IRIDEX CORP
Form 10-Q
August 07, 2012
Table of Contents

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, 2012

Or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number: 0-27598

IRIDEX CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**77-0210467**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
1212 Terra Bella Avenue	
Mountain View, California	**94043-1824**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (650) 940-4700

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

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 common stock, $.01 par value, issued and outstanding as of July 24, 2012 was 9,007,300.

Table of Contents

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements (unaudited)

IRIDEX Corporation

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, in thousands except share and per share data)

	June 30, 2012	December 31, 2011 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,785	$ 10,789
Accounts receivable, net of allowance for doubtful accounts of $139 at June 30, 2012 and $162 at December 31, 2011	5,924	5,551
Inventories, net	7,539	6,659
Prepaid expenses and other current assets	1,228	464
Current assets of discontinued operations	558	6,043
Total current assets	29,034	29,506
Property and equipment, net	388	325
Intangible assets, net	653	745
Goodwill	533	533
Other long-term assets	170	199
Restricted cash related to discontinued operations	510	0
Non-current assets of discontinued operations	4	841
Total assets	$ 31,292	$ 32,149
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,139	$ 1,580
Accrued compensation	1,296	1,180
Accrued expenses	1,037	1,920
Accrued warranty	525	556
Deferred revenue	800	1,014
Current liabilities of discontinued operations	79	2,663
Total current liabilities	5,876	8,913
Long-term liabilities:		
Other long-term liabilities	649	810
Total liabilities	6,525	9,723
Stockholders equity:		
Convertible preferred stock, $0.01 par value:		
Authorized: 2,000,000 shares;		
Issued and outstanding: 500,000 shares at June 30, 2012 and at December 31, 2011	5	5

Common stock, $0.01 par value:		
Authorized: 30,000,000 shares;		
Issued and outstanding 8,981,445 and 8,917,824 shares at June 30, 2012 and December 31, 2011, respectively	93	92
Additional paid-in capital	42,692	42,032
Accumulated other comprehensive loss	0	(35)
Treasury stock, at cost (343,355 and 167,885 shares at June 30, 2012 and December 31, 2011, respectively)	(1,374)	(1,078)
Accumulated deficit	(16,649)	(18,590)
Total stockholders equity	24,767	22,426
Total liabilities and stockholders equity	$ 31,292	$ 32,149

(1) Derived from the audited consolidated financial statements included in the annual report filed on Form 10-K with the SEC for the year ended December 31, 2011.

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

Table of Contents

IRIDEX Corporation

Condensed Consolidated Statements of Operations

(Unaudited, in thousands except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Total revenues	$ 8,445	$ 8,085	$ 16,750	$ 16,281
Cost of revenues	4,334	4,147	8,653	8,259
Gross profit	4,111	3,938	8,097	8,022
Operating expenses:				
Research and development	1,106	890	2,288	1,853
Sales and marketing	2,122	1,786	3,986	3,564
General and administrative	1,233	1,022	2,409	2,105
Total operating expenses	4,461	3,698	8,683	7,522
(Loss) income from continuing operations	(350)	240	(586)	500
Legal settlement	800	800	800	800
Interest and other income (expense), net	(48)	3	(75)	7
Income from continuing operations before income taxes	402	1,043	139	1,307
Provision for income tax expense	5	144	7	223
Income from continuing operations	397	899	132	1,084
(Loss) income from discontinued operations, net of tax	(61)	10	(223)	391
Gain on sale of discontinued operations, net of tax	0	0	2,032	0
(Loss) income from discontinued operations, net of tax	(61)	10	1,809	391
Net income	$ 336	$ 909	$ 1,941	$ 1,475
Net (loss) income per share:				
Basic				
Continuing operations	$ 0.04	$ 0.10	$ 0.01	$ 0.12
Discontinued operations	0.00	0.00	0.21	0.04
Net income	$ 0.04	$ 0.10	$ 0.22	$ 0.16
Diluted				
Continuing operations	$ 0.04	$ 0.09	$ 0.01	$ 0.10
Discontinued operations	(0.01)	0.00	0.18	0.04
Net income	$ 0.03	$ 0.09	$ 0.19	$ 0.14

Weighted average shares used in computing net income per common share				
Basic	8,983	8,961	8,958	8,962
Diluted	10,286	10,231	10,270	10,223

Condensed Consolidated Statements of Comprehensive Income

(Unaudited, in thousands)

	Three Months Ended		Six Months Ended	
	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Net income	$ 336	$ 909	$ 1,941	$ 1,475
Foreign currency translation adjustments	0	(10)	0	(33)
Recognition of accumulated foreign currency translation loss related to sale of foreign operations	0	170	35	170
Comprehensive income	$ 336	$ 1,069	$ 1,976	$ 1,612

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

Table of Contents

IRIDEX Corporation

Condensed Consolidated Statements of Cash Flows

(Unaudited, in thousands)

	Six Months Ended	
	June 30, 2012	July 2, 2011
Operating activities:		
Net income	$ 1,941	$ 1,475
Less income from discontinued operations	1,809	391
Income from continuing operations	132	1,084
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	203	97
Change in fair value of earn-out liability	78	0
Stock compensation cost recognized	297	219
Provision for doubtful accounts	(23)	(12)
Provision for inventory reserves	232	(60)
Changes in operating assets and liabilities:		
Accounts receivable	(350)	41
Inventories	(1,112)	(1,121)
Prepaid expenses and other current assets	(764)	(86)
Other long-term assets	29	(30)
Accounts payable	559	95
Accrued compensation	116	(278)
Accrued expenses	(883)	(459)
Accrued warranty	(31)	21
Deferred revenue	(214)	(25)
Other long-term liabilities	(239)	14
Net cash used in operating activities	(1,970)	(500)
Investing activities:		
Acquisition of property and equipment	(174)	(36)
Net cash used in investing activities	(174)	(36)
Cash flows from financing activities:		
Proceeds from stock option exercises	364	315
Repurchase of common stock	(296)	(401)
Net cash provided by (used in) financing activities	68	(86)
Net cash provided by operating activities from discontinued operations	405	572
Net cash provided by in investing activities from discontinued operations	4,632	0
Effect of foreign exchange rate changes from discontinued operations	35	0
Net cash provided by discontinued operations	5,072	572

Net increase (decrease) in cash and cash equivalents	2,996	(50)
Cash and cash equivalents, beginning of period	10,789	8,347
Cash and cash equivalents, end of period	$ 13,785	$ 8,297
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Income taxes	$ 16	$ 485
Interest paid	$ 0	$ 0

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

Table of Contents

IRIDEX Corporation

Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of IRIDEX Corporation (the Company , we , our , or us) have been prepared in accordance with accounting principles generally accepted in the United States (US GAAP) for interim financial information and pursuant to the instructions to Form 10-Q and Article 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the financial statements have been included.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto, together with management s discussion and analysis of the Company s financial condition and results of operations, contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, which was filed with the Securities and Exchange Commission (SEC) on March 30, 2012. The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of the results for the year ending December 29, 2012 or any future interim period.

2. Summary of Significant Accounting Policies

The Company s significant accounting policies are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011, which was filed with the SEC on March 30, 2012.

Reclassifications.

In February 2012, we completed the sale of our aesthetics business to Cutera, Inc. In accordance with US GAAP, we have reclassified the financial information disclosed within this Form 10-Q to show the results from our ophthalmology business as continuing operations and the results from our aesthetics business as discontinued operations.

Discontinued Operations.

Discontinued operations are presented and accounted for in accordance with Accounting Standards Codification (ASC) 360, *Impairment or Disposal of Long-Lived Assets,* (ASC 360). When a qualifying component of the Company is disposed of or has been classified as held for sale, the operating results of that component are removed from continuing operations for all periods presented and displayed as discontinued operations if: (a) elimination of the component s operations and cash flows from the Company s ongoing operations has occurred (or will occur) and (b) significant continuing involvement by the Company in the component s operations does not exist after the disposal transaction.

In February 2012, we completed the sale of our aesthetics business to Cutera, Inc. The operating results and the associated assets and liabilities of our aesthetics business have been classified as discontinued operations for all periods presented under the requirements of ASC 360. The Company received $5.1 million in net cash and recorded a net pre-tax gain on the sale of $1.1 million before income taxes, which was included as part of income from discontinued operations, net of tax, in the Company s condensed consolidated statement of operations in the first quarter of 2012.

The following table summarizes activities for discontinued operations during the three and six month periods ended June 30, 2012 and July 2, 2011.

	Three Months Ended	
(in thousands)	**June 30, 2012**	**July 2, 2011**
Net sales	$ 299	$ 2,713
(Loss) gain from discontinued operations	$ (61)	$ 39
(Loss) income before income taxes	$ (61)	$ 39
Income tax benefit (expense)	$ 0	$ (29)

(Loss) income from discontinued operations, net of tax	$ (61)	$ 10

	Six Months Ended	
(in thousands)	June 30, 2012	July 2, 2011
Net sales	$ 1,228	$ 5,729
(Loss) gain from discontinued operations	$ (223)	$ 439
Gain on sales of aesthetics business, net	$ 1,149	$ 0
Income before income taxes	$ 926	$ 439
Income tax benefit (expense)	$ 883	$ (48)
Income from discontinued operations, net of tax	$ 1,809	$ 391

A summary of the assets and liabilities of discontinued operations as of June 30, 2012 and December 31, 2011 is provided as follows (in thousands):.

	June 30, 2012	December 31, 2011
Assets:		
Cash	$ 105	$ 382
Accounts receivable, net	194	2,065
Inventory, net	245	3,480
Other current assets	14	116
Total current assets	558	6,043
Restricted cash	510	0
Property, plant & equipment, net	4	24
Intangible assets, net	0	813
Other assets	0	4
Total assets	$ 1,072	$ 6,884
Liabilities:		
Accounts payable	$ 36	$ 387
Accrued liabilities	43	967
Accrued warranty	0	234
Deferred revenue	0	1,075
Total liabilities	$ 79	$ 2,663

Table of Contents

Revenue Recognition.

Our revenues arise from the sale of laser consoles, delivery devices, consumables and service and support activities. Revenue from product sales is recognized upon receipt of a purchase order and product shipment provided that no significant obligations remain and collection of the receivables is reasonably assured. Shipments are generally made with Free-On-Board (FOB) shipping point terms, whereby title passes upon shipment from our dock. Any shipments with FOB receiving point terms are recorded as revenue when the shipment arrives at the receiving point. Cost is recognized as product sales revenue is recognized. The Company s sales may include post-sales obligations for training or other deliverables. For revenue arrangements such as these, we recognize revenue in accordance with ASC 605, *Revenue Recognition, Multiple-Element Arrangements*. The Company allocates revenue among deliverables in multiple-element arrangements using the relative selling price method. Revenue allocated to each element is recognized when the basic revenue recognition criteria is met for each element. The Company is required to apply a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (i) vendor-specific objective evidence of fair value (VSOE), (ii) third-party evidence of selling price (TPE) and (iii) best estimate of the selling price (ESP). In general, the Company is unable to establish VSOE or TPE for all of the elements in the arrangement; therefore, revenue is allocated to these elements based on the Company s ESP, which the Company determines after considering multiple factors such as management approved pricing guidelines, geographic differences, market conditions, competitor pricing strategies, internal costs and gross margin objectives. These factors may vary over time depending upon the unique facts and circumstances related to each deliverable. As a result, the Company s ESP for products and services could change. Revenues for post-sales obligations are recognized as the obligations are fulfilled.

In international regions, we utilize distributors to market and sell our products. We recognize revenue upon shipment for sales to these independent, third party distributors as we have no continuing obligations subsequent to shipment. Generally our distributors are responsible for all marketing, sales, installation, training and warranty labor coverage for our products. Our standard terms and conditions do not provide price protection or stock retention rights to any of our distributors.

Taxes Collected from Customers and Remitted to Governmental Authorities.

Taxes collected from customers and remitted to governmental authorities are recognized on a net basis in the accompanying consolidated statements of operations.

Deferred Revenue

Revenue related to service contracts is deferred and recognized on a straight line basis over the period of the applicable service contract. Costs associated with these service arrangements are recognized as incurred. A reconciliation of the changes in the Company s deferred revenue balance for the six months ended June 30, 2012 and July 2, 2011 is as follows:

	Six Months Ended	
(in thousands)	**June 30, 2012**	**July 2, 2011**
Balance, beginning of period	$ 1,014	$ 1,002
Additions to deferral	339	530
Revenue recognized	(553)	(555)
Balance, end of period	$ 800	$ 977

Warranty

The Company accrues for estimated warranty cost upon shipment of products. Actual warranty costs incurred have not materially differed from those accrued. The Company s warranty policy is applicable to products which are considered defective in their performance or fail to meet the product specifications. Warranty costs are reflected in the statements of operations as cost of revenues. A reconciliation of the changes in the Company s warranty liability for the six months ended June 30, 2012 and July 2, 2011 is as follows:

	Six Months Ended

(in thousands)	June 30, 2012	July 2, 2011
Balance, beginning of period	$ 556	$ 607
Accruals for product warranties	85	83
Cost of warranty claims and adjustments	(116)	(62)
Balance, end of period	$ 525	$ 628

Goodwill

Goodwill is tested for impairment at least annually in our second quarter or whenever there is a change in circumstances that indicates the carrying value of these assets may be impaired. In accordance with Accounting Standards Update (ASU) 2011-08, the Company assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350, *Intangibles-Goodwill and Other*. The Company did not record any impairment of goodwill for the six months ended June 30, 2012 and July 2, 2011. The carrying value of goodwill was $533 thousand at June 30, 2012 and December 31, 2011.

Intangible Assets

The purchase method of accounting for acquisitions requires estimates and assumptions to allocate the purchase price to the fair value of net tangible and intangible assets acquired. The amounts allocated to, and the useful lives estimated for, intangible assets, affect future amortization. There are a number of generally accepted valuation methods used to estimate fair value of intangible assets, and we primarily use a discounted cash flow method, which requires management judgment to forecast the future operating results and to estimate the discount factors used in the analysis. An asset is considered impaired if its carrying amount exceeds the value of future net cash flow the asset is expected to generate. If an asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. The Company did not record any impairment for the six months ended June 30, 2012 and July 2, 2011.

Future changes in events or circumstances, such as an inability to achieve the cash flows determined above, may indicate that the recorded value of the intangible assets will not be recovered through future cash flows and the Company may be required to record an impairment charge for the intangible assets or modify the period of expected lives for the intangible assets.

Table of Contents

Intangible assets consist of the following (in thousands):

	June 30, 2012			December 31, 2011			
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Amortization Life
Patents	$ 720	$ 271	$ 449	$ 720	$ 187	$ 533	Varies
Customer Relations	240	36	204	240	28	212	13.4 years
	$ 960	$ 307	$ 653	$ 960	$ 215	$ 745	

Amortization expense totaled $92 thousand and $96 thousand for the six months ended June 30, 2012 and July 2, 2011, respectively.

Future estimated amortization expense (in thousands):	
2012 (six months)	$ 70
2013	334
2014	85
2015	16
2016	16
Thereafter	132
Total	$ 653

Stock Repurchases

In May 2011, the Company approved a stock repurchase program authorizing the Company to purchase in open market or privately negotiated transactions, up to $2.0 million worth of our common stock, from time to time during the next 12 months. In February 2012, the Company approved an extension of its stock repurchase program authorizing the Company to purchase up to $4.0 million worth of our common stock, from time to time prior to March 2013. During the six months ended June 30, 2012, the Company has purchased 72,470 shares at an average price of $4.08 per share. As of June 30, 2012, the Company still has the authorization to purchase up to $3.3 million in common shares under the stock repurchase program. See Item 2, Unregistered Sales of Equity Securities and Use of Proceeds in Part II, Other Information, for additional information. In March 2011, the Company purchased the remaining 75,698 shares of our common stock held by American Medical Systems Holdings, Inc. (AMS) that were issued to AMS as part of a 2007 purchase transaction at $4.00 per share.

Recently Issued and Adopted Accounting Standards

In September 2011, the Financial Accounting Standards Board (FASB) issued ASU 2011-08, *Intangibles-Goodwill and Other* (Topic 350): Testing Goodwill for Impairment (ASU 2011-08). This standard is intended to simplify how entities test goodwill for impairment. ASU 2011-08 permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350, Intangibles-Goodwill and Other. The more likely than not threshold is defined as having a likelihood of more than 50%. ASU 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company adopted this standard in the first quarter of fiscal year 2012 and it did not have a material effect on its financial position, results of operations, or cash flows.

In June 2011, FASB issued ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income (ASU 2011-05)*. ASU 2011-05 allows an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders equity. It does not, however, change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net

income. In December 2011, the FASB issued ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05,* in order to redeliberate the portion of the earlier ASU relating to presentation of reclassifications from other comprehensive income. Both updates are effective for us during the first quarter of 2012, applied retrospectively. As ASU 2011-05 and ASU 2011-12 are only presentation standards, these standards did not have a material impact on our financial position, results of operations, or cash flows.

3. Business Combination

Ocunetics, Inc:

On September 15, 2011, the Company acquired certain assets of Ocunetics, Inc**.** The purchase price for the acquired assets consisted of $75 thousand in cash consideration and an earn-out provision with an estimated fair value of $105 thousand. The earn-out is tied to future revenues and could result in additional cash and share consideration being paid to Ocunetics, Inc. based on the future performance of the acquired products and intellectual property. In accordance with ASC 805, Business Combinations, the acquisition has been accounted for as a business combination.

Under the purchase method of accounting, the assets acquired from Ocunetics, Inc. at the date of acquisition are recorded in the consolidated financial statements at their respective fair values as of the acquisition date. The excess of the purchase price over the fair value of the acquired net assets has been recorded as goodwill in the amount of $60 thousand. This goodwill is expected to be non-deductible for tax purposes. The purchase price includes the fair value of the cash earn-out which is recorded as a long-term liability. No value was attributed to the contingent equity-based consideration because management does not believe certain targets will be achieved in the future. Costs incurred associated with the acquisition were immaterial. The financial results of Ocunetics, Inc. prior to the acquisition were immaterial for purposes of pro forma financial disclosures. As of the end of the reporting period, there has been no revenues or earnings generated by the acquiree since the acquisition date.

Identifiable intangible assets. Intangible assets included in the purchase price allocation consist of technology patents of $120 thousand, assigned an economic useful life whereby the economic value of the asset is its ability to provide the Company relief from royalty and is being amortized as a percentage of revenues generated per units sold.

Goodwill. Approximately $60 thousand has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the underlying net tangible and intangible assets. In accordance with ASC 350-20, goodwill is not amortized but instead is tested for impairment at least annually in our second quarter (more frequently if certain indicators are present). In the event that management determines that the value of goodwill has become impaired, an accounting charge for the amount of impairment is incurred in the fiscal quarter in which the determination is made. The Company believes the goodwill realized was the result of a number of factors, including expected revenue growth opportunities for existing products and the opportunity to commercialize acquired intellectual property.

Table of Contents

4. Inventories, net

The components of the Company s inventories as of June 30, 2012 and December 31, 2011 are as follows:

(in thousands)	June 30, 2012	December 31, 2011
Raw materials and work in process	$ 4,601	$ 2,694
Finished goods	2,938	3,965
Total inventories	$ 7,539	$ 6,659

5. Fair Value Measurement

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity s own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities.

Level 2: Directly or indirectly observable inputs as of the reporting date through correlation with market data, including quoted prices for similar assets and liabilities in active markets and quoted prices in markets that are not active. Level 2 also includes assets and liabilities that are valued using models or other pricing methodologies that do not require significant judgment since the input assumptions used in the models, such as interest rates and volatility factors, are corroborated by readily observable data from actively quoted markets for substantially the full term of the financial instrument.

Level 3: Unobservable inputs that are supported by little or no market activity and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management s estimates of market participant assumptions.

In determining fair value, the Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible as well as considers counterparty credit risk in its assessment of fair value.

The carrying amounts of the Company s financial assets and liabilities, including cash and cash equivalents, accounts receivable, and accounts payable at June 30, 2012 and December 31, 2011, approximate fair value because of the short maturity of these instruments.

As of June 30, 2012 and December 31, 2011, financial assets and liabilities measured and recognized at fair value on a recurring basis and classified under the appropriate level of the fair value hierarchy as described above was as follows (in thousands):

	June 30, 2012 Fair Value Measurements				December 31, 2011 Fair Value Measurements			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets:								
Cash equivalents	$ 13,136	0	0	$ 13,136	$ 10,133	0	0	$ 10,133
Liabilities:								

Earn-out-cash	$ 0	0	681	$ 681	$ 0	0	765	$ 765

The Company s Level 1 financial assets are money market funds whose fair values are based on quoted market prices. The Company does not have any Level 2 financial assets or liabilities. The Company s Level 3 financial liabilities are related to the fair value of the contingent consideration (the earn-out to be paid in cash) in connection with the RetinaLabs and Ocunetics, Inc. acquisitions. At June 30, 2012, observable market information was not available to determine the fair value of the Company s liability. Therefore, the fair value is based on valuation models that relied on Level 3 inputs including those that are based on probability of outcomes, expected cash flow streams, market discount rates and overall capital market liquidity. The valuation of the earn-out liability related to the RetinaLabs and Ocunetics, Inc. acquisitions is subject to uncertainties that are difficult to predict.

The following table provides a reconciliation of the beginning and ending balances of the earn-out cash (Level 3 liabilities) (in thousands):

	June 30, 2012	December 31, 2011
Balance at the beginning of the period	$ 765	$ 380
Addition of earn-out cash related to Ocunetics, Inc. acquisition	0	105
Payment made on earn-out RetinaLabs	(162)	0
Change in fair value of contingent consideration	78	280
Balance at the end of the period	$ 681	$ 765

The earn-out liability is recorded in accrued expenses and other long-term liabilities on the accompanying condensed consolidated balance sheets. At June 30, 2012 and December 31, 2011, accrued expenses included $210 thousand and $197 thousand and other long-term liabilities included $471 thousand and $568 thousand related to the earn-out liability.

6. Bank Borrowings

The Company had a Loan and Security Agreement (Loan Agreement) with Silicon Valley Bank (Lender) which expired in June 2012.

7. Stock Based Compensation

2008 Equity Incentive Plan

For the six months ended June 30, 2012, the only active share-based compensation plan was the 2008 Equity Incentive Plan (the Incentive Plan). The terms of awards granted during the six months ended June 30, 2012 were consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2011.

Summary of Stock Options

The following table summarizes information regarding activity in our stock option plan during the six months ended June 30, 2012 and July 2, 2011:

	Number of Shares	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value (thousands)
Outstanding at December 31, 2011	1,766,401	$ 3.63	
Granted	113,550	$ 4.10	
Exercised	(136,091)	$ 2.67	
Canceled or forfeited	(45,305)	$ 4.62	
Outstanding at June 30, 2012	1,698,555	$ 3.71	$ 1,594

Table of Contents

The weighted-average grant date fair value of the options granted under the Company s stock plans as calculated using Black-Scholes was $2.75 per share for the three months ended June 30, 2012. The weighted-average grant date fair value of the options granted under the Company s stock plans as calculated using Black-Scholes was $2.77 per share for the six months ended June 30, 2012.

The Company uses the Black-Scholes option-pricing model to estimate fair value of stock-based awards with the following weighted average assumptions:

	Three Months Ended		Six Months Ended	
	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Average risk free interest rate	0.68%	1.51%	0.70%	1.85%
Expected life (in years)	4.55 years	4.75 years	4.55 years	4.75 years
Dividend yield	0.0%	0.0%	0.0%	0.0%
Average volatility	91%	91%	91%	91%

The following table shows stock-based compensation expense included in the condensed consolidated statements of operations for the three and six month periods ended June 30, 2012 and July 2, 2011 (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Cost of revenues	$ 16	$ 14	$ 34	$ 28
Research and development	20	16	39	36
Sales and marketing	26	29	55	56
General and administrative	88	45	169	99
	$ 150	$ 104	$ 297	$ 219

Approximately $6 thousand and $5 thousand of the stock based compensation expense recognized was capitalized into inventory as a component of overhead at June 30, 2012 and July 2, 2011, respectively.

Information regarding stock options outstanding, exercisable and expected to vest at June 30, 2012 is summarized below:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (thousands)
Options outstanding	1,698,555	$ 3.71	3.56	$ 1,594
Options vested and expected to vest	1,583,062	$ 3.72	3.39	$ 1,514
Options exercisable	1,206,552	$ 3.76	2.59	$ 1,292

The aggregate intrinsic value in the table above represents the pre-tax intrinsic value, based on the Company s closing price as of June 29, 2012, that would have been received by option holders had all option holders exercised their stock options as of that date. This amount changes based on the fair market value of the Company s stock. The total intrinsic value of options exercised for the six months ended June 30, 2012 and July 2, 2011 were approximately $198 thousand and $51 thousand, respectively.

As of June 30, 2012, there was $1,022 thousand of total unrecognized compensation cost, net of forfeitures, related to non-vested share-based compensation arrangements under the Incentive Plan. The cost is expected to be recognized over a weighted average period of 2.96 years.

Summary of Restricted Stock Units and Awards

The Company recognizes the estimated compensation expense of restricted stock units and awards, net of estimated forfeitures, over the vesting term. The estimated compensation expense is based on the fair value of the Company s common stock on the date of grant.

Information regarding the restricted stock units outstanding, vested and expected to vest as of June 30, 2012 is summarized below:

	Number of Shares	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (thousands)
Restricted stock units outstanding	95,189	1.66	$ 397
Restricted stock units vested and expected to vest	75,443	1.24	$ 315

The aggregate intrinsic value in the table above represents the pre-tax intrinsic value, based on the Company s closing price as of June 29, 2012, that would have been received by option holders had all option holders exercised their stock options as of that date. There were no restricted stock units granted, vested, released or forfeited for the six months ended June 30, 2012 and July 2, 2011.

There were no restricted stock awards granted, vested, released or forfeited for the six months ended June 30, 2012 and July 2, 2011. There were 10,126 shares outstanding at June 30, 2012 with a weighted average grant date fair value of $3.95.

8. Income Taxes

Provision for Income Tax

Under ASC Topic 740-270, Interim Reporting Income Taxes, we are required to make our best estimate of the annual effective tax rate for the full fiscal year and use that rate to provide for income taxes on a current year-to-date basis. An exception applied to the current quarter as the Company was not able to provide a

Table of Contents

sufficiently precise forecast of taxable income for the year primarily due to the sale of the aesthetics business in the first quarter. The Company recorded, for continuing operations, a provision for income tax of $7 thousand and $223 thousand for the six months ended June 30, 2012 and July 2, 2011, respectively. The Company s estimated effective tax rate for continuing operations was 4.9% and 15.6%, for the six months ended June 30, 2012 and July 2, 2011, respectively. The decrease in our effective tax rate for the six months ended June 30, 2012 was associated primarily with the decrease in the Company s taxable income.

Deferred Income Taxes

The Company accounts for income taxes in accordance with ASC topic 740, *Income Taxes* (ASC 740), which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. ASC 740 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax assets will not be realized. As of December 31, 2011, the Company had a deferred tax asset of approximately $11.7 million which is fully offset by a valuation allowance. When realized, the asset will be reflected on the Company s balance sheet and the reversal of the corresponding valuation allowance will result in a tax benefit being recorded in the income statement in the respective period.

Uncertain Tax Positions

The Company accounts for its uncertain tax positions in accordance with ASC 740. As of December 31, 2011, the Company had $1.2 million of unrecognized tax benefits which would impact the income statement if recognized.

During the first quarter the Company incurred a tax loss from the disposal of discontinued operations and anticipates the ability to carry back the loss to 2010 and 2011 for federal income tax purpose. As a result, the Company recognized a tax benefit of $0.3 million from release and reclassification of the ASC 740 long term liability. The Company is not aware of any other uncertain tax positions that could result in significant additional payments, accruals, or other material deviation in this estimate during the fiscal year.

The Company files U.S. federal and state returns as well as foreign returns in France. The tax years 2001 to 2010 remain open in several jurisdictions, none of which have individual significance.

9. Computation of Basic and Diluted Net (Loss) Income Per Common Share

Basic net income (loss) per share is computed by dividing net income (loss) for the period by the weighted average number of shares outstanding during the period.

Diluted net income (loss) per share is computed by dividing net income (loss) for the period by the weighted average number of shares, plus common stock equivalents outstanding during the period which includes 1,000,000 shares of common stock issuable upon the conversion of 500,000 shares of convertible Series A Preferred Stock. Common stock equivalents also include the effect of outstanding dilutive stock options and awards computed using the treasury stock method. In periods of net loss from continuing operations, the Company excludes common stock equivalents from the computation of diluted weighted average shares outstanding because their inclusion would be anti-dilutive.

A reconciliation of the numerator and denominator of basic and diluted net income per common share is provided as follows (in thousands, except per share amounts):

	Three Months Ended		Six Months Ended	
	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Numerator:				
Income from continuing operations	$ 397	$ 899	$ 132	$ 1,084
(Loss) income from discontinued operations	(61)	10	1,809	391
Net income	$ 336	$ 909	$ 1,941	$ 1,475
Denominator:				
Weighted average shares of common stock (basic)	8,983	8,961	8,958	8,962
Effect of dilutive preferred shares	1,000	1,000	1,000	1,000
Effect of dilutive stock options	262	258	277	249
Effect of dilutive contingent shares	41	12	35	12
Weighted average shares of common stock (diluted)	10,286	10,231	10,270	10,223
Per share data:				
Basic income per share:				
Income before discontinued operations	$ 0.04	$ 0.10	$ 0.01	$ 0.12
Discontinued operations	0.00	0.00	0.21	0.04
Net income	$ 0.04	$ 0.10	$ 0.22	$ 0.16
Diluted (loss) income per share:				
Income before discontinued operations	0.04	0.09	0.01	0.10
Discontinued operations	(0.01)	0.00	0.18	0.04
Net income	$ 0.03	$ 0.09	$ 0.19	$ 0.14

The Company excludes options from the computation of diluted weighted average shares outstanding if the exercise price of the options is greater than the average market price of the shares because the inclusion of these options would be anti-dilutive to earnings per share. Accordingly, for the three months ended June 30, 2012 and July 2, 2011, respectively, stock options to purchase 921,241 and 604,256 shares were excluded from the computation of diluted weighted average shares outstanding. For the six months ended June 30, 2012 and July 2, 2011, respectively, stock options to purchase 880,371 and 662,691 shares were excluded from the computation of diluted weighted average shares outstanding.

10. Business Segments

The Company operates in one segment, ophthalmology. Our revenues arise from the sale of laser consoles, delivery devices, consumables, service and support activities.

Table of Contents

Our revenues by geographic region, based on the location at which each sale originates, is summarized as follows:

Revenue information shown by geographic region is as follows (in thousands):

	Three Months Ended		Six Months Ended	
(in thousands)	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
United States	$ 4,442	$ 4,376	$ 8,664	$ 8,965
Europe	1,932	1,787	3,777	3,483
Rest of Americas	626	615	1,328	1,063
Asia/Pacific Rim	1,445	1,307	2,981	2,770
	$ 8,445	$ 8,085	$ 16,750	$ 16,281

Revenues are attributed to countries based on location of end customers. No individual country accounted for more than 10% of the Company s sales, except for the United States, which accounted for 52% and 55% of sales for the six months ended June 30, 2012 and July 2, 2011, respectively.

No one customer accounted for more than 10% of total revenue for the three and six month periods ended June 30, 2012 and July 2, 2011, respectively.

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

This Quarterly Report on Form 10-Q contains trend analysis and other forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, such as statements relating to levels of future sales, long term growth, market acceptance and adoption of our products and operating results; license revenue; gross margins; expenses; managing cash flows; general economic conditions and levels of international sales; tax and corporate strategy; effects of seasonality; FDA inspections; our current and future liquidity and capital requirements; and levels of future investment in research and development efforts. In some cases, forward-looking statements can be identified by terminology, such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, intends, potential, continue, or the negative of such terms or other comparable terminology. These statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to differ materially from those expressed or implied by such forward-looking statements, including as a result of the factors set forth under Factors That May Affect Future Operating Results and other risks detailed in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2012 and detailed from time to time in our reports filed with the Securities and Exchange Commission. The reader is cautioned not to place undue reliance on these forward-looking statements, which reflect management s analysis only as of the date of this quarterly report on Form 10-Q. We undertake no obligation to update such forward-looking statements to reflect events or circumstances occurring after the date of this report.

Overview

IRIDEX Corporation is a leading worldwide provider of therapeutic based laser systems, delivery devices and consumable instrumentation used to treat sight-threatening eye diseases in ophthalmology. In February 2012, we completed the sale of our aesthetics business to Cutera, Inc. We view this as a significant step forward in executing our long term strategy because it allows us to focus solely on our ophthalmology business which is our core strength, and affords us with the best opportunity for long term profitable growth. In accordance with US GAAP, we have disclosed the financial results from our aesthetics business as discontinued operations. This discussion and analysis will focus on our ophthalmology business because it constitutes our continuing business and therefore provides more relevant information to the reader of our financial statements both on a retrospective and prospective basis.

We manage and evaluate our business in one segment ophthalmology. We break down this segment by geography Domestic (U.S.) and International (the rest of the world). In addition, we review trends by laser system sales (consoles and durable delivery devices) and recurring sales (single use disposable laser probes and other associated instrumentation (consumables), service and support).

Our ophthalmology revenues arise from the sale of our IQ and OcuLight laser systems, consumables and service and support activities. Our current family of IQ products includes IQ 532, IQ 577 and IQ 810 laser photocoagulation systems and our OcuLight products include OcuLight TX, OcuLight Symphony (Laser Delivery System), OcuLight SL, OcuLight SLx, OcuLight GL and OcuLight GLx laser photocoagulation systems.

Our ophthalmology products are sold in the United States predominantly through a direct sales force and internationally through approximately 70 independent distributors into over 100 countries. Sales to international distributors are made on open credit terms or letters of credit and are currently denominated in U.S. dollars and accordingly, are not subject to risks associated with currency fluctuations.

Cost of revenues consists primarily of the cost of purchasing components and sub-systems; assembling, packaging, shipping and testing components at our facility; direct labor and associated overhead; warranty, royalty and amortization of intangible assets; and depot service costs.

Research and development expenses consist primarily of personnel costs, materials to support new product development and research support provided to clinicians at medical institutions developing new applications which utilize our products, and regulatory expenses. Research and development costs have been expensed as incurred.

Sales and marketing expenses consist primarily of costs of personnel, sales commissions, travel expenses, advertising and promotional expenses.

General and administrative expenses consist primarily of costs of personnel, legal, accounting and other public company costs, insurance and other expenses not allocated to other departments.

Table of Contents

Results of Operations

The following table sets forth certain operating data as a percentage of revenues:

	Three Months Ended		Six Months Ended	
	June 30, 2012	July 2, 2011	June 30, 2012	July 2, 2011
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	51.3%	51.3%	51.7%	50.7%
Gross margin	48.7%	48.7%	48.3%	49.3%
Operating expenses:				
Research and development	13.1%	11.0%	13.6%	11.4%
Sales and marketing	25.1%	22.1%	23.8%	21.9%
General and administrative	14.6%	12.6%	14.4%	12.9%
Total operating expenses	52.8%	45.7%	51.8%	46.2%
(Loss) income from continuing operations	(4.1)%	3.0%	(3.5)%	3.1%
Legal settlement	9.5%	9.9%	4.8%	4.9%
Other (expense) income, net	(0.6)%	0.0%	(0.5)%	0.0%
Income from continuing operations before income taxes	4.8%	12.9%	0.8%	8.0%
Provision for income taxes	0.1%	1.8%	0.0%	1.3%
Income from continuing operations, net of tax	4.7%	11.1%	0.8%	6.7%
(Loss) income from discontinued operations, net of tax	(0.7)%	0.1%	10.8%	2.4%
Net income	4.0%	11.2%	11.6%	9.1%

The following comparisons are between the three month periods ended June 30, 2012 and July 2, 2011:

Revenues.

(in millions)	Three Months Ended June 30, 2012	Three Months Ended July 2, 2011	Change in $	Change in %
Systems domestic	$ 1,516	$ 1,583	$ (67)	(4.2)%
Systems international	2,441	2,373	68	2.9%
Recurring revenues	4,395	4,011	384	9.6%
OEM	93	118	(25)	(22.0)%
Total revenues	$ 8,445	$ 8,085	$ 360	4.5%

System sales were fairly consistent. Recurring revenues increased primarily by the addition of sales of our licensed GreenTip product by our distribution partner, Alcon, and we anticipate benefiting from these sales for the foreseeable future. OEM sales are expected to cease shortly as our OEM partner, B&L, has discontinued selling this product.

Gross Profit and Gross Margin.

Gross profit was $4.1 million compared with $3.9 million an increase of $0.2 million or 4.4%. Gross margin remained constant at 48.7% for both periods. Our short term goal for gross margin remains 50%.

Gross margins as a percentage of revenues will continue to fluctuate due to changes in the relative proportions of domestic and international sales, the product mix of sales, manufacturing variances, total unit volume changes that lead to greater or lesser production efficiencies and a variety of other factors. See Item 1A. Risk Factors Factors That May Affect Future Results *Our Operating Results May Fluctuate from Quarter to Quarter and Year to Year.*

Research and Development.

Research and development (R&D) expenses increased $0.2 million or 24.3% from $0.9 million to $1.1 million, as a result of increasing headcount and spending on materials and outside services in support of an increased rate of new product introductions. We anticipate expenses to increase in support of new products.

Sales and Marketing.

Sales and marketing expenses increased by 18.8% from $1.8 million to $2.1 million. The increases were attributable to an increase in headcount and related cost and to an increase in associated selling and marketing expenses due to and in support of the increase in sales. We anticipate an increase in our sales and marketing spending with the objective of driving increased sales.

General and Administrative.

General and administrative expenses increased by $0.2 million or 20.6%, from $1.0 million to $1.2 million, as a result of increasing headcount and associated expenses.

Legal Settlement and Interest and Other Income (Expense), Net.

The legal settlement relates to monies received from Synergetics associated with a 2007 settlement of legal claims for patent infringement. The payment of $0.8 million received during the three month period ended June 30, 2012 represents the final payment. For the three months ended June 30, 2012, interest and other income (expense), net consisted primarily of additional expense recorded for the fair value remeasurement of the contingent earn-out liabilities incurred as a result of the Company s recent acquisitions. For the same period a year earlier, interest and other income (expense), net consisted primarily of bank interest.

Income Taxes.

The Company recorded an income tax provision of $5 thousand and $144 thousand, respectively, for continuing operations.

The following comparisons are between the six months ended June 30, 2012 and July 2, 2011:

(in millions)	Six Months Ended June 30, 2012	Six Months Ended July 2, 2011	Change in $	Change in %
Systems domestic	$ 2,791	$ 3,262	$ (471)	(14.4)%
Systems international	5,049	4,583	466	10.2%
Recurring revenues	8,770	8,196	574	7.0%
OEM	140	240	(100)	(41.7)%
Total revenues	$ 16,750	$ 16,281	$ 469	2.9%

Fluctuations in systems sales were driven primarily by local economic conditions. Recurring revenues increased primarily as a result of the addition of sales of our licensed GreenTip product by our distribution partner, Alcon, and we anticipate benefiting from these sales for the foreseeable future. OEM sales are expected to cease shortly as our OEM partner, B&L, has discontinued selling this product.

Table of Contents

Gross Profit and Gross Margin.

Gross profit was $8.1 million compared with $8.0 million an increase of $0.1 million or 0.1%. Gross margin remained fairly constant at 48.3% compared to 49.3%. Our short term goal for gross margin remains 50%.

Gross margins as a percentage of revenues will continue to fluctuate due to changes in the relative proportions of domestic and international sales, the product mix of sales, manufacturing variances, total unit volume changes that lead to greater or lesser production efficiencies and a variety of other factors. See Item 1A. Risk Factors Factors That May Affect Future Results *Our Operating Results May Fluctuate from Quarter to Quarter and Year to Year.*

Research and Development.

Research and development (R&D) expenses increased $0.4 million or 23.5% from $1.9 million to $2.3 million, as a result of increasing headcount and spending on materials and outside services in support of an increased rate of new product introductions. We anticipate expenses to increase in support of new products.

Sales and Marketing.

Sales and marketing expenses increased by 11.8% from $3.6 million to $4.0 million. The increases were attributable to an increase in headcount and related cost and to an increase in associated selling and marketing expenses due to and in support of the increase in sales. We anticipate an increase in our sales and marketing spending with the objective of driving increased sales.

General and Administrative.

General and administrative expenses increased by $0.3 million or 14.4%, from $2.1 million to $2.4 million, as a result of increasing headcount and associated expenses.

Legal Settlement and Interest and Other Income (Expense), Net.

The legal settlement relates to monies received from Synergetics associated with a 2007 settlement of legal claims for patent infringement. The payment of $0.8 million received during the period represents the final payment. For the six months ended June 30, 2012, interest and other income (expense), net consisted primarily of additional expense recorded for the fair value remeasurement of the contingent earn-out liabilities incurred as a result of the Company s recent acquisitions. For the same period a year earlier, interest and other income (expense), net consisted primarily of bank interest.

Income from Continuing Operations.

We are increasing our investment in people and programs to make necessary product and organizational changes that we believe will drive sales growth faster than our historical rates. We intend to balance our increase in investments with our revenue growth to maintain profitability for the year.

Income Taxes.

For the six months ended June, 2012 and July 2, 2011, the Company recorded an income tax provision of $7 thousand and $223 thousand, respectively, for continuing operations.

Discontinued Operations.

In February 2012, we sold our aesthetics business to Cutera, Inc. The operating results and the associated assets and liabilities of our aesthetics business have been classified as discontinued operations for all periods presented. The Company received $5.1 million in net cash and recorded a pre-tax net gain on the sale of $1.1 million before income taxes. As a result of the sale, we were able to record a tax benefit in the amount of $0.9 million, thus the total gain on the sale of the aesthetics business was $2.0 million.

For the quarter ended June 30, 2012, a loss of $61 thousand, net of tax, was incurred, compared with income of $10 thousand, net of tax, generated for the comparable quarter in 2011. For the six month period ended June 30, 2012, a loss of $223 thousand, net of tax, was incurred,

compared with income of $391 thousand, net of tax, generated for the comparable six month period in 2011.

As a result of the sale of the aesthetics business the Company generated an $18.5 million tax loss from discontinued operations. This loss was created primarily as a result of writing off goodwill and intangibles related to the aesthetics business for tax purposes that had previously been written off for financial statement purposes in prior accounting periods. The Company intends to carry the tax loss generated back to offset the profits made in 2010 and 2011 and obtain a tax refund of approximately $0.6 million. The potential net operating loss carry back also results in a reduction in uncertain tax liabilities of $0.3 million. The remainder of the tax loss (approximately $15 million) will be carried forward to be used to offset current year and future tax profits. Because of the uncertainty of future taxable profits the Company maintains a valuation reserve allowance against its deferred tax assets.

Liquidity and Capital Resources.

Liquidity is our ability to generate sufficient cash flows from operating activities to meet our obligations and commitments. In addition, liquidity includes the ability to obtain appropriate financing or to raise capital.

As of June 30, 2012, we had cash and cash equivalents of $13.8 million, working capital of $23.2 million and $0.5 million of cash held in escrow compared to cash and cash equivalents of $10.8 million and working capital of $20.6 million as of December 31, 2011. The $3.0 million increase in cash and cash equivalents and the $0.5 million of cash held in escrow for the six months ended June 30, 2012 was generated primarily by the sale of the aesthetics business for $5.1 million. We used $2.0 million in operating activities for the six months ended June 30, 2012 as a result of generating $0.7 million from continued operations (after adding back non-cash items) offset by changes in operating assets of $2.7 million. We used $0.2 million on capital expenditures. Exercises of stock options generated $0.4 million and we spent $0.3 million to purchase stock under our stock repurchase program. See Item 2, Unregistered Sales of Equity Securities and Use of Proceeds in Part II, Other Information, for additional information.

Management is of the opinion that the Company s current cash and cash equivalents together with our ability to generate cash flows from operations provide sufficient liquidity to operate for the next 12 months.

Table of Contents

Item 3. Quantitative and Qualitative Disclosure about Market Risk

Market risk represents the risk of loss that may impact the financial position, results of operations or cash flows due to adverse changes in financial and commodity market prices and rates. We transact the majority of our business in US dollars and therefore changes in foreign currency rates will not have a significant impact on our income statement or cash flows. However, increases in the value of the US dollar against any local currencies could cause our products to become relatively more expensive to customers in a particular country or region, leading to reduced revenue or profitability in that country or region. As we continue to expand our international sales, our non-US dollar denominated revenue and our exposure to gains and losses on international currency transactions may increase. We currently do not engage in transactions to hedge against the risk of the currency fluctuation, but we may do so in the future.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures, as such term is defined in Rules 13a-15(e) or 15d-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

As required by SEC Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2012. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the period covered by this Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we may be involved in legal proceedings arising in the ordinary course of business. We believe there is no litigation currently pending that could have, individually or in the aggregate, a material adverse effect on our operations or financial condition.

Item 1A. Risk Factors

Factors That May Affect Future Results

In addition to the other information contained in this Quarterly Report Form 10-Q, we have identified the following risks and uncertainties that may have a material adverse effect on our business, common stock price, financial condition or results of operation. You should carefully consider the risks described below before making an investment decision.

We have marked with an asterisk (*) those risk factors below that reflect substantive changes from the risk factors included in our Annual Report on Form 10-K filed with the SEC on March 30, 2012.

We Recently Sold our Aesthetics Business Unit and Therefore Our Operating Results Will Be Adversely Affected in the Near Term

In February 2012, we completed the sale of our aesthetics business. Prior to the sale, our aesthetics business covered its direct costs and therefore contributed to the profitability of the overall company. The sale of the aesthetics business means that we will need to adjust our cost structure and/or grow revenues from our continuing ophthalmology business to remain profitable. In addition, we provided the purchaser typical indemnification provisions associated with this type of transaction, and there is a risk that an adverse event may occur that requires us to fulfill our indemnity obligation. In the near term these factors will have a material adverse effect on our business, financial condition and results of operations.

Our Operating Results May Fluctuate from Quarter to Quarter and Year to Year.

Our sales and operating results may vary significantly from quarter to quarter and from year to year in the future. Our operating results are affected by a number of factors, many of which are beyond our control. Factors contributing to these fluctuations include the following:

general economic uncertainties and political concerns;

the timing of the introduction and market acceptance of new products, product enhancements and new applications;

changes in demand for our existing line of ophthalmology products;

the cost and availability of components and subassemblies, including the willingness and ability of our sole or limited source suppliers to timely deliver components at the times and prices that we have planned;

our ability to increase revenues at a level sufficient to cover existing manufacturing costs and increases in operating expenses;

Table of Contents

- fluctuations in our product mix within ophthalmology products and foreign and domestic sales;
- the effect of regulatory approvals and changes in domestic and foreign regulatory requirements;
- introduction of new products, product enhancements and new applications by our competitors, entry of new competitors into our markets, pricing pressures and other competitive factors;
- our long and highly variable sales cycle;
- changes in the prices at which we can sell our products;
- changes in customers or potential customers budgets as a result of, among other things, reimbursement policies of government programs and private insurers for treatments that use our products; and
- increased product innovation costs.

In addition to these factors, our quarterly results have been, and are expected to continue to be, affected by seasonal factors. For example, our European sales during the third quarter are generally lower due to many businesses being closed for the summer vacation season.

Our expense levels are based, in part, on expected future sales. If sales levels in a particular quarter do not meet expectations, we may be unable to adjust operating expenses quickly enough to compensate for the shortfall of sales, and our results of operations may be adversely affected. In addition, we have historically made a significant portion of each quarter s product shipments near the end of the quarter. If that pattern continues, any delays in shipment of products could have a material adverse effect on results of operations for such quarter. Due to these and other factors, we believe that quarter to quarter and year to year comparisons of our past operating results may not be meaningful. You should not rely on our results for any quarter or year as an indication of our future performance. Our operating results in future quarters and years may be below expectations, which would likely cause the price of our common stock to fall.

Our Stock Price Has Been and May Continue to be Volatile and an Investment in Our Common Stock Could Suffer a Decline in Value.

The trading price of our common stock has been subject to wide fluctuations in response to a variety of factors, some of which are beyond our control, including quarterly variations in our operating results, announcements by us or our competitors of new products or of significant clinical achievements, changes in market valuations of other similar companies in our industry and general market conditions. In addition, the trading price of our common stock has been significantly adversely affected by our recent operating performance and by liquidity issues. For the current year to date, the trading price of our common stock has fluctuated from a low of $3.22 per share to a high of $4.48 per share. There can be no assurance that our common stock trading price will not suffer declines. Our common stock may experience an imbalance between supply and demand resulting from low trading volumes and therefore broad market fluctuations could have a significant impact on the market price of our common stock regardless of our performance.

We Rely on Continued Market Acceptance of Our Existing Products and Any Decline in Sales of Our Existing Products Would Adversely Affect Our Business and Results of Operations.

We currently market visible and infrared medical laser systems and delivery devices to the ophthalmology market. We believe that continued and increased sales, if any, of products is dependent upon a number of factors including the following:

- acceptance of product performance, features, ease of use, scalability and durability;

recommendations and opinions by ophthalmologists, other clinicians, and their associated opinion leaders;

clinical study outcomes;

price of our products and prices of competing products and technologies particularly in light of the current macro-economic environment where healthcare systems and healthcare operators are becoming increasingly price sensitive;

availability of competing products, technologies and alternative treatments; and

level of reimbursement for treatments administered with our products.

In addition, we derive a meaningful portion of our sales in the form of recurring revenues from selling consumable instrumentation including our EndoProbe devices and service. Our ability to increase recurring revenues from the sale of consumable products will depend primarily upon the features of our current products and product innovation, the quality of our products, ease of use and prices of our products, including the relationship to prices of competing products. The level of our service revenues will depend on the quality of service we provide and the responsiveness and the willingness of our customers to request our services rather than purchase competing products or services. Any significant decline in market acceptance of our products or our revenues derived from the sales of laser systems, delivery devices, consumables or services may have a material adverse effect on our business, results of operations and financial condition.

We Face Strong Competition in Our Markets and Expect the Level of Competition to Grow in the Foreseeable Future.

Competition in the market for devices used for ophthalmic treatment procedures is intense and is expected to increase. Our competitive position depends on a number of factors including product performance, characteristics and functionality, ease of use, scalability, durability and cost. Our principal competitors in ophthalmology are Alcon Inc., Carl Zeiss Meditec AG, Nidek Co. Ltd., Synergetics, Topcon Corporation, Ellex Medical Lasers, Ltd., Quantel Medical SA, and Lumenis Ltd. Most of these companies currently offer a competitive, semiconductor-based laser system for ophthalmology. Also within ophthalmology, pharmaceutical alternative treatments for AMD and DME such as Lucentis/Avastin (Genentech), Eylea (Regeneron), and to a lesser extent Visudyne (Novartis), Macugen (OSI Pharmaceuticals) and Osurdex (Allergen) compete rigorously with traditional laser procedures. A number of these competitors have substantially greater financial,

Table of Contents

engineering, product development, manufacturing, marketing and technical resources than we do, including greater name recognition, and benefit from long-standing customer relationships. Some medical companies, academic and research institutions, or others, may develop new technologies or therapies that are more effective in treating conditions targeted by us or are less expensive than our current or future products. Any such developments could have a material adverse effect on our business, financial condition and results of operations.

Our Operating Results May be Adversely Affected by Uncertainty Regarding Healthcare Reform Measures and Changes in Third Party Coverage and Reimbursement Policies.

Changes in government legislation or regulation or in private third-party payers policies toward reimbursement for procedures employing our products may prohibit adequate reimbursement. There have been a number of legislative and regulatory proposals to change the healthcare system, reduce the costs of healthcare and change medical reimbursement policies. Doctors, clinics, hospitals and other users of our products may decline to purchase our products to the extent there is uncertainty regarding reimbursement of medical procedures using our products and any healthcare reform measures. Further proposed legislation, regulation and policy changes affecting third party reimbursement are likely. We are unable to predict what legislation or regulation, if any, relating to the health care industry or third-party coverage and reimbursement may be enacted in the future, or what effect such legislation or regulation may have on us. However, denial of coverage and reimbursement of our products would have a material adverse effect on our business, results of operations and financial condition.

Our ophthalmology products are typically purchased by doctors, clinics, hospitals and other users, which bill various third-party payers, such as governmental programs and private insurance plans, for the health care services provided to their patients. Third-party payers are increasingly scrutinizing and challenging the coverage of new products and the level of reimbursement for covered products. Doctors, clinics, hospitals and other users of our products may not obtain adequate reimbursement for use of our products from third-party payers. While we believe that the laser procedures using our products have generally been reimbursed, payers may deny coverage and reimbursement for our products if they determine that the device was not reasonable and necessary for the purpose used, was investigational or was not cost-effective.

We Depend on International Sales for a Significant Portion of Our Operating Results.

We derive, and expect to continue to derive, a large portion of our revenues from international sales. For the second quarter of fiscal year 2012, our international ophthalmology sales were $4.0 million or 47.4% of total sales. We anticipate that international sales will continue to account for a significant portion of our revenues in the foreseeable future. None of our international revenues and costs are denominated in foreign currencies. As a result, an increase in the value of the U.S. dollar relative to foreign currencies makes our products more expensive and thus less competitive in foreign markets. Our international operations and sales are subject to a number of risks and potential costs, including:

- impact of international conflicts, terrorist and military activity, civil unrest;
- impact of recessions in global economies and availability of credit;
- fluctuations in foreign currency exchange rates;
- foreign certification requirements, including continued ability to use the CE mark in Europe, and other local regulatory requirements;
- performance of our international channel of distributors;
- longer accounts receivable collection periods;
- differing local product preferences and product requirements;

cultural differences;

changes in foreign medical reimbursement and coverage policies and programs;

political and economic instability;

reduced or limited protections of intellectual property rights in jurisdictions outside the United States;

potentially adverse tax consequences; and

multiple protectionist, adverse and changing foreign governmental laws and regulations.

Any one or more of these factors stated above could have a material adverse effect on our business, financial condition or results of operations.

As we expand our existing international operations we may encounter new risks. For example, as we focus on building our international sales and distribution networks in new geographic regions, we must continue to develop relationships with qualified local distributors and trading companies. If we are not successful in developing and maintaining these relationships, we may not be able to grow sales in these geographic regions. These or other similar risks could adversely affect our revenues and profitability.

Our Future Success Depends on Our Ability to Develop and Successfully Introduce New Products and New Applications.

Our future success is dependent upon, among other factors, our ability to develop, obtain regulatory approval or clearance of, manufacture and market new products. Successful commercialization of new products and new applications will require that we effectively transfer production processes from research and development to manufacturing and effectively coordinate with our suppliers. In addition, we must successfully sell and achieve market acceptance of new products and applications and enhanced versions of existing products. The extent of, and rate at which, market acceptance and penetration are achieved by future products is a

Table of Contents

function of many variables, which include, among other things, price, safety, efficacy, reliability, marketing and sales efforts, the development of new applications for these products, the availability of third-party reimbursement of procedures using our new products, the existence of competing products and general economic conditions affecting purchasing patterns. Our ability to market and sell new products may also be subject to government regulation, including approval or clearance by the FDA and foreign government agencies. Any failure in our ability to successfully develop and introduce new products or enhanced versions of existing products and achieve market acceptance of new products and new applications could have a material adverse effect on our operating results and would cause our net revenues to decline.

We Are Exposed to Risks Associated With Worldwide Economic Slowdowns and Related Uncertainties.

We are subject to macro-economic fluctuations in the U.S. and worldwide economy. Concerns about consumer and investor confidence, volatile corporate profits and reduced capital spending, international conflicts, terrorist and military activity, civil unrest and pandemic illness could reduce customer orders or cause customer order cancellations. In addition, political and social turmoil related to international conflicts and terrorist acts may put further pressure on economic conditions in the United States and abroad.

Weak economic conditions and declines in consumer spending and consumption may harm our operating results. Purchases of our products are often discretionary. During uncertain economic times, customers or potential customers may delay, reduce or forego their purchases of our products and services, which may impact our business in a number of ways, including lower prices for our products and services and reducing or delaying sales. There could be a number of follow-on effects from economic uncertainty on our business, including insolvency of key suppliers resulting in product delays, delays in customer payments of outstanding accounts receivable and/or customer insolvencies, counterparty failures negatively impacting our operations, and increasing expense or inability to obtain future financing.

If economic uncertainty persisted, or if the economy entered a prolonged period of decelerating growth, our results of operations may be harmed.

If We Cannot Increase Our Sales Volumes, Reduce Our Costs or Introduce Higher Margin Products to Offset Anticipated Reductions in the Average Unit Price of Our Products, Our Operating Results May Suffer.

The average unit price of our products may decrease in the future in response to changes in product mix, competitive pricing pressures, new product introductions by our competitors or other factors. If we are unable to offset the anticipated decrease in our average selling prices by increasing our sales volumes or through new product introductions, our net revenues will decline. In addition, to maintain our gross margins we must continue to reduce the manufacturing cost of our products. If we cannot maintain our gross margins our business could be seriously harmed, particularly if the average selling price of our products decreases significantly without a corresponding increase in sales.

**We Depend on Collaborative Relationships to Develop, Introduce and Market New Products, Product Enhancements and New Applications.*

We depend on both clinical and commercial collaborative relationships. We have entered into collaborative relationships with academic medical centers and physicians in connection with the research and innovation and clinical testing of our products. Commercially, we currently have a distribution and licensing agreement with Alcon for our GreenTip SoftTip Cannula. Sales of and royalties from the GreenTip SoftTip Cannula are dependent upon the sales performance of Alcon, which depends on the efforts of our partner and is beyond our control. Historically we have collaborated with Bausch & Lomb to design and manufacture a solid-state green wavelength (532nm) laser photocoagulator module for Bausch & Lomb, called the Millennium Endolase module. Bausch & Lomb has introduced a new product to replace the product that included the Millennium Endolase module and as such we have seen sales to Bausch & Lomb decline and we anticipate sales to continue to decline. The failure to obtain any additional future clinical or commercial collaborations and the resulting failure or success of such arrangements of any current or future clinical or commercial collaboration relationships could have a material adverse effect on our ability to introduce new products or applications and therefore could have a material adverse effect on our business, results of operations