CUTERA INC
Form 10-Q
November 05, 2007
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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 September 30, 2007

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period __________ to __________.

Commission file number: 000-50644

Cutera, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**77-0492262**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. employer identification no.)**

3240 Bayshore Blvd., Brisbane, California 94005

(Address of principal executive offices)

(415) 657-5500

(Registrant s telephone number, including area code)

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

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 Rule 12b-2 of the Exchange Act.): Yes ¨ No x

The number of shares of Registrant s common stock issued and outstanding as of October 31, 2007 was approximately 12,691,000.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CUTERA, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

(unaudited)

	September 30, 2007	December 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 11,376	$ 11,800
Marketable investments	88,160	96,285
Accounts receivable, net	11,512	9,601
Inventories	6,524	5,220
Deferred tax asset	5,736	5,792
Other current assets	3,063	2,702
Total current assets	126,371	131,400
Property and equipment, net	1,417	1,029
Intangibles, net	1,278	1,446
Deferred tax asset, net of current portion	227	
Total assets	$ 129,293	$ 133,875
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 1,739	$ 2,212
Accrued liabilities	14,113	13,675
Deferred revenue	4,861	3,514
Total current liabilities	20,713	19,401
Deferred rent	1,586	1,424
Deferred revenue, net of current portion	4,429	3,258
Income tax liability	704	60
Total liabilities	27,432	24,143
Commitments and contingencies (Note 8)		
Stockholders equity:		
Common stock	13	13
Additional paid-in capital	71,135	86,242
Deferred stock-based compensation		(331)
Retained earnings	30,655	23,866
Accumulated other comprehensive gain/(loss)	58	(58)
Total stockholders equity	101,861	109,732

Total liabilities and stockholders equity	$ 129,293	$ 133,875

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

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CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Net revenue	$ 28,143	$ 25,059	$ 75,273	$ 70,211
Cost of revenue	9,607	7,931	25,298	21,510
Gross margin	18,536	17,128	49,975	48,701
Operating expenses:				
Sales and marketing	10,586	8,174	28,839	25,025
Research and development	1,764	1,679	5,435	4,538
General and administrative	3,078	2,992	8,996	11,615
Litigation settlement		544		18,935
Total operating expenses	15,428	13,389	43,270	60,113
Income (loss) from operations	3,108	3,739	6,705	(11,412)
Interest and other income, net	1,096	829	3,206	2,615
Income (loss) before income taxes	4,204	4,568	9,911	(8,797)
Provision (benefit) for income taxes	1,112	1,618	3,031	(3,805)
Net income (loss)	$ 3,092	$ 2,950	$ 6,880	$ (4,992)
Net income (loss) per share:				
Basic	$ 0.24	$ 0.23	$ 0.52	$ (0.40)
Diluted	$ 0.22	$ 0.21	$ 0.48	$ (0.40)
Weighted-average number of shares used in per share calculations:				
Basic	13,026	12,675	13,283	12,460
Diluted	13,970	14,238	14,422	12,460

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

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CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended September 30, 2007	2006
Cash flows from operating activities:		
Net income (loss)	$ 6,880	$ (4,992)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	681	636
Allowance for doubtful accounts	(26)	(63)
Provision for excess and obsolete inventories	228	90
Change in deferred tax asset	267	(3,684)
Stock-based compensation	4,305	3,231
Tax benefit from employee stock options	2,408	
Excess tax benefit related to stock-based compensation expense	(1,863)	
Gain on disposal of assets	(6)	
Changes in assets and liabilities:		
Accounts receivable	(1,885)	(2,583)
Inventories	(1,532)	(403)
Other current assets	(361)	(270)
Accounts payable	(473)	44
Accrued liabilities	893	3,414
Deferred rent	162	246
Deferred revenue	2,518	2,226
Income tax liability	(340)	
Net cash provided by (used in) operating activities	11,856	(2,108)
Cash flows from investing activities:		
Acquisition of property and equipment	(881)	(441)
Acquisition of intangibles	(20)	(1,218)
Proceeds from sale of property and equipment	6	
Proceeds from sales of marketable investments	48,643	12,303
Proceeds from maturities of marketable investments	26,558	76,693
Purchase of marketable investments, net	(66,960)	(89,807)
Net cash provided by (used in) investing activities	7,346	(2,470)
Cash flows from financing activities:		
Proceeds from exercise of stock options and employee stock purchase plan	3,511	2,376
Repurchase of common stock	(25,000)	
Excess tax benefit related to stock-based compensation expense	1,863	
Net cash (used in) provided by financing activities	(19,626)	2,376
Net decrease in cash and cash equivalents	(424)	(2,202)
Cash and cash equivalents at beginning of period	11,800	5,260

Cash and cash equivalents at end of period	$	11,376	$	3,058
Non-cash disclosure of cash flow information:				
Change in deferred stock-based compensation, net of terminations	$	(9)	$	(1,261)

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

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CUTERA, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Description of Operations

Cutera, Inc., or Cutera or the Company, is a Delaware corporation headquartered in Brisbane, California. The Company is a medical device company specializing in the design, development, manufacture, marketing and servicing of laser and other light-based aesthetic systems for practitioners worldwide. The Company offers easy-to-use products on three platforms - CoolGlide, Solera and Xeo- which enable physicians and other qualified practitioners to offer safe and effective aesthetic treatments to their customers. The Company s wholly-owned subsidiaries in Australia, Canada, France, Japan, Spain, Switzerland and the United Kingdom market, sell and service its products outside of the United States.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated.

Unaudited Interim Financial Information

The financial information furnished is unaudited. The Condensed Consolidated Financial Statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for the fair statement of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The December 31, 2006 Condensed Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The results for interim periods are not necessarily indicative of the results for the entire year or any other interim period. The Condensed Consolidated Financial Statements should be read in conjunction with the Company s financial statements and the notes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2006 filed with the Securities and Exchange Commission, or SEC, on March 16, 2007.

Use of Estimates

The preparation of the interim Condensed Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States requires the Company s management to make estimates and assumptions that affect the amounts reported and disclosed in the financial statements and the accompanying notes. Actual results could differ materially from those estimates. On an ongoing basis, the Company evaluates its estimates, including those related to the fair values of marketable investments, accounts receivable and sales allowances, fair values of acquired intangible assets, useful lives of intangible assets and property and equipment, accrued product warranty costs, accrued commission expense, fair values of options to purchase the Company s common stock, recoverability of deferred tax assets, and effective income tax rates, among others. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Significant Accounting Policies

The Company s significant accounting policies are disclosed in the Company s annual report on Form 10-K for the year ended December 31, 2006 and have not changed significantly as of September 30, 2007, except for the following:

Accounting for Income Taxes

In July 2006, the Financial Accounting Standards Board, or FASB, issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, or FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with Statement of Financial Accounting Standards, or SFAS, No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted the provisions of FIN 48 effective January 1, 2007. Refer to Note 7 for further details of the impact of adoption.

Recent Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115. This Statement permits an entity to choose to measure financial instruments and certain other items similar to financial instruments at fair value. All subsequent changes in fair value for the financial instrument would be reported in earnings. By electing the fair value option, an entity can also achieve consistent accounting for related assets and liabilities without having to apply complex hedge accounting. This Statement is effective January 1, 2008. The Company is currently evaluating the impact of adopting this standard on the consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, or SFAS No. 157. This standard defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America, and expands disclosure about fair value measurements. This pronouncement applies under other accounting standards that require or permit fair value measurements. Accordingly, this statement does not require any new fair value measurement. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company will be required to adopt SFAS 157 in the quarter ended March 31, 2008. The Company is currently assessing the impact that SFAS 157 may have on its consolidated financial position, results of operations and cash flows.

Note 2. Balance Sheet Details

Cash, Cash Equivalents and Marketable Investments:

The Company considers all highly liquid investments, with an original maturity of three months or less at the time of purchase, to be cash equivalents. Investments in debt securities are accounted for as available-for-sale securities, carried at fair value with unrealized gains and losses reported in other comprehensive income, held for use in current operations and classified in current assets as Marketable Investments.

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

	September 30, 2007			
	Amortized Cost	Gross Unrealized Gains	Unrealized Losses	Fair Market Value
Cash and cash equivalents	$ 11,376	$	$	$ 11,376
Marketable investments	88,102	58		88,160
	$ 99,478	$ 58	$	$ 99,536

	December 31, 2006			
	Amortized Cost	Gross Unrealized Gains	Unrealized Losses	Fair Market Value
Cash and cash equivalents	$ 11,800	$	$	$ 11,800
Marketable investments	96,343		(58)	96,285
	$ 108,143	$	$ (58)	$ 108,085

Inventories:

Inventories consist of the following (in thousands):

	September 30, 2007	December 31, 2006
Raw materials	$ 3,518	$ 2,816
Finished goods	3,006	2,404
	$ 6,524	$ 5,220

Intangible Assets:

Intangible assets are principally comprised of a technology sublicense acquired in 2002; a patent sublicense acquired in 2006; and other intangibles. The components of intangible assets were as follows (in thousands):

	September 30, 2007		
	Gross Carrying Amount	Accumulated Amortization Amount	Net Carrying Amount
Patent sublicense	$ 1,218	$ 207	$ 1,011
Technology sublicense	538	288	250
Other intangibles	185	168	17
Total	$ 1,941	$ 663	$ 1,278

	December 31, 2006		
	Gross Carrying Amount	Accumulated	Net Carrying Amount

		Amortization Amount	
Patent sublicense	$ 1,218	$ 104	$ 1,114
Technology sublicense	538	247	291
Other intangibles	165	124	41
Total	$ 1,921	$ 475	$ 1,446

For the nine months ended September 30, 2007 and 2006, amortization expense for intangible assets was $188,000 and $172,000, respectively.

Based on intangible assets recorded at September 30, 2007, and assuming no subsequent additions to, or impairment of the underlying assets, the remaining estimated annual amortization expense is expected to be as follows (in thousands):

Fiscal year ending December 31:	
2007 remainder	$ 50
2008	202
2009	196
2010	192
2011	192
Thereafter	446
Total	$ 1,278

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Note 3. Service Contract Revenue

Service contract revenue is recognized on a straight-line basis over the period of the applicable service contract. The deferred service contract revenue balances as of September 30, 2007 and 2006, were as follows (in thousands):

	September 30, 2007	September 30, 2006
Balance at December 31, 2006 and 2005	$ 6,652	$ 3,117
Add: Payments received	6,996	4,836
Less: Revenue recognized	(4,468)	(2,740)
Balance at September 30, 2007 and 2006	$ 9,180	$ 5,213

Costs incurred under service contracts during the nine months ended September 30, 2007 and 2006, amounted to $1.6 million and $1.3 million, respectively. All service contract costs are recognized as incurred.

Note 4. Stock Repurchase Program and Stock-based Compensation

Stock Repurchase Program

On May 15, 2007, the Company s Board of Directors approved a stock repurchase program under which the Company was authorized to use up to $25 million over a period of up to one year to repurchase shares of its common stock. Per this program, the Company entered into a pre-arranged Rule 10b5-1 trading plan with a broker to facilitate the repurchase of its shares. Acquisitions were made in accordance with the trading plan, at prevailing prices, subject to market conditions and other factors. This repurchase program terminated on August 31, 2007, when the Company had acquired $25 million worth of shares of its common stock. During the nine months ended September 30, 2007, the Company repurchased 1,107,856 shares of its common stock at an average price of $22.57. The stock repurchased under the plan will be cancelled and returned to authorized share status.

Stock-based Compensation Expenses

The pre-tax stock-based compensation expense recognized during the three and nine months ended September 30, 2007 and 2006 was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Cost of sales	$ 225	$ 170	$ 674	$ 512
Sales and marketing	419	406	1,268	1,083
Research and development	209	189	571	549
General and administrative	664	468	1,792	1,087
Total stock-based compensation expense	$ 1,517	$ 1,233	$ 4,305	$ 3,231

Note 5. Net Income (Loss) Per Share

Basic net income (loss) per share is calculated by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per share is calculated by using the weighted-average number of common shares outstanding during the period increased to include the number of additional shares of common stock that would have been outstanding if the dilutive potential shares of common stock had been issued. The dilutive effect of outstanding options, the Employee Stock

Purchase Plan, or ESPP, shares and restricted stock units is reflected in diluted net income (loss) per share by application of the treasury stock method, which includes consideration of stock-based compensation required by Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment (revised 2004)*, or SFAS 123(R), and SFAS No. 128, *Earnings Per Share.*

The following table sets forth the computation of basic and diluted net income and the weighted average number of shares used in computing basic and diluted net income per share (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Numerator:				
Net income (loss) available to common stockholders Basic and Diluted	$ 3,092	$ 2,950	$ 6,880	$ (4,992)
Denominator:				
Weighted-average number of common shares outstanding used in computing basic net income (loss) per share	13,026	12,675	13,283	12,460
Dilutive potential common shares used in computing diluted net income (loss) per share	944	1,563	1,139	
Total weighted-average number of shares used in computing diluted net income (loss) per share	13,970	14,238	14,422	12,460

Anti-dilutive securities

The following number of outstanding options and restricted stock units, prior to the application of the treasury stock method, were excluded from the computation of diluted net income (loss) per common share for the periods presented because including them would have had an anti-dilutive effect (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Options to purchase common stock	969	783	735	2,691
Restricted stock units				61
Employee stock purchase plan shares	18		18	51
	987	783	753	2,803

Note 6. Comprehensive Income (Loss)

Comprehensive income (loss) generally represents all changes in stockholders equity except those resulting from investments or contributions by stockholders. The Company s unrealized gain on marketable investments represents the only component of other comprehensive income (loss) that is excluded from net income (loss). The changes in components of other comprehensive income (loss) for the periods presented are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Net income (loss)	$ 3,092	$ 2,950	$ 6,880	$ (4,992)
Unrealized income on marketable investments	157	106	116	67
Comprehensive income (loss)	$ 3,249	$ 3,056	$ 6,996	$ (4,925)

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Note 7. Income Taxes

The interim effective income tax rate is based on management s best estimate of the annual effective income tax rate. The effective tax rates for the three and nine months ended September 30, 2007 were 26% and 31%, respectively, and for the three and nine months ended September 30, 2006 were 35% and 43%, respectively. These rates reflect applicable United States federal and state tax rates and the tax impact of foreign operations, offset primarily by research and development tax credits in the nine months ended September 30, 2007 and tax exempt interest income in both the nine months ended September 30, 2007 and 2006. The effective income tax rate for the three and nine months ended September 30, 2007 was significantly lower than same period in the prior year, due primarily to higher projected income before taxes, tax exempt interest income, research and development tax credits, and Section 199 deductions.

For the three and nine months ended September 30, 2006, given the litigation settlement expense of $18.9 million resulted in a significantly lower level of income (loss) before income taxes, the impact of deductible permanent items tax-exempt interest income, deductions for disqualifying incentive stock option exercises resulted in a substantially more pronounced impact on our effective income tax rate, as they represented a larger percentage of our loss before income taxes. In addition, our effective tax rate for 2006 was adversely impacted by the reduction of the Section 199 deduction and Extraterritorial Income exclusion, due to our loss position, and because of the expiration of the research and development tax credit on December 31, 2005. The research and development tax credit was re-approved in December 2006.

Undistributed earnings of the Company s foreign subsidiaries of approximately $1.5 million and $901,000 at September 30, 2007 and 2006, respectively, are considered to be indefinitely reinvested and, accordingly, no provision for federal and state income taxes has been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, the Company would be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to various foreign countries.

Impact of Adoption of FIN 48

The Company implemented the provisions of FIN 48 as of January 1, 2007 and recorded the cumulative effect of applying the provisions of the Interpretation as an adjustment to the Company s retained earnings balance as of January 1, 2007. The total amount of unrecognized tax benefits as of the date of adoption was approximately $943,000. The Company reduced its January 1, 2007 retained earnings by approximately $91,000.

Included in the balance of unrecognized tax benefits at January 1, 2007 were approximately $542,000 of tax benefits that, if recognized, would affect the effective tax rate; and approximately $401,000 of tax benefits that, if recognized, would result in an adjustment to deferred tax assets.

Accrued interest and penalties relating to the income tax on the unrecognized tax benefits as of September 30, 2007 and January 1, 2007 were approximately $113,000 and $93,000, respectively, with approximately $12,000 being included as a component of the provision for income taxes for the nine months ended September 30, 2007. In general, the Company s income tax returns are subject to examination by U.S. federal, state and foreign tax authorities for tax years 2003 onward and by various U.S. state tax authorities for tax years 2002 onward. The Company does not expect that the amounts of unrecognized tax benefits will change significantly within the next 12 months.

Note 8. Commitments, Contingencies and Litigation

Litigation

Two securities class action lawsuits were filed against the Company and two of its executive officers in April 2007 and May 2007, respectively, in the U.S. District Court for the Northern District of California following declines in the Company s stock price. The plaintiffs claim to represent purchasers of the Company s common stock from January 31, 2007 through May 7, 2007. The complaints generally allege that materially false statements and omissions were made regarding the Company s financial prospects, and seek unspecified monetary damages. On November 1, 2007, the Court ordered the two cases consolidated, and gave the plaintiffs until December 17, 2007 to file a consolidated, amended complaint. The Company intends to defend this consolidated case vigorously. Although the Company retains director and officer liability insurance, there is no assurance that such insurance will cover the claims that are made or will insure the Company fully for all losses on covered claims. During the quarter and nine months ended September 30, 2007, the Company has not incurred a material amount of legal fees in defending these cases. Since the outcome of the litigation is unpredictable, and since the Company believes that a significant adverse result is not probable, no expense has been recorded with respect to the contingent liability associated with this matter.

Litigation Settlement

In 2006, the Company settled its patent litigation with Palomar Medical Technologies and Massachusetts General Hospital- with Palomar granting the Company an irrevocable sublicense to the subject patents. In connection with this settlement, the Company recorded a litigation settlement charge of $18.9 million relating to past royalties, interest and legal settlement costs.

Other Legal Matters

In addition to the foregoing lawsuits, the Company is named from time to time as a party to product liability and contractual lawsuits in the normal course of its business. As of September 30, 2007, the Company was not a party to any material pending litigation.

Facility Leases

The Company leases its office and manufacturing facility in Brisbane, California, and also leases offices in Japan, Switzerland and France under operating leases. These leases qualify for operating lease accounting treatment under SFAS No. 13, Accounting for Leases, and, as such, these facilities are not included on its Condensed Consolidated Balance Sheets.

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The following is a schedule of payments under operating leases (in thousands):

Fiscal Year Ending December 31,	
2007 remainder	$ 310
2008	1,192
2009	1,213
2010	1,231
2011	1,309
Thereafter	2,972
Future minimum rental payments	$ 8,227

Warranty Obligations.

The Company provides standard one to two year warranty coverage on its systems. Warranty coverage is for labor and parts necessary to repair the systems during the warranty period. The Company accounts for the estimated warranty cost as a charge to cost of revenue, when revenue is recognized. The estimated warranty cost is based on historical product performance and expenses to repair systems. Utilizing actual service records, the Company calculates the average service labor, overhead and parts expense per system and applies those averages to the actual units exposed to future warranty claims. The Company updates these estimates on a quarterly basis.

The following table provides the changes in the product warranty accrual for the nine months ended September 30, 2007 and 2006 (in thousands):

	September 30, 2007	September 30, 2006
Balance at December 31, 2006 and 2005	$ 3,055	$ 2,043
Accruals for warranties issued during the period	3,667	4,383
Settlements made during the period	(4,044)	(3,325)
Balance at September 30, 2007 and 2006	$ 2,678	$ 3,101

Purchase Commitments.

The Company maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply for key components. The Company s liability in these purchase commitments is generally restricted to a forecasted time-horizon as agreed between the parties. These forecasted time-horizons can vary among different suppliers. The Company s open inventory purchase commitments were not material at September 30, 2007.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Caution Regarding Forward-Looking Statements

The following discussion should be read in conjunction with the attached financial statements and notes thereto, and with our audited financial statements and notes thereto for the fiscal year ended December 31, 2006 as contained in our annual report on Form 10-K filed with the SEC on March 16, 2007. This quarterly report, including the following sections, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that involve risks and uncertainties. These statements include, but are not limited to, statements relating to future financial performance, the planned expansion of and improvements in our sales force, distribution networks and customer base, the success of new product launches, future capital expenditures and requirements and the impact of exchange rate volatility. These forward-looking statements involve risks and uncertainties. The cautionary statements set forth below and those contained in Part II, Item 1A Risk Factors commencing on page 16, identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. The reader is cautioned not to place undue reliance on these forward-looking statements, which reflect management s analysis and expectations only as of the date of this report. We undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this Form 10-Q. Cutera s financial performance for the quarter and nine months September 30, 2007, as discussed in this report on Form 10-Q, is preliminary and unaudited, and subject to adjustment.

Introduction

The Management s Discussion and Analysis, or MD&A, is organized as follows:

Executive summary. This section provides a general description and history of our business, a brief discussion of our product lines and the opportunities, trends, challenges and risks we focus on in the operation of our business.

Critical accounting policies and estimates. This section describes the key accounting policies that are affected by critical accounting estimates.

Recent accounting pronouncements. This section describes the issuance and effect of new accounting pronouncements that may be applicable to us.

Results of operations. This section provides our analysis and outlook for the significant line items on our Consolidated Statements of Operations.

Liquidity and capital resources. This section provides an analysis of our liquidity and cash flows, as well as a discussion of our commitments that existed as of September 30, 2007.

Executive Summary

Company Description. We are a global medical device company engaged in the design, development, manufacture, marketing and servicing of laser and other light-based aesthetics systems for practitioners worldwide. We offer easy-to-use products on three platforms CoolGlide, Solera and Xeo which enable physicians and other qualified practitioners to offer safe and effective aesthetic treatments to their customers.

Our corporate headquarters and U.S. operations are located in Brisbane, California, from where we conduct our manufacturing, warehousing, research, regulatory, sales, service, marketing and administrative activities. In the United States, we market, sell and service our products primarily through direct sales and service employees and through a distribution relationship with PSS World Medical Shared Services, Inc., a wholly-owned subsidiary of PSS World Medical, or PSS, which has over 700 sales professionals serving physician offices throughout the United States. In addition, we also sell certain items, like Titan handpiece refills and marketing brochures, via the web.

International sales are generally made through a direct sales force and through independent sales professionals and distributors in over 30 countries. Outside the United States, we have a direct sales presence in Australia, Canada, France, Japan, Spain, Switzerland and the United Kingdom.

Products. Our revenue is derived from the sale of products, product upgrades, service and Titan handpiece refills. Product revenue represents the sale of a system console that includes a universal graphic user interface, a laser and/or other light-based module, control system software, high voltage electronics and one or more handpieces. We offer our customers the ability to select the system that best fits their practice at the time of purchase and then to cost-effectively add applications to their system as their practice grows. This enables customers to upgrade their systems whenever they want and provides us with a source of recurring revenue, which we classify as product upgrade revenue. Service revenue relates to amortization of prepaid service contract revenue and receipts for services on out-of-warranty products. Titan handpiece refill revenue is associated with our Titan handpiece, which requires a periodic refilling process, which includes the replacement of the optical source after a set number of pulses has been performed.

Significant Business Trends. We believe that our revenue growth has been, and will continue to be, primarily attributable to the following:

- Investments made in our global sales and marketing infrastructure, including the expansion of our sales force to increase our market penetration in the aesthetic laser market.

- Continuing introduction of new aesthetic products and applications.

- Marketing to physicians outside the core dermatology and plastic surgeon specialties.

- Generating service, upgrade, and Titan handpiece refill revenue from our growing installed base of customers.

During the three months ended September 30, 2007, compared to the same period in 2006, our total revenue increased by 12%, our U.S. revenue increased by 2% and our international revenue increased by 35%. During the nine months ended September 30, 2007, compared to the same period in 2006, our total revenue increased by 7%, our U.S. revenue remained flat and our international revenue increased by 24%. The increase in our international revenue growth rate was primarily attributable to investments in building our international sales channels. These efforts have resulted in increased revenue from Australia and Canada, and from our international-distributor network. The decrease in our U.S. revenue growth rates for the three and nine months ended September 30, 2007, compared to the same periods in 2006, was primarily due to slower-than-expected adoption of our new Pearl product by new customers and to lower sales productivity of our recently-hired U.S. sales professionals. Also, some of our public competitors have reported reduced growth rates for the three months ended September 30, 2007, which may indicate signs of a slowing market growth rate that could have contributed to a decrease in our U.S. revenue growth rate.

In the second quarter ended June 30, 2007, we started shipping our new Pearl product. Pearl uses a unique wavelength, and is designed to renew the skin s surface and to provide a more-pronounced clinical outcome, compared to non-invasive light-based treatments, with minimal patient downtime. Primarily due to sales of Pearl upgrades to our existing customer base, our product upgrade revenue increased by 217% and 129% in the third quarter and nine months ended September 30, 2007, compared to the same periods in 2006, respectively. However, sales of Pearl to new customers did not meet our expectations for the third quarter ended September 30, 2007. Also, due to the recent expansion of our U.S. direct sales force, more than half of its members were hired within the nine months ended September 30, 2007. As such, productivity of these recently-hired sales professionals had not increased to our expected level.

Though our fourth quarter revenue has been cyclically the highest revenue quarter of the year in the past, due to the slower-than-expected adoption of our Pearl product by new customers, a potential slowing of market growth rate, the lower sales productivity of our recently-hired U.S. sales professionals, short sales cycles in our business and the fact that many of our customer orders in any given quarter are received during the last month of a quarter, we are unable to accurately forecast our revenue for the fourth quarter ending December 31, 2007.

Our gross margin for the three months ended September 30, 2007 was 66%, compared to 68% in the same period of 2006. This decrease in gross margin percentage was primarily due to lower introductory margins for our Pearl-enabled systems and upgrades. For the nine months ended September 30, 2007, our gross margin declined to 66%, compared to 69% in the same period of 2006. This reduction in gross margin percentage was primarily attributable to lower introductory margins for our upgrades, and $1,049,000 of higher patent royalty expense. We settled our patent litigation in the second quarter of 2006, and as a result, the first quarter of 2006 did not include patent royalty expenses. For the fourth quarter ending December 31, 2007, we anticipate our gross margin will improve slightly due to improved Pearl margins.

For the three and nine months ended September 30, 2007, compared to the same period in 2006, sales and marketing expenses increased by 30% and 15%, respectively. These increases were primarily attributable to higher employee and travel related expenses associated with the continued investments in expanding our U.S. and international direct sales force. We expect that sales and marketing expenses for the fourth quarter ending December 31, 2007, will be higher than the third quarter ended September 30, 2007.

General and administrative expenses for the nine months ended September 30, 2007, compared to the same period in 2006, decreased by $2.6 million or 23%. This decrease was primarily attributable to $3.5 million of lower legal expenses due primarily to the patent litigation settlement in the second quarter of 2006 which was partly offset by a $705,000 increase in stock-based compensation expenses. In April and May 2007, two securities class action lawsuits were filed against us see Part II, Item 1 Legal Proceedings. However, given that we retain director and officer liability insurance with a deductible, we expect the impact from this litigation to not be material for the remainder of 2007. As a percentage of total revenue, general and administrative expenses for the three and nine months ended September 30, 2007, were 11% and 12%, respectively.

Factors that May Impact Future Performance

Our industry is impacted by numerous competitive, regulatory and other significant factors. Our industry is highly competitive and our success depends on our ability to compete successfully. Additionally, the growth of our business relies on our ability to continue to develop new products and innovative technologies, obtain regulatory clearances for our products, protect the proprietary technology of our products and our manufacturing processes, manufacture our products cost effectively, and successfully market and distribute our products in a profitable manner. If we fail to compete effectively, fail to continue to develop new products and technologies, fail to obtain regulatory clearances, fail to protect our intellectual property, fail to produce our products cost effectively, or fail to market and distribute our products in a profitable manner, our business could suffer. A detailed discussion of these and other factors that could impact our future performance are provided in Part II, Item 1A Risk Factors section.

Critical Accounting Policies and Estimates

The accounting policies that we consider to be critical, subjective, or requiring complex judgments in their application are summarized in Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2006 filed with the SEC on March 16, 2007. Other than the adoption of FIN 48, there have been no significant changes during the nine months ended September 30, 2007 to the items that we disclosed as our critical accounting policies and estimates in our Annual Report on Form 10-K for the year ended December 31, 2006.

Income Taxes We operate in multiple taxing jurisdictions, both within the United States and outside the United States. We have filed tax returns with positions that may be challenged by the tax authorities. These positions relate to, among others, deductibility of certain expenses, transfer pricing, expenses included in our research and development tax credit computations, as well as other matters. Although the outcome of tax audits is uncertain, in management s opinion, adequate provisions for income taxes have been made for potential liabilities resulting from such matters. We regularly assess the tax positions for such matters and include reserves for those differences in position. The reserves are utilized or reversed once the statute of limitations has expired and/or at the conclusion of the tax examination. We believe that the ultimate outcome of these matters will not have a material impact on our financial position, financial operations or liquidity. Effective January 1, 2007, we adopted FIN 48 (refer to Note 7).

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Recent Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115. This Statement permits an entity to choose to measure financial instruments and certain other items similar to financial instruments at fair value. All subsequent changes in fair value for the financial instrument would be reported in earnings. By electing the fair value option, an entity can also achieve consistent accounting for related assets and liabilities without having to apply complex hedge accounting. This Statement is effective January 1, 2008. We are currently evaluating the impact of adopting this standard on the consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, or SFAS No. 157. This standard defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America, and expands disclosure about fair value measurements. This pronouncement applies under other accounting standards that require or permit fair value measurements. Accordingly, this statement does not require any new fair value measurement. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We will be required to adopt SFAS No. 157 in the quarter ending March 31, 2008 and are currently assessing the impact that this may have on our consolidated financial position, results of operations and cash flows.

Results of Operations

The following table sets forth selected consolidated financial data for the periods indicated, expressed as a percentage of net revenue:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Consolidated Statement of Operations- Operating Ratios:				
Net revenue	100%	100%	100%	100%
Cost of revenue	34%	32%	34%	31%
Gross margin	66%	68%	66%	69%
Operating expenses:				
Sales and marketing	38%	32%	38%	36%
Research and development	6%	7%	7%	6%
General and administrative	11%	12%	12%	16%
Litigation settlement	%	2%	%	