 510(k) premarket notification with the FDA for the CryoValve SG. On February 4, 2004 the Company received a letter from the FDA requesting additional information. On August 24, 2004 the Company submitted an amendment to its original 510(k) submission providing clarification and additional information. The FDA requested further additional information in November 2004. On June 8, 2005 CryoLife responded to some of these additional requests. CryoLife also has initiated an appeal of other requests through administrative procedures. The FDA requested further additional information in January 2006. Since March 2006 the Company has had discussions with the FDA to address the outstanding requests for additional information and seek

clearance for the CryoValve SG pulmonary valve. On July 21, 2006 the Company submitted an amendment to its 510(k) application addressing information requested by the FDA. The Company has undertaken further clinical and preclinical evaluations in response to requests by the FDA. These evaluations were submitted to the FDA in an additional 510(k) amendment on February 20, 2007. On July 18, 2007 the Company received a letter from the FDA requesting additional information for the submission. The Company is reviewing the request and is in the process of preparing a response. The FDA may still require that additional studies be undertaken. Clearance of the 510(k) premarket notification with the FDA will be required before the Company can resume distribution of SynerGraft processed CryoValve SG s.

On December 8, 2003 the Company received a letter from the FDA stating that it was the agency s position that certain additional cardiovascular tissues processed with the SynerGraft technology should be regulated as medical devices. On September 14, 2004 the Company met with the FDA to discuss the data to be used to support a formal Request for Designation (RFD) filing for SynerGraft processed non-valved cardiac and vascular tissue, including the CryoVein SG. An RFD submission establishes the regulatory status of the tissue. The Company submitted the RFD on October 5, 2004. The FDA affirmed its original decision in letters received in December 2004. That decision was subject to an administrative appeal. On October 20, 2005 CryoLife was informed that the FDA had denied the appeal and that CryoLife will be unable to distribute CryoVein tissues with the SynerGraft technology until further submissions and FDA approvals are granted. The Company is evaluating whether it will file and seek FDA approvals for CryoVein SG or discontinue the CryoVein SG.

As a result of these FDA communications, in 2003 the Company suspended the use of the SynerGraft technology in the processing of allograft tissue and the distribution of tissues on hand previously processed with the SynerGraft technology until the regulatory issues associated with these tissues are resolved. Additionally, the Company discontinued labeling its vascular grafts for use as A-V access grafts. Until such time as the issues surrounding SynerGraft are resolved, the Company is employing its traditional processing methods on these tissues. As of June 30, 2007 the Company had no deferred preservation costs related to SynerGraft processed tissues on its Summary Consolidated Balance Sheets.

Note 3 Exchange and Service Agreement

On December 19, 2006 the Company announced that it had entered into the RTI Agreement, an exchange and service agreement with Regeneration Technologies, Inc., and certain of its affiliates, respecting procurement, processing, and distribution activities for cardiovascular and vascular tissue processed and distributed by RTI and orthopaedic tissue for the knee processed and distributed by CryoLife. In accordance with the RTI Agreement, CryoLife ceased accepting donated human orthopaedic tissue for processing commencing January 1, 2007 and began work to transition existing arrangements for recovery of human orthopaedic tissue to RTI. Likewise, on January 1, 2007 RTI ceased accepting donated human cardiovascular and vascular tissues for processing and began work to transition its arrangements for recovery of these tissues to CryoLife. Certain physical assets relating to the tissues that are the subject of the agreement may also be transferred between the parties. No cash was exchanged in the transaction. CryoLife will continue to distribute its existing orthopaedic tissue inventory, and RTI will continue to distribute its existing cardiovascular and vascular tissue inventory, through June 30, 2008. After that date CryoLife will become entitled to distribute RTI s remaining cardiovascular and vascular tissue inventory, and RTI will become entitled to distribute CryoLife s remaining orthopaedic tissue inventory, for a fee. Under the RTI Agreement, from July 1, 2008 through December 31, 2016, except as set forth above, CryoLife has agreed not to market or solicit orders for certain human orthopaedic tissues and RTI has agreed not to market or solicit orders for human cardiac and vascular tissues. The agreement also provides for a non-exclusive license of technology from CryoLife to RTI, and contains customary provisions regarding indemnification and confidentiality.

As a result of the RTI Agreement, the Company recorded a net $159,000 loss during the fourth quarter of 2006, which was composed of a write-down of $2.8 million in cost of human tissue preservation services and a $2.6 million gain on exit activities. The $2.8 million write-down was due to the impairment of certain orthopaedic tissues and processing materials. The $2.6 million gain on exit activities was primarily due to a gain on the recording of intangible assets received from RTI, partially offset by several individually immaterial asset write-downs and expense accruals incurred as a result of the transaction.

Note 4 Cash Equivalents and Marketable Securities

The Company maintains cash equivalents and investments in several large, well-capitalized financial institutions, and the Company s policy excludes investment in any securities rated less than investment-grade by national rating services. Management determines the appropriate classification of its marketable securities at the time of purchase and reevaluates such designations quarterly.

Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity. Held-to-maturity securities are stated at amortized cost. Trading securities are securities that are acquired principally for the purpose of generating a profit from short-term fluctuations in price. Trading securities are stated at their fair values, with the realized and unrealized gains and losses, interest, and dividends included in investment income. Debt securities not classified as held-to-maturity or marketable equity securities not classified as trading are classified as available-for-sale. Available-for-sale securities are stated at their fair values, with the unrealized gains and losses, net of income taxes, reported in a separate component of shareholders equity. Interest, dividends, realized gains and losses, and declines in value judged to be other than temporary are included in investment income. The cost of securities sold is based on the specific identification method.

As of June 30, 2007 $5.9 million of marketable securities were designated as available-for-sale. As of December 31, 2006 $4.0 million of marketable securities were designated as available-for-sale and $571,000 were designated as held-to-maturity. The held-to-maturity securities were designated as such due to a contractual commitment to hold the securities as pledged collateral relating to one of the Company s product liability insurance policies, and, therefore, they were reported as restricted securities on the December 31, 2006 Consolidated Balance Sheets. During the quarter ended March 31, 2007 the restricted securities matured and were replaced with a letter of credit subfacility, as discussed in Note 7 below.

The Company s cash equivalents include advance funding received under the U.S. Congress 2005 Defense Appropriations Conference Report (the 2005 DOD Grant) and the U.S. Congress 2006 Defense Appropriations Conference Report (the 2006 DOD Grant) for the continued development of protein hydrogel technology for use on the battlefield. The advance funding is accounted for as deferred income on the Summary Consolidated Balance Sheets and is recognized as other revenue as expenses are incurred related to these grants. As of June 30, 2007 and December 31, 2006 $1.7 million and $806,000, respectively, of cash equivalents and deferred income were related to the 2005 and 2006 DOD grants.

The following is a summary of cash equivalents and marketable securities (in thousands):

	Cost Basis	Unrealized Holding (Losses) Gains	Estimated Market Value
June 30, 2007			
Cash equivalents:			
Money market funds	$ 4,233	$	$ 4,233
Marketable securities:			
Government entity sponsored debt securities	5,929	(3)	5,926
December 31, 2006			
Cash equivalents:			
Money market funds	$ 2,484	$	$ 2,484
Marketable securities:			
Government entity sponsored debt securities	3,964	1	3,965
Restricted securities:			
Government entity sponsored debt securities	571		571

There were no gross realized gains or losses on sales of available-for-sale securities for both the three and six months ended June 30, 2007 and 2006. Differences between cost and market listed above, consisting of an unrealized holding loss of $3,000 at June 30, 2007 and an unrealized holding gain of $1,000 at December 31, 2006,

are included as a separate component of other comprehensive income in the shareholders equity section of the Summary Consolidated Balance Sheets.

At June 30, 2007 $3.0 million of the Company s marketable securities had a maturity date within 90 days and $2.9 million had a maturity date between 90 days and one year. At December 31, 2006 all of the Company s marketable securities had a maturity date within 90 days.

Note 5 Inventories

Inventories are comprised of the following (in thousands):

	June 30, 2007 (Unaudited)	December 31, 2006
Raw materials	$ 3,662	$ 3,048
Work-in-process	447	479
Finished goods	1,725	1,626
Total inventories	$ 5,834	$ 5,153

Note 6 Income Taxes

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and tax return purposes. The Company generated deferred tax assets beginning in 2002 primarily as a result of write-downs of deferred preservation costs, accruals for product liability claims, and operating losses. The Company assesses the recoverability of its deferred tax assets, in accordance with Statement of Financial Accounting Standards (SFAS) No. 109 Accounting for Income Taxes (SFAS 109), on an annual basis and on an interim basis, as necessary, when the Company experiences changes that could materially affect its determination of the recoverability of its deferred tax assets. Management provides a valuation allowance when, as a result of this analysis, management believes it is more likely than not that its deferred tax assets will not be realized. In assessing the recoverability of its deferred tax assets at December 31, 2006 the Company reviewed its historical operating results, including the reasons for its operating losses in prior years and uncertainties regarding projected future operating results. Based on the results of this analysis, at December 31, 2006 the Company determined that it was more likely than not the Company s deferred tax assets would not be realized. Therefore, as of December 31, 2006 the Company had a total of $33.0 million in valuation allowances against deferred tax assets and a net deferred tax liability of $226,000 related to taxes in a foreign jurisdiction.

Based on the Company s results for the six months ended June 30, 2007 and its projected results for the year ended December 31, 2007, the Company anticipates that it will utilize a portion of its net operating loss carryforwards in the 2007 income tax year to offset its taxable income. Although CryoLife is beginning to utilize its net operating loss carryforwards, the Company does not currently believe that a change in its determination of the recoverability of its deferred tax assets is warranted. CryoLife will continue to evaluate its determination in accordance with the guidance in SFAS 109, which indicates the Company s net losses in recent years constitute significant evidence against the recoverability of its deferred tax assets that is difficult to overcome. CryoLife will reverse the remaining valuation allowance, or a portion thereof, when and if its deferred tax assets meet the SFAS 109 more likely than not standard for recognition. The realizability of the Company s deferred tax assets could be limited in future periods as mandated by Internal Revenue Service Section 382.

The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the adoption of FIN 48, the Company recorded $2.0 million in liabilities for unrecognized tax benefits. The $2.0 million of liabilities for unrecognized tax benefits was accounted for as a decrease to the January 1, 2007 balance of retained earnings of $762,000 and a reclassification of a portion of the valuation allowances against the Company s deferred tax assets of $1.2 million to a liability. To the extent these unrecognized tax benefits are ultimately recognized, it would not affect the annual effective income tax rate due to the existence of the valuation allowance.

The tax years 2003-2006 remain open to examination by the major taxing jurisdictions to which the Company is subject.

The Company recognizes interest and penalties related to uncertain tax positions in other income and expense. As of June 30, 2007 the Company has approximately $313,000 of accrued interest and penalties related to uncertain tax positions.

Note 7 Debt

On February 8, 2005 CryoLife and its subsidiaries entered into a credit agreement with Wells Fargo Foothill, Inc. as lender (the Credit Agreement). The Credit Agreement provides for a revolving credit facility in an aggregate amount equal to the lesser of $15.0 million (including a letter of credit subfacility of up to an aggregate of $2.0 million) or a borrowing base determined in accordance with the terms of the Credit Agreement. Generally, the borrowing base is 20% of the appraised value of the business of CryoLife, reduced by specified lender reserves. The Credit Agreement places limitations on the amount that the Company may borrow, and includes various affirmative and negative covenants, including financial covenants such as a requirement that CryoLife either (i) maintain quarterly a minimum aggregate borrowing availability under the Credit Agreement, less certain payables incurred outside the Company s historical practices, plus unrestricted cash and cash equivalents, as defined (Availability), of at least $12.5 million or (ii) achieve as of each quarter end a minimum level of earnings before extraordinary gains, interest, taxes, depreciation, and amortization (EBITDA), BioGlue gross margins of at least 70% for the preceding twelve months, as well as Availability of at least $5.0 million. In the first quarter of 2007 the Company obtained a $500,000 letter of credit subfacility relating to one of the Company s product liability insurance policies. This reduced the Company s aggregate borrowing capacity under the Credit Agreement to $14.5 million. While the Company expects that its aggregate borrowing capacity under the Credit Agreement will remain at $14.5 million, there can be no assurance that the capacity will remain at this level. The Credit Agreement also includes customary conditions on incurring new indebtedness and limitations on cash dividends. Cash dividends on any class of capital stock are prohibited, provided that cash dividends on preferred stock may be paid so long as the Company maintains $7.5 million, in the aggregate, of cash, cash equivalents, and borrowing capacity, as defined. There is no restriction on the payment of stock dividends. Commitment fees are paid based on the unused portion of the facility. The Credit Agreement expires on February 7, 2008, at which time the outstanding principal balance will be due.

Amounts borrowed under the Credit Agreement are secured by substantially all of the tangible and intangible assets of CryoLife and its subsidiaries and bear interest at the bank s prime rate plus 1%, which aggregated 9.25% as of June 30, 2007. As of June 30, 2007 the outstanding balance of the Credit Agreement was $4.5 million and the remaining borrowing availability was $10.0 million.

The Company routinely enters into agreements to finance insurance premiums for periods not to exceed the terms of the related insurance policies. In the second quarter of 2007 the Company entered into two agreements to finance approximately $1.4 million and $478,000 in insurance premiums associated with the yearly renewal of certain of the Company s insurance policies. The amounts financed accrued interest at 7.027% and were payable in equal monthly payments over a nine month and an eight month period, respectively. As of June 30, 2007 the aggregate outstanding balance under these agreements was $1.3 million.

In the second quarter of 2006 the Company entered into two agreements to finance approximately $1.6 million and $715,000 in insurance premiums associated with the yearly renewal of certain of the Company s insurance policies. The amounts financed accrued interest at 6.71% and 6.7%, respectively, and were payable in equal monthly payments over a nine month and an eight month period, respectively. As of June 30, 2007 the aggregate outstanding balance under these agreements was zero.

Note 8 Convertible Preferred Stock

On December 17, 2004 the Company announced that it had filed a shelf registration statement on Form S-3 with the SEC covering the sale from time to time of up to $50 million of its common stock, preferred stock, depositary shares, or any combination of these securities for its own account in one or more offerings.

On March 18 and April 19, 2005 the Company completed a public offering of 417,000 shares of 6% convertible preferred stock (the Preferred Stock) at a price to the public of $50.00 per share. Net proceeds from the offering, after deducting underwriting discounts and offering-related expenses, totaled approximately $19.1 million.

Dividends on the Preferred Stock were cumulative from the date of original issue at the annual rate of 6% of the liquidation preference of the Preferred Stock, payable quarterly on the first day of January, April, July, and October, commencing July 1, 2005. Any dividends were required to be declared by the Company s board of directors and to come from funds legally available for dividend payments. On March 13, 2007 the Company declared a dividend of $0.75 per share on its Preferred Stock. The dividend of approximately $243,000 was paid on April 2, 2007 to shareholders of record on March 22, 2007. No dividends were declared in the second quarter of 2007.

The Preferred Stock was convertible at the option of the holder at any time into the Company s common stock at a conversion rate of approximately 6.2189 shares of common stock for each share of Preferred Stock, based on an initial conversion price of $8.04. The Company had reserved 4,600,000 shares of common stock for issuance upon conversion. Through June 4, 2007 holders had cumulatively voluntarily converted 139,000 shares of Preferred Stock into 867,000 shares of common stock, of which 47,000 shares of Preferred Stock were voluntarily converted into 292,000 shares of common stock in the second quarter of 2007.

The Preferred Stock contained provisions that allowed the Company to convert its Preferred Stock into common stock if the closing price of the Company s common stock exceeded $12.06, which is 150% of the conversion price of the Preferred Stock, for at least 20 trading days during any 30-day trading period, ending within five trading days prior to notice of automatic conversion. This condition was satisfied on June 4, 2007 and on that day the Company exercised its right to automatically convert the Preferred Stock into common stock. As a result, on June 25, 2007 the Company automatically converted the remaining 278,000 shares of Preferred Stock into 1,726,000 shares of common stock at the conversion rate of approximately 6.2189 shares of common stock per share of Preferred Stock.

The Company was required to make additional payments for both the voluntary and automatic conversions of Preferred Stock equal to the aggregate amount of dividends that would have been payable on the Preferred Stock through and including April 1, 2008, less any dividends already paid on the Preferred Stock, the Dividend Make-Whole Payment . The Dividend Make-Whole Payment was payable in cash or, at the Company s option, in shares of the Company s common stock, or a combination of cash and shares of common stock. The Dividend Make-Whole Payment is discussed further in Note 9 below.

As of June 30, 2007 there were no outstanding shares of Preferred Stock.

Note 9 Derivative

In accordance with Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), the Company was required to separate and account for the Dividend Make-Whole Payment feature of its Preferred Stock as an embedded derivative, (the Derivative). As an embedded derivative instrument, the Dividend Make-Whole Payment feature must be measured at fair value and reflected as a current liability on the Company s Summary Consolidated Balance Sheets. Changes in the fair value of the Derivative are recognized in the line item change in valuation of derivative as a non-operating income/expense on the Company s Summary Consolidated Statements of Operations.

The Company determined the fair value of the Derivative to be $1.0 million on March 18, 2005, the date of issuance. The Company determined the fair value of the Derivative related to the issuance of additional Preferred Stock upon exercise of the underwriter s over allotment option to be $32,000 on April 19, 2005, the date of issuance.

The proceeds from the Preferred Stock recorded on the Summary Consolidated Balance Sheets were reduced by these amounts, which were allocated to the derivative liability.

As discussed in Note 8 above, on June 25, 2007 the Company automatically converted the remaining shares of the Preferred Stock into common stock, thereby triggering the payment of the remaining Dividend Make-Whole payment. Through June 4, 2007 the Company had issued 132,000 shares of common stock to converting holders in satisfaction of the Dividend Make-Whole Payment. On June 25, 2007 the Company issued 69,000 shares of common stock to preferred shareholders to satisfy the Dividend Make Whole Payment due to the automatic conversion. The value of the Dividend Make-Whole payment was $878,000 based on the share price of $12.71 on the date of conversion. The Company recorded other expense of $866,000 for the three months ended June 30, 2007 related to the automatic and voluntary conversions of the Preferred Stock to common stock. The Company recorded other expense of $821,000 for the six months ended June 30, 2007 related to the first quarter revaluation of the derivative and the automatic and voluntary conversions of the Preferred Stock to common stock. The expenses for the voluntary and automatic conversions represent the value of the Dividend Make-Whole Payments paid by the Company that exceeded the derivative liability accrued in prior periods.

The Company recorded other expense of $11,000 and $67,000 for the three and six months ended June 30, 2006, respectively, related to the quarterly revaluations of the derivative.

At June 30, 2007 there was no remaining derivative liability as a result of the automatic conversion of the Preferred Stock to common stock.

Note 10 Comprehensive Income (Loss)

The following is a summary of comprehensive income (loss) (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007 (Unaudited)	2006	2007 (Unaudited)	2006
Net income (loss)	$ 1,291	$ 217	$ 2,645	$ (1,563)
Unrealized (loss) gain on investments	(3)	(1)	(4)	2
Translation adjustment	(30)	(25)	(58)	(22)
Comprehensive income (loss)	$ 1,258	$ 191	$ 2,583	$ (1,583)

The tax effect on both the unrealized gain/loss and the translation adjustment is zero for each period presented.

Components of accumulated other comprehensive income consist of the following, net of tax (in thousands):

	June 30, 2007 (Unaudited)	December 31, 2006
Unrealized (loss) gain on investments	$ (3)	$ 1
Translation adjustment	101	159
Total accumulated other comprehensive income	$ 98	$ 160

Note 11 Income (Loss) per Common Share

The following table sets forth the computation of basic and diluted income (loss) per common share (in thousands, except per share data). The net income (loss) for the three and six months ended June 30, 2007 and 2006 is adjusted by the effect of the Company s cumulative, convertible Preferred Stock to arrive at net income (loss) applicable to common shares in accordance with SFAS No. 128, Earnings Per Share (SFAS 128). The Company also

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considers the effect of its Preferred Stock, as discussed in Note 8, the Derivative, as discussed in Note 9, and common stock options, as discussed in Note 12, in the calculation of diluted weighted-average shares below.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Unaudited)		(Unaudited)	
Numerator for basic income (loss) per common share:				
Net income (loss)	$ 1,291	$ 217	$ 2,645	$ (1,563)
Effect of preferred stock [a]		(244)	(243)	(487)
Net income (loss) applicable to common shares	$ 1,291	$ (27)	$ 2,402	$ (2,050)
Denominator for basic income (loss) per common share:				
Basic weighted-average common shares	25,480	24,807	25,234	24,783
Basic income (loss) per common share	$ 0.05	$ 0.00	$ 0.10	$ (0.08)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(Unaudited)		(Unaudited)	
Numerator for diluted income (loss) per common share:				
Net income (loss)	$ 1,291	$ 217	$ 2,645	$ (1,563)
Effect of preferred stock [b]		(244)	(243)	(487)
Effect of stock options [c]				
Net income (loss) applicable to common shares	$ 1,291	$ (27)	$ 2,402	$ (2,050)
Denominator for diluted income (loss) per common share:				
Basic weighted-average common shares	25,480	24,807	25,234	24,783
Effect of dilutive convertible preferred stock [b]				
Effect of dilutive stock options [c]	853		735	
Adjusted weighted-average common shares	26,333	24,807	25,969	24,783
Diluted income (loss) per common share	$ 0.05	$ 0.00	$ 0.09	$ (0.08)

[a] The amount of the accumulated dividend on Preferred Stock decreased the net income applicable to common shares by $243,000 for the six months ended June 30, 2007. The amount of the accumulated dividend on Preferred Stock offset the net income and increased the net loss applicable to common shares with a total unfavorable effect of $244,000 for the three months ended June 30, 2006 and increased the net loss applicable to common shares by $487,000 for the six months ended June 30, 2006.

[b] The amount of the accumulated dividend on the Preferred Stock decreased the net income applicable to common shares by $243,000 for the six months ended June 30, 2007. The adjustment for the Dividend Make-Whole Payment for conversions during the period would have instead increased net income applicable to common shareholders by $866,000 for the three months ended June 30, 2007. The adjustment for the Dividend Make-Whole Payment for conversions during the period and the adjustment for the quarterly revaluation of the derivative liability would have instead increased net income applicable to common shareholders by $821,000 for the six months ended June 30, 2007. The common shares that would have been issued to shareholders at the beginning of the period for the conversion of the remaining Preferred Stock and in payment of the remaining

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Dividend Make-Whole Payment would have increased the weighted-average shares by 1.8 million and 2.0 million for the three and six months ended June 30, 2007, respectively. These adjustments were excluded from the calculation above, as they were anti-dilutive pursuant to the provisions of SFAS 128.

The amount of the accumulated dividend on the Preferred Stock offset the net income and increased the net loss applicable to common shares with a total unfavorable effect of $244,000 for the three months ended June 30, 2006 and increased the net loss applicable to common shares by $487,000 for the six months ended June 30, 2006. The adjustment for the quarterly revaluation of the derivative liability, would have instead decreased the net loss applicable to common shareholders by $11,000 and $67,000 for the three and six months ended June 30, 2006, respectively, and the common shares that would be issued to shareholders upon conversion of the remaining Preferred Stock and in payment of the remaining Dividend Make-Whole Payment would have increased the weighted-average shares by 2.3 million for both the three and six months ended June 30, 2006. These adjustments were excluded from the calculation above, as they were anti-dilutive pursuant to the provisions of SFAS 128.

[c] Outstanding options to purchase the Company s common stock that would have resulted in additional dilutive common shares of 200,000 and 195,000 for the three and six months ended June 30, 2006, respectively, were excluded from the calculation, as these items were anti-dilutive pursuant to the provisions of SFAS 128.

In future periods the basic and diluted earnings (loss) per common share are expected to be affected by stock option transactions including the exercise of stock options and the issuance of additional stock options as well as fluctuations in the fair value of the Company s common stock.

Note 12 Stock Compensation

The Company has stock option and stock incentive plans that provide for grants of shares and options to purchase shares of Company common stock to employees and directors at exercise prices generally equal to the fair values of such stock at the dates of grant. The Company maintains a shareholder approved Employee Stock Purchase Plan (the ESPP) for the benefit of its employees. The ESPP allows eligible employees the right to purchase common stock on a quarterly basis at the lower of 85% of the market price at the beginning or end of each three-month offering period. Pursuant to the adoption of SFAS 123 Revised, Share-Based Payment (SFAS 123R), both the Company s 15% discount on ESPP stock purchases and the look back portion of ESPP stock purchases are considered components of stock compensation and must be expensed in the Company s financial statements. The look back portion of the Company s ESPP constitutes an option and, as such, the expense is determined by performing a valuation as discussed below.

Stock Grants

In May 2007 the Company s Board of Directors authorized grants of stock to non-employee Directors. The stock grant totaled 37,500 shares of common stock, which was valued at $495,000 based on the stock price of $13.21 on the date of grant. A second stock grant was issued to a non-employee Director of 1,000 shares of common stock, which was valued at $15,000 based on the stock price $14.10 on the date of grant. The value of these stock grants will be recorded as stock compensation expense over the 12-month vesting period. The Company recorded $84,000 in compensation expense related to these stock grants during both the three and six months ended June 30, 2007.

In February 2007 the Company s Board of Directors authorized the grant of stock to certain Company executives. The stock grants totaled 29,000 shares of common stock, which was valued at $265,000 based on the stock price of $9.02 on the date of grant. The value of this stock grant will be recorded as stock compensation expense over the 36-month vesting period. The Company recorded $19,000 and $28,000 in compensation expense related to these stock grants during the three and six months ended June 30, 2007, respectively.

In February 2007 the Company s Board of Directors authorized the grant of stock as part of the 2006 Performance-Based Bonus Plan for certain Company executives. The stock grant totaled 68,000 shares of common stock valued at $587,000 based on the stock price of $8.57 on the date of grant. The Company recorded the entire expense for the executive stock grants during the year ended December 31, 2006.

In February 2007 the Company s Board of Directors approved the terms of and awards under certain performance-based bonus plans to recognize the fiscal 2007 performance of the Company and its executives and managers. A portion of the awards under of these plans will be paid in Company stock pursuant to the Company s existing stock plans, if the required performance is achieved. The Company is recording the anticipated liability related to this stock grant during 2007.

In February 2006 the Company s Board of Directors authorized the grant of stock to recognize the performance of certain Company executives. The stock grants totaled 34,000 shares of common stock, which were valued at $145,000 based on the stock price of $4.25 on the date of grant. The Company purchased $50,000 of Company stock from employees, based on the closing price on the New York Stock Exchange on the day the stock was transferred to the Company, to pay employee federal and state withholding taxes related to these stock grants. The Company recorded the $145,000 in compensation expense related to these stock grants during the first quarter of 2006.

Stock Options

In February 2007 the Company s Compensation Committee authorized a stock option grant to certain Company executives. The stock options were granted from the 1998 Long-Term Incentive Plan and will become exercisable over a three-year vesting period and have a seven-year term. The options granted totaled 176,000 shares with an exercise price of $8.70.

In January 2007 the Company s Compensation Committee authorized a stock option grant to certain Company employees. The stock options were granted from the 1998 Long-Term Incentive Plan and will become exercisable over a five-year vesting period and have a 66-month term. The options granted totaled 97,000 shares with an exercise price of $7.88.

The Company uses the Black-Scholes model to value its stock option grants under SFAS 123R and expenses the related compensation cost using the straight-line method over the vesting period. The fair value of the Company s ESPP options is also determined using the Black-Scholes model and is expensed quarterly at the end of the purchase period, as the option is fully vested at that time. The fair value of stock options is determined on the grant date using assumptions for the expected term, expected volatility, dividend yield, and the risk free interest rate. The term assumption is primarily based on the contractual term of the option and historic data related to exercise and post-vesting cancellation history experienced by the Company, adjusted based on management s expectations of future results. The expected term is determined separately for options issued to the Company s directors and to employees. The Company s anticipated volatility level is primarily based on the historic volatility of the Company s common stock, adjusted to remove the effects of certain periods of unusual volatility not expected to recur, and adjusted based on management s expectations of future volatility, for the life of the option or option group. The Company s model includes a zero dividend yield assumption, as the Company has not historically paid nor does it anticipate paying dividends on its common stock. The risk free interest rate is based on recent U.S. Treasury note auction results with a similar life to that of the option. The Company s model does not include a discount for post-vesting restrictions, as the Company has not issued awards with such restrictions. The period expense is then determined based on the valuation of the options, and at that time an estimated forfeiture rate is used to reduce the expense recorded. The Company s estimate of pre-vesting forfeitures is primarily based on the recent historical experience of the Company, and is adjusted to reflect actual forfeitures at each vesting date.

The following weighted-average assumptions were used to determine the fair value of options under SFAS 123R:

	Three Months Ended June 30, 2007		Six Months Ended June 30, 2007	
	Stock Options	ESPP Options	Stock Options	ESPP Options
	(Unaudited)		(Unaudited)	
Expected stock price volatility	N/A	.50	.60	.44
Risk-free interest rate				