

IRIDEX CORP
Form 10-Q
May 08, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2018

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 (State or other jurisdiction of incorporation or organization)	77-0210467 (I.R.S. Employer Identification Number)
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1212 Terra Bella Avenue

Mountain View, California (Address of principal executive offices)	94043-1824 (Zip Code)
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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 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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth 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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares of common stock, \$0.01 par value, issued and outstanding as of April 20, 2018 was 11,637,702.

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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)

	March 31, 2018	December 30, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 18,522	\$ 21,707
Accounts receivable, net of allowance for doubtful accounts of \$223 as of March 31, 2018 and \$226 as of December 30, 2017	6,400	7,863
Inventories	9,306	9,381
Prepaid expenses and other current assets	681	500
Total current assets	34,909	39,451
Property and equipment, net	1,488	1,403
Intangible assets, net	112	116
Goodwill	533	533
Other long-term assets	170	143
Total assets	\$37,212	\$ 41,646
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,976	\$ 1,724
Accrued compensation	1,741	2,459
Accrued expenses	2,358	2,153
Accrued warranty	935	1,536
Deferred revenue	2,245	2,520
Total current liabilities	9,255	10,392
Long-term liabilities:		
Accrued warranty	180	199
Other long-term liabilities	522	533
Total liabilities	9,957	11,124
Stockholders' equity:		
Preferred stock, \$0.01 par value, 2,000,000 shares authorized, no shares issued and outstanding	-	-
Common stock, \$0.01 par value: Authorized: 30,000,000 shares; Issued and outstanding 11,637,361 and 11,596,274 shares		
as of March 31, 2018 and December 30, 2017, respectively	126	126
Additional paid-in capital	59,698	59,385

Accumulated other comprehensive income	23	-
Accumulated deficit	(32,592)	(28,989)
Total stockholders' equity	27,255	30,522
Total liabilities and stockholders' equity	\$37,212	\$ 41,646

(1) Derived from the audited consolidated financial statements included in the Annual Report on Form 10-K filed with the SEC for the year ended December 30, 2017.

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

IRIDEX Corporation

Condensed Consolidated Statements of Operations

(Unaudited, in thousands except per share data)

	Three Months Ended	
	March 31, 2018	April 1, 2017
Total revenues	\$9,509	\$10,483
Cost of revenues	5,587	6,018
Gross profit	3,922	4,465
Operating expenses:		
Research and development	1,104	1,339
Sales and marketing	4,050	2,923
General and administrative	2,385	2,061
Total operating expenses	7,539	6,323
Loss from operations	(3,617)	(1,858)
Other income (expense), net	18	(2)
Loss from operations before provision for income taxes	(3,599)	(1,860)
Provision for income taxes	4	6
Net loss	\$(3,603)	\$(1,866)
Net loss per share:		
Basic	\$(0.31)	\$(0.16)
Diluted	\$(0.31)	\$(0.16)
Weighted average shares used in computing net loss per common share:		
Basic	11,628	11,518
Diluted	11,628	11,518

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

IRIDEX Corporation

Condensed Consolidated Statements of Comprehensive Loss

(Unaudited, in thousands)

	Three Months	
	Ended	
	March	April 1,
	31,	2017
	2018	
Net loss	\$ (3,603)	\$ (1,866)
Foreign currency translation adjustments	23	—
Comprehensive loss	\$ (3,580)	\$ (1,866)

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

IRIDEX Corporation

Condensed Consolidated Statements of Cash Flows

(Unaudited, in thousands)

	Three Months Ended	
	March 31, 2018	April 1, 2017
Operating activities:		
Net loss	\$(3,603)	\$(1,866)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	193	207
Change in fair value of earn-out liability	29	25
Stock-based compensation	428	392
Changes in operating assets and liabilities:		
Accounts receivable	1,463	1,159
Inventories	75	(85)
Prepaid expenses and other current assets	(181)	(118)
Other long-term assets	(27)	5
Accounts payable	252	(50)
Accrued compensation	(718)	(777)
Accrued expenses	164	(541)
Accrued warranty	(620)	46
Deferred revenue	(275)	(22)
Other long-term liabilities	93	3
Net cash used in operating activities	(2,727)	(1,622)
Investing activities:		
Acquisition of property and equipment	(274)	(341)
Payment on earn-out liability	(92)	(84)
Net cash used in investing activities	(366)	(425)
Financing activities:		
Proceeds from issuance of common stock, net of issuance costs	—	2,263
Proceeds from stock option exercises	23	163
Taxes paid related to net share settlements of equity awards	(138)	(268)
Net cash (used in) provided by financing activities	(115)	2,158
Effect of foreign exchange rate changes	23	—
Net (decrease) increase in cash and cash equivalents	(3,185)	111
Cash and cash equivalents, beginning of period	21,707	23,747
Cash and cash equivalents, end of period	\$18,522	\$23,858
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Income taxes	\$-	\$-
Supplemental disclosure of non-cash activities:		

Transfer of inventory to property and equipment	\$60	\$-
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The accompanying notes are an integral part of these condensed consolidated financial statements.

IRIDEX Corporation

Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of IRIDEX Corporation (“IRIDEX”, the “Company”, “we”, “our”, or “us”) have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. 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 U.S. GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation of the financial statements have been included.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated 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 30, 2017, which was filed with the Securities and Exchange Commission (“SEC”) on March 14, 2018. The results of operations for the three months ended March 31, 2018 and April 1, 2017 are not necessarily indicative of the results for the fiscal year ending December 29, 2018 or any future interim period. The three months periods ended March 31, 2018 and April 1, 2017, each had 13 weeks. For purposes of reporting the financial results, the Company’s fiscal years end on the Saturday closest to the end of December. Periodically, the Company includes a 53rd week to a year in order to end that year on the Saturday closest to the end of December.

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 30, 2017, which was filed with the SEC on March 14, 2018.

Financial Statement Presentation.

The unaudited condensed consolidated financial statements include the accounts of the Company and our wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates.

The preparation of consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and the related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. In addition, any change in these estimates or their related assumptions could have an adverse

effect on our operating results.

Revenue Recognition.

Our revenues arise from the sale of laser consoles, delivery devices, consumables, service, and support activities. We also derive revenue from royalties from third parties which are typically based on licensees' net sales of products that utilize our technology. Our revenue is recognized in accordance with Accounting Standards Codification ("ASC") 606, "Revenue from Contracts with Customers."

The Company has the following revenue transaction types: (1) Product Sale Only, (2) LAP Programs, (3) Extended Warranty, (4) System Repairs (outside of warranty) and (5) Royalty Revenue.

(1)Product Sale Only: The Company's products consist of laser consoles, delivery devices and consumable instrumentation, including laser probes. The Company's products are currently sold for use by ophthalmologists specializing in the treatment of eye disease in the retina, glaucoma and pediatrics eye diseases. Inside the United States the products are sold directly to the end users. Outside of the United States, the Company utilizes independent, third-party distributors to market and sell the Company's products. There is no continuing obligation subsequent to the shipment to the distributors.

Under the new guidance, there is no change in our revenue recognition for product sale only-transactions, as compared to revenue recognition for these transactions under the prior revenue recognition standards. For a description of our prior revenue recognition standards, see Note 2 to the consolidated financial statements included as part of our Annual Report

on Form 10-K for the period ended December 30, 2017. The Company recognizes revenue from product sale at a point in time. When a system or disposables are sold without any additional deliverables, the Company recognizes revenue using the five-step model: (1) identifying the contract with the customer, (2) identifying the performance obligations in the contract, (3) determining expected transaction price, (4) allocating the transaction price to the distinct performance obligations in the contract, and (5) recognizing revenue when (or as) the performance obligations are satisfied.

(2) VIP/LAP Programs: The Company sometimes enters into VIP or Laser Advantage Program (LAP) contracts with customers. For the VIP program, under the terms of such contracts, the customer is not charged for the system upon the initial agreement, but rather is obligated to purchase a quarterly minimum quantity of endoprobes (classified as disposables) at a premium during the contract period, such that at the end of the contract period the system has been paid in full. The Company decided to replace its previously utilized VIP program (contract length of two years) with an LAP program (contract length of 12 months or less) beginning in fourth quarter of 2016. Under the LAP program, the system is given away free of charge and title is transferred after the customer purchases the minimum required number of boxes of probes (classified as disposables). Customers with older machines have the ability to trade in their old machines for the most current laser equipment offered in the program (G6 Laser) and receive a discount on the program's minimum purchase requirements. Under ASC 606, this non-cash consideration must be included in the transaction price. However, the Company has determined that there is no value associated with the old machine and the trade in is essentially offered to encourage customers to purchase more consumables under the program.

Under the new guidance, there is no change in our revenue recognition for product sales under VIP/LAP programs as compared to revenue recognition for these transactions under the prior revenue recognition standards. The Company recognizes revenue from product sales under VIP/LAP programs at a point in time. For both programs, the Company allocates the transaction price of the distinct performance obligations in the contract by determining stand-alone selling price using historical pricing net of any variable consideration or discounts to specifically allocate to a particular performance obligation.

(3) Extended Warranty: The Company offers a standard 2 year warranty on all system sales (5 years on the laser heads for its IQ 532/577 laser consoles). The Company also offers an extended warranty which is sold to customers in incremental, one-year warranty periods which begin subsequent to the expiration of the standard 2 year warranty. The customer can opt to purchase the extended warranty at the time of the system sale or after the initial system sale.

Under the new guidance, there is no change in our revenue recognition for extended warranty as compared to revenue recognition for these transactions under the prior revenue recognition standards. The Company recognizes revenue from extended warranty ratably over the warranty period. Revenue recognition for the sale of an extended warranty is largely dependent on the timing of the sale as follows:

a. Extended Warranty Sale in Conjunction with System Sale: If the customer opts to purchase an extended warranty at the time of the system sale, the Company allocates the transaction price of the distinct performance obligations in

the contract by determining stand-alone selling price using historical pricing net of any variable consideration or discounts to specifically allocate to a particular performance obligation.

b. Extended Warranty Sale Subsequent to System Sale: If the customer opts to purchase an extended warranty after the initial system sale, the Company determines the amount of time that has elapsed since the initial system sale. If the extended warranty is purchased within 60 days of the initial sale, the Company considers this sale to be an additional element of the original sale and allocates the transaction price of the distinct performance obligations in the contract by determining stand-alone selling price using historical pricing net of any variable consideration or discounts to specifically allocate to a particular performance obligation. If the extended warranty is purchased subsequent to sixty days after the initial sale, the sale of the extended warranty is deemed a separate contract and is deferred at the selling price and recognized ratably over the extended warranty period as the performance obligation is satisfied.

(4) System Repairs (outside of warranty): Customers will sometime request repairs from the Company subsequent to the expiration of the standard warranty and outside of an extended warranty contract.

Under the new guidance, there is no change in our revenue recognition for system repairs (outside warranty) as compared to revenue recognition for these transactions under the prior revenue recognition standards. The Company recognizes revenue from system repairs (outside of warranty) at a point in time. When the customer request repairs from the Company subsequent to the expiration of the standard warranty and outside of an extended warranty contracts, these repair contracts are considered separate from the initial sale, and as such, revenue is recognized as the repair services are rendered and the performance obligation satisfied.

(5) Royalty Revenue: The Company has royalty agreements with two customers related to sales of the Company's intellectual property. Under the terms of these agreements, the customer is to remit a percentage of sales to the Company.

Under the new guidance, since these arrangements are for sales-based licenses of intellectual property, for which the guidance in paragraph ASC 606-10-55-65 applies, the Company recognizes revenue only as the subsequent sale occurs. However, the Company notes that such sales being reported by the licensee with a quarter in arrear, such revenue is recognized at the time it is reported and paid by the licensee given that any estimated variable consideration would have to be fully constrained due to the unpredictability of such estimate and the unavoidable risk that it may lead to significant revenue reversals.

The Company elected the practical expedient allowing it to not recognize as a contract asset the commission paid to its salesforce on the sale of its products as an incremental cost of obtaining a contract with a customer but rather recognize such commission as expense when incurred as the amortization period of the asset that the Company would have otherwise recognized is one year or less.

Concentration of Credit Risk.

Our cash and cash equivalents are deposited in demand and money market accounts. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally these deposits may be redeemed upon demand and therefore, bear minimal risk.

We market our products to distributors and end-users throughout the world. Sales to international distributors are generally made on open credit terms and letters of credit. Management performs ongoing credit evaluations of our customers and maintains an allowance for potential credit losses. Historically, we have not experienced any significant losses related to individual customers or a group of customers in any particular geographic area. For the three month periods ended March 31, 2018 and April 1, 2017 no single customer accounted for more than 10% of total revenues. As of March 31, 2018 and December 30, 2017, no customer accounted for over 10% of our accounts receivable.

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 condensed consolidated statements of operations.

Shipping and Handling Costs.

Our shipping and handling costs billed to customers are included in revenues and the associated expense is recorded in cost of revenues for all periods presented.

Deferred Revenue.

Deferred revenue represents contract liabilities. Revenue related to extended 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. The deferred revenue balance is expected to be recognized over the next 12 months.

A reconciliation of the changes in the Company's deferred revenue balance for the three months ended March 31, 2018 and April 1, 2017 is as follows:

	Three Months Ended	
	March 31, 2018	April 1, 2017
Balance, beginning of period	\$2,520	\$1,383
Additions to deferral	372	280
Revenue recognized	(647)	(302)
Balance, end of period	\$2,245	\$1,361

Warranty.

In March 2017, the Company began offering a 5 year warranty on the laser heads for its IQ 532/577 laser consoles. The Company has previously provided a one to two year warranty on its products, which is accrued for 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 statement of operations as cost of revenues.

A reconciliation of the changes in the Company's warranty liability for the three months ended March 31, 2018 and April 1, 2017 is as follows:

	Three Months Ended	
	March 31, 2018	April 1, 2017
Balance, beginning of period	\$ 1,734	\$ 603
Accruals for product warranties	(374)	109
Cost of warranty claims	(245)	(63)
Balance, end of period	\$ 1,115	\$ 649

Reclassifications.

Certain reclassifications have been made to the prior year financial statements included in these condensed consolidated financial statements to conform to the current year presentation. The reclassifications had no impact on previously reported net loss or accumulated deficit.

Recently Issued and Adopted Accounting Standards.

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09 Revenue from Contracts with Customers (Topic 606) ("ASC 606"), which, along with amendments issued in 2015, 2016 and 2017, replaces nearly all current U.S. GAAP guidance on this topic with a comprehensive revenue measurement and recognition standard and expanded disclosure requirements. This new guidance provides a five-step analysis in determining when and how revenue is recognized. Under the new guidance, revenue is recognized when a customer obtains control of promised goods or services and is recognized in an amount that reflects the consideration which the entity expects to receive in exchange for those goods or services. In addition, the new guidance requires disclosure of the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

As part of our assessment and implementation plan, we evaluated our policies, procedures and internal controls. In preparation for adoption of the standard, the Company has implemented internal controls to enable the preparation of financial information, including the assessment of the impact of the standard. The Company has adopted this guidance using the modified retrospective method in the first quarter of fiscal 2018. Under the modified retrospective method, the new standards apply to all new contracts initiated on or after the effective date, and for contracts which have remaining obligations as of the effective date, an adjustment to the opening balance of retained earnings is required. Based on the results of the procedures taken in adopting this standard, we determined that our accounting for revenues under the then prescribed standard (ASC 605) was not different from the new ASC 606 standard. As such, we did not have any adjustments to our opening balance of our retained earnings.

In February 2016, the FASB issued ASU 2016-02, "Leases," amending ASC 842. This ASU requires the Company to recognize on the balance sheet the assets and liabilities for the rights and obligations created by leases with terms of more than twelve months. This ASU also requires disclosures enabling the users of financial statements to understand the amount, timing and uncertainty of cash flows arising from leases. This new standard will become effective for annual periods beginning after December 15, 2018 (including interim reporting periods within those periods). Early adoption is permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact of this new standard on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15 "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." The amendment gives guidance and reduces diversity in practice with respect to certain types of cash flows. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The adoption of this standard in fiscal year 2018 did not have a material impact on our consolidated financial statements.

In October 2016, the FASB issued ASU 2016-16, to ASC 740 "Income Taxes," which simplifies the recording of an inter-entity transfer of assets other than inventory. The new guidance requires that a company recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. The new guidance becomes effective for annual reporting

periods beginning after December 15, 2017 and must be applied using a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the adoption period. The adoption of this standard in fiscal year 2018 did not have a material impact on the Company's consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, "Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting." The amendments in ASU 2017-09 include guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. These amendments require the entity to account for the effects of a modification unless if all of the following conditions are met: the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is the same as the fair value (or value using an alternative measurement method) of the original award immediately before the original award is modified. If the modification does not affect any of the inputs to the valuation technique that the entity uses to value the award, the entity is not required to estimate the value immediately before and after the modification; the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified; and the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified. This guidance is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period, with early adoption permitted. The Company is currently evaluating the effect of the adoption of this guidance on its consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-02, "Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." The amendments in ASU 2018-02 are intended to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. The guidance in ASU 2018-02 is effective for annual periods beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption permitted. The Company is currently evaluating the effect of the adoption of this guidance on its consolidated financial statements.

In March 2018, the FASB issued ASU 2018-05, "Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118." ASU 2018-05 formally amended ASC Topic 740, Income Taxes ("ASC 740") for the guidance previously provided by SEC Staff Accounting Bulletin No. 118 ("SAB 118"), which provides guidance for the application of ASC 740 in the reporting period in which the U.S. Tax Cuts and Jobs Act (the "Tax Reform Act") was signed into law. The Company is currently evaluating the effect of the adoption of this guidance on its consolidated financial statements.

3. Inventories

The components of the Company's inventories as of March 31, 2018 and December 30, 2017 are as follows:

	March 31, 2018	December 30, 2017
Raw materials	\$3,659	\$ 4,147
Work in process	1,021	1,567
Finished goods	4,626	3,667

Total inventories \$9,306 \$ 9,381

4. Goodwill and Intangible Assets

Goodwill.

The carrying value of goodwill was \$0.5 million as of March 31, 2018 and December 30, 2017.

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in a business combination. The Company reviews goodwill for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. The Company performs an annual impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceed the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. In addition, income tax effects from any tax deductible goodwill carrying amount of the reporting unit should be considered when measuring the goodwill impairment loss, if applicable. The Company has determined that it has a single reporting unit for purposes of performing its goodwill impairment test. As the Company uses the market approach to assess impairment, its common stock price is an important component of the fair value calculation. If the Company's stock price continues to experience significant price and volume fluctuations, this will impact the fair value of the reporting unit and can lead to potential impairment in future periods. The Company performed its annual impairment test during the second quarter of fiscal 2017 and

determined that its goodwill was not impaired. As of March 31, 2018, the Company had not identified any factors that indicated there was an impairment of its goodwill and determined that no additional impairment analysis was then required.

Intangible Assets.

The following table summarizes the components of gross and net intangible asset balances:

	March 31, 2018				December 30, 2017		
	Gross Carrying Amount		Net Carrying Amount		Gross Carrying Amount		Net Carrying Amount
	Amount	Accumulated Amortization	Amount	Remaining Amortization Life	Amount	Accumulated Amortization	Amount
Customer relations	240	128	112	7.0 Years	240	124	116

For the three months ended March 31, 2018 and April 1, 2017, amortization expense totaled \$4 thousand for each period.

The amortization of customer relations was charged to sales and marketing expense and the amortization of patents was charged to cost of revenues. Future estimated amortization expense (in thousands):

Fiscal Year:	
2018 (nine months)	12
2019	16
2020	16
2021	16
2022	16
Thereafter	36
Total	\$112

5. Fair Value Measurements

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, accounts payable, and accrued expenses as of March 31, 2018 and December 30, 2017, approximate fair value because of the short maturity of these instruments.

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As of March 31, 2018 and December 30, 2017, 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 were as follows:

(in thousands)	As of March 31, 2018				As of December 30, 2017			
	Fair Value Measurements				Fair Value Measurements			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets:								
Money market funds	\$17,761	\$ —	\$ —	\$17,761	\$20,950	\$ —	\$ —	\$20,950
Liabilities:								
Earn-out liability	\$ —	\$ —	\$509	\$509	\$ —	\$ —	\$572	\$572

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 fair value of the earn-out liability arising from the acquisition of RetinaLabs, Inc. is classified within Level 3 of the fair value hierarchy since it is based on significant unobservable inputs. The significant unobservable inputs include projected royalties and discount rates to present value the payments. A significant increase (decrease) in the projected royalty payments in isolation could result in a significantly higher (lower) fair value measurement and a significant increase (decrease) in the discount rate in isolation could result in a significantly lower (higher) fair value measurement. The fair value of the earn-out liability is calculated on a quarterly basis by the Company based on a collaborative effort of the Company's operations, finance and accounting groups as additional information becomes available. Any change in the fair value adjustment is recorded in the statement of operations of that period.

The following tables present quantitative information about the inputs and valuation methodologies used for our fair value measurements classified in Level 3 of the fair value hierarchy as of March 31, 2018 and December 30, 2017.

As of	Fair Value (in thousands)	Valuation Technique	Significant	Weighted
			Unobservable Input	Average (range)
March 31, 2018			Projected royalties	
Earn-out liability	\$ 509	Discounted cash flow	(in thousands) Discount rate	\$1,539 10.41% (10.41% - 27.00%)
As of	Fair Value (in thousands)	Valuation Technique	Significant Unobservable Input	Weighted Average (range)
December 30, 2017				

		Projected royalties	
Earn-out liability	\$ 572	Discounted cash flow (in thousands)	\$1,622
		Discount rate	10.90%
			(10.90% - 27.00%)

A reconciliation of the changes in the Company's earn-out liability (Level 3 liability) for the three months ended March 31, 2018 and April 1, 2017 is as follows:

(in thousands)	Three Months Ended	
	March 31, 2018	April 1, 2017
Balance as of beginning of the period	\$572	\$693
Payments against earn-out	(92)	(84)
Change in fair value of earn-out liability	29	25
Balance as of the end of the period	\$509	\$634

The earn-out liability is included in accrued expenses and other long-term liabilities in the condensed consolidated balance sheets. Any change in the fair value adjustment is recorded to other expense in the condensed consolidated statements of operations.

6. Stock Based Compensation

The Company accounts for stock-based compensation granted to employees and directors, including employees stock option awards, restricted stock and restricted stock units in accordance with ASC 718, "Compensation – Stock Compensation" ("ASC 718").

Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the employee's service period. The Company recognizes compensation expense on a ratable basis over the requisite service period of the award.

The Company values options using the Black-Scholes option pricing model. Restricted stock and time-based restricted stock units are valued at the grant date fair value of the underlying common shares. Performance-based restricted stock units with market conditions are valued using the Monte Carlo simulation model. The Black-Scholes option pricing model requires the use of highly subjective and complex assumptions which determine the fair value of stock-based awards, including the option's expected term and the price volatility of the underlying stock. The Monte Carlo simulation model incorporates assumptions for the holding period, risk-free interest rate, stock price volatility and dividend yield.

2008 Equity Incentive Plan.

For the three months ended March 31, 2018, the only active stock-based compensation plan was the 2008 Equity Incentive Plan (the "Incentive Plan"). The terms of awards granted during the three months ended March 31, 2018 were consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 30, 2017.

Summary of Stock Options

The following table summarizes information regarding activity under the Incentive Plan during the three months ended March 31, 2018:

	Number of Shares	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value (thousands)
Outstanding as of December 30, 2017	857,311	\$ 9.49	
Granted	38,600	\$ 5.88	
Exercised	(6,250)	\$ 3.72	
Canceled or forfeited	(22,113)	\$ 11.80	
Outstanding as of March 31, 2018	867,548	\$ 9.31	\$ 78

The weighted average grant date fair value of the options granted under the Incentive Plan as calculated using the Black-Scholes option-pricing model was \$2.21 and \$5.44 per share for the three months ended March 31, 2018 and April 1, 2017, respectively.

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

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	Three Months Ended			
	March		April 1,	
	31,		2017	
	2018			
Average risk free interest rate	2.53	%	1.78	%
Expected life (in years)	4.55		4.55	
	years		years	
Dividend yield	—	%	—	%
Average volatility	41	%	42	%

Option-pricing models require the input of various subjective assumptions, including the option's expected life and the price volatility of the underlying stock. The expected stock price volatility is based on analysis of the Company's stock price history over a period commensurate with the expected term of the options, trading volume of the Company's stock, look-back volatilities and Company specific events that affected volatility in a prior period. The expected term of employee stock options represents the weighted average period the stock options are expected to remain outstanding and is based on the history of exercises and cancellations on all past option grants made by the Company, the contractual term, the vesting period and the expected remaining term of the outstanding options. The risk-free interest rate is based on the U.S. Treasury interest rates whose term is consistent with the expected life of the stock options. No dividend yield is included as the Company has not issued any dividends and does not anticipate issuing any dividends in the future.

The following table shows stock-based compensation expense included in the condensed consolidated statements of operations for the three months ended March 31, 2018 and April 1, 2017:

	Three Months Ended	
	March 31, 2018	April 1, 2017
Cost of revenues	\$24	\$36
Research and development	60	44
Sales and marketing	96	73
General and administrative	248	239
	\$428	\$392

Stock-based compensation expense capitalized to inventory was immaterial for the three months ended March 31, 2018 and April 1, 2017.

Occasionally, the Company will grant stock-based instruments to non-employees. During the three months ended March 31, 2018 and April 1, 2017, the amount of stock-based compensation related to non-employee options was not material.

Information regarding stock options outstanding, vested, expected to vest, and exercisable as of March 31, 2018 is summarized below:

	Weighted Average			
	Number of Shares	Weighted Average Exercise Price	Remaining Contractual Life (Years)	Aggregate Intrinsic Value (thousands)
Options outstanding	867,548	\$ 9.31	5.25	\$ 78
Options vested and expected to vest	798,665	\$ 9.29	5.16	\$ 78
Options exercisable	272,540	\$ 8.45	3.14	\$ 78

The aggregate intrinsic value in the table above represents the pre-tax intrinsic value, based on the Company's closing price as of March 31, 2018, 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 common stock. The total intrinsic value of options exercised for the three months ended March 31, 2018 and April 1, 2017 was

approximately \$16 thousand and \$226 thousand, respectively.

As of March 31, 2018, there was \$3.6 million of total unrecognized compensation cost, net of expected forfeitures, related to non-vested stock-based compensation arrangements under the Incentive Plan. The cost is expected to be recognized over a weighted average period of 3.21 years.

Summary of Restricted Stock Units and Awards

Information regarding the restricted stock units (“RSUs”) activity for the three months ended March 31, 2018 is summarized below:

	Number of Shares
Outstanding as of December 30, 2017	361,148
Restricted stock units granted	6,300
Restricted stock units released	(52,213)
Restricted stock units cancelled	(750)
Outstanding as of March 31, 2018	314,485

During the three months ended March 31, 2018, the Company awarded 6,300 restricted stock units at a weighted-average grant date fair value of \$6.29 per share.

RSUs granted with market conditions are valued using the Monte Carlo simulation model and compensation expense is recognized ratably during the service period even if the market condition is not satisfied. To the extent that the market condition is not met, the RSUs will not vest and will be cancelled. No RSUs with market conditions were granted during the three months ended March 31, 2018.

RSUs granted with performance conditions are valued at the grant date fair value of the underlying common shares. The Company makes a determination regarding the probability of the performance criteria being achieved and compensation expense is recognized ratably over the vesting period, if it is expected that the performance criteria will be met.

Information regarding the RSUs granted with performance conditions activity for the three months ended March 31, 2018 is summarized below:

	Number of Shares
Outstanding as of December 30, 2017	4,301
Restricted stock awards granted	—
Restricted stock awards released	—
Outstanding as of March 31, 2018	4,301

During the three months ended March 31, 2018, the Company awarded 4,301 RSUs granted with performance conditions at a weighted-average grant date fair value of \$9.30 per share.

7. Income Taxes

Provision for Income Tax.

The Company calculates its interim tax provision in accordance with the provisions of ASC 740-270, Income Taxes; Interim Reporting. For interim periods, the Company estimates its annual effective income tax rate and applies the estimated rate to the year-to-date income or loss before income taxes. The Company also computes the tax provision or benefit related to items reported separately and recognizes the items net of their related tax effect in the interim periods in which they occur. The Company also recognizes the effect of changes in enacted tax laws or rates in the interim periods in which the changes occur. The Company recorded a provision for income tax of \$4 thousand and \$6 thousand for the three months ended March 31, 2018 and April 1, 2017, respectively.

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act makes broad and complex changes to the U.S. tax code that affected 2017, the current year and onwards, including, but not limited to, a reduction of the U.S. federal corporate tax rate from as high as 35% to 21%, a general elimination of U.S. federal income taxes on dividends from foreign subsidiaries, net operating loss deduction limitations, and 100% disallowance of entertainment expense.

In addition on December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 ("SAB 118") which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740, Income taxes for the year ended December 31, 2017. In accordance with SAB 118, a company must

reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. The Company is still within the measurement period as of the end of the first quarter of 2018 and the Company is continuing to review the impact of the adoption of the Tax Act on the Company.

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 the fourth quarter of fiscal year 2016, based on the Company’s recent history of earnings and its forecasted losses, management believes on the more likely than not basis that a full valuation allowance is required. Accordingly, in the fourth quarter of fiscal year 2017, the company provided a full valuation allowance on its federal and states deferred tax assets.

Uncertain Tax Positions.

The Company accounts for its uncertain tax positions in accordance with ASC 740. As of December 30, 2017, the Company had \$1.0 million of unrecognized tax benefits, none of the unrecognized tax benefits would result in a change in the Company’s effective tax rate if recognized in future years.

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 is subject to United States federal income tax as well as to income taxes in state jurisdictions. The Company's federal and state income tax returns are open to examination by tax authorities for three years and three-to-five years, respectively.

8. Computation of Basic and Diluted Net Loss Per Common Share

Basic and diluted net loss per share is based upon the weighted average number of common shares outstanding during the period. Common stock equivalents consist of incremental common shares issuable upon the exercise of stock options, and the release (vesting) of restricted stock units and awards and are calculated under the treasury stock method. Common stock equivalent shares from unexercised stock options, and unvested restricted stock units and awards are excluded from the computation for periods in which we incur a net loss or if the exercise price of such options is greater than the average market price of our common stock for the period as their effect would be anti-dilutive.

For the three months ended March 31, 2018 and April 1, 2017, stock options, RSUs, and Restricted Stock Awards ("RSAs") to purchase 1,186,334 and 799,016 shares, respectively, were excluded from the computation of diluted weighted average shares outstanding.

A reconciliation of the numerator and denominator of basic and diluted net loss per common share is provided as follows:

	Three Months Ended March	
	31, 2018	April 1, 2017
Numerator:		
Net (loss) income	\$(3,603)	\$(1,866)
Denominator:		
Weighted average shares of common stock (basic)	11,628	11,518
Effect of dilutive preferred shares		
Effect of dilutive stock options	—	—
Effect of dilutive contingent shares	—	—
Weighted average shares of common stock (diluted)	11,628	11,518
Per share data:		

Basic net (loss) income per share	\$(0.31)	\$(0.16)
Diluted net (loss) income per share	\$(0.31)	\$(0.16)

9. Business Segments

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

Revenue information shown by geographic region, based on the sales destination, is as follows:

	Three Months Ended March	
	31, 2018	April 1, 2017
United States	\$4,860	\$5,704
Europe	2,434	1,935
Rest of Americas	652	609
Asia/Pacific Rim	1,563	2,235
	\$9,509	\$10,483

Revenues are attributed to countries based on location of end customers.

No individual country accounted for more than 10% of the Company's revenues, other than the United States. United States accounted for 51.1% and 54.4% of revenues for the three month periods ended March 31, 2018 and April 1, 2017, respectively. International sales, other than the United States, accounted for 48.9% and 45.6% of revenues for the three month periods ended March 31, 2018 and April 1, 2017, respectively.

No customer accounted for more than 10% of total revenues for the three month periods ended March 31, 2018 or April 1, 2017.

No customer accounted for more than 10% of account receivable balance for the three month periods ended March 31, 2018 or April 1, 2017.

10. Subsequent Events

On February 23, 2018, we initiated a voluntary recall of a specific laser accessory called the TruFocus LIO Premiere™ ("LIO"). On April 27, 2018, Iridex began shipments of the updated TruFocus LIO Premiere device to countries outside the United States that do not require FDA clearance (or do not require supplemental device registration for the updated device) under applicable U.S. export regulations. Return of the LIO device to the U.S. market will likely require FDA clearance of a 510(k) Premarket Notification.

Based on this, we have reversed the sales return reserve and warranty expense associated with products shipped outside of the United States that were accrued in December 2017, specifically \$172 thousand in sales return reserve and \$368 thousand in materials and other warranty related expense as these reserves are no longer deemed required.

As of March 31, 2018, there is an accrual for approximately \$1.5 million consists of \$637 thousand in sales return reserve and \$853 thousand in materials and other warranty related costs associated with the voluntary recall of LIO products in the United States.

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

This Quarterly Report on Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements are based on management's beliefs and assumptions and on information currently available to management. These statements include statements concerning future demand and order levels for the Company's products, future operating expenses, changes in personnel, product development and intellectual property related matters, the adoption and effect of Company products on its results, the markets in which the Company operates, usage and efficacy of the Company's products, the Company's future financial results, the impact of the Company's adoption of new or revised accounting standards, and the Company's strategic plans and objectives. 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, although not all forward looking statements contain these words.

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. The reader is strongly urged to read the information contained under Item 1A of Part II of this Quarterly Report on Form 10-Q for a more detailed description of these significant risks and uncertainties. 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.

As used in this Quarterly Report on Form 10-Q, the terms "Company," "IRIDEX," "we," "us" and "our" refer to IRIDEX Corporation, and its consolidated subsidiaries.

Overview

IRIDEX Corporation is an ophthalmic medical technology company focused on the development and commercialization of breakthrough products and procedures used to treat sight-threatening eye conditions, including glaucoma and retinal diseases. Certain of our products are powered by our proprietary MicroPulse technology, which is a method of delivering laser energy using a mode which chops the continuous wave laser beam into short, microsecond-long laser pulses. Our products consist of laser consoles, delivery devices and consumable instrumentation, including laser probes.

Our laser consoles consist of the following product lines:

- Glaucoma – This product line includes our Cyclo G6 laser system used for the treatment of glaucoma;
- Medical Retina – Our medical retina product line includes our IQ 532 and IQ 577 laser photocoagulation systems, which are used for the treatment of diabetic macular edema and other retinal diseases; and
- Surgical Retina – Our surgical retina line of products includes our OcuLight TX, OcuLight SL, OcuLight SLx, OcuLight GL and OcuLight GLx laser photocoagulation systems. These systems are often used in vitrectomy procedures, which are used to treat proliferative diabetic retinopathy, macular holes, retinal tears and detachments.

Our business generates recurring revenues through sales of consumable products, predominantly single-use laser probe devices and other instrumentation, as well as repair, servicing and extended service contracts for our laser systems. Our laser probes consist of the following product lines:

- Glaucoma – Probes used in our glaucoma product line include our patented MicroPulse P3 (“MP3”) probe and G-Probe; and

- Surgical Retina – Our surgical retina probes include our EndoProbe family of products used in vitrectomy procedures.

Ophthalmologists typically use our laser systems in hospital operating room (“OR”) and ambulatory surgical centers (“ASCs”), as well as their offices and clinics. In the ORs and ASCs, ophthalmologists use our laser systems with either an indirect laser ophthalmoscope or a consumable, single use MP3 probe, G-Probe or EndoProbe.

Our products are sold in the United States predominantly through a direct sales force and internationally primarily through independent distributors. We recently established direct sales capabilities in Germany.

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. However, increases in the value of the U.S. dollars 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. Sales to direct end users transacted through our German office will be denominated in Euros and will be subject to risks associated with the currency fluctuations.

Cost of revenues consists primarily of our direct manufacturing costs which includes the cost of 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. For certain of our products, we are responsible for the cost of the fully assembled product that is manufactured by a third-party.

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.

Results of Operations

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

	Three Months Ended	
	March 31, 2018	April 1, 2017
Revenues	100.0%	100.0%
Cost of revenues	58.8 %	57.4 %
Gross margin	41.2 %	42.6 %
Operating expenses:		
Research and development	11.6 %	12.8 %
Sales and marketing	42.6 %	27.9 %
General and administrative	25.1 %	19.7 %
Total operating expenses	79.3 %	60.4 %
Loss from operations	(38.1 %)	(17.8 %)
Other income (expense), net	0.2 %	(0.0 %)
Loss from operations before provision for income taxes	(37.9 %)	(17.8 %)
Provision for income taxes	0.0 %	0.1 %
Net loss	(37.9 %)	(17.8 %)

The following comparisons are between the three month periods ended March 31, 2018 and April 1, 2017:

Revenues.

(in millions)	Three Months Ended March 31, 2018	Three Months Ended April 1, 2017	Change in \$	Change in %
Systems – domestic	\$ 1,253	\$ 2,134	\$ (881)	(41.3 %)
Systems – international	2,593	2,972	(379)	(12.8 %)
Recurring revenues	5,663	5,377	286	5.3 %
Total revenues	\$ 9,509	\$ 10,483	\$ (974)	(9.3 %)

Our total revenues decreased \$1.0 million, or 9.3%, from \$10.5 million to \$9.5 million for the first quarter of fiscal year 2018. The decrease is due mainly from a decrease in both our domestic and international systems sales, \$0.9 million and \$0.4 million, respectively. The decrease in our systems sales was primarily due to a decrease in sales of our retina products as a result of the

voluntary recall of the TruFocus LIO Premiere™, which impacted our medical and surgical retina products. This decrease was partially offset by an increase in sales of G6 systems and a reversal of a portion of the sales returns reserve associated with the voluntary LIO recall. For further information about this sales return reserve reversal, see footnote 10, “Subsequent Events.” Our recurring revenues increased \$0.3 million, due to an increase in G6 related probe sales, partially offset by a decrease in legacy probe sales.

Gross Profit and Gross Margin.

Gross profit was \$3.9 million compared with \$4.5 million, a decrease of \$0.6 million. Gross margin was 41.2% compared with 42.6%, a decrease of 1.4 percentage points. Gross margin was primarily impacted by unfavorable geographic mix and less efficient overhead absorption, partially offset by the benefit of higher margin G6 revenues and the reversal of a portion of the sales return reserve and warranty expense related to the voluntary recall of LIO products. For further information about this sales return reserve and warranty expense reversal, see footnote 10, “Subsequent Events.”

Gross margins are expected to fluctuate due to changes in the relative proportion of domestic and international sales, the product mix of sales, introduction of new products, manufacturing variances, total unit volume changes that lead to greater or lesser production efficiencies and other factors.

Research and Development.

Research and development (“R&D”) expenses decreased by \$0.2 million, or 17.6%, from \$1.3 million to \$1.1 million. The decrease in spending was primarily attributable to a decrease in salaries and related costs as a result of a decrease in headcount, partially offset by an increase in regulatory costs.

Sales and Marketing.

Sales and marketing expenses increased \$1.2 million, or 38.6%, from \$2.9 million to \$4.1 million. The increase in spending was attributable to an increase in salaries and related costs due to an increase in headcount, commission expense, and other general selling and marketing expenses.

General and Administrative.

General and administrative expenses increased \$0.3 million, or 15.7%, from \$2.1 million to \$2.4 million. The increase in spending was attributable to an increase in bonus expense, an increase in severance, an increase in our German operations and an increase in other public company reporting and compliance expenses.

Other Income (Expense), Net.

Other income, net amounted to \$18 thousand, compared with other expense, net of \$2 thousand. Other income (expense), net, consisted primarily of the change in expense associated with the re-measurement of the contingent liabilities, partially offset by interest income.

Income Taxes.

We recorded an income tax provision of \$4 thousand and \$6 thousand, respectively.

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 March 31, 2018, we had cash and cash equivalents of \$18.5 million and working capital of \$25.7 million compared to cash and cash equivalents of \$21.7 million and working capital of \$29.1 million as of December 30, 2017.

For the three months ended March 31, 2018, net cash used in operating activities was \$2.7 million, primarily as a result of the net loss of \$3.6 million, partially offset by non-cash items and changes in assets and liabilities. The non-cash items primarily consisted of stock-based compensation expense of \$0.4 million and depreciation and amortization expense of \$0.2 million. The net cash inflow

from changes in assets and liabilities was primarily due to a decrease in accounts receivable of \$1.5 million due to improved collections, partially offset by a decrease in accrued compensation of \$0.7 million that resulted from the payout of accrued bonuses and a decrease in accrued warranty of \$0.6 million that resulted from the reversal of the accrued warranty expense associated with the voluntary recall of LIO products shipped outside of the United States.

For the three months ended March 31, 2018, net cash used in investing activities was \$0.4 million, which consisted of capital expenditures of \$0.3 million for property and equipment and payment on the contingent earn-out liability of \$0.1 million.

For the three months ended March 31, 2018, net cash used in financing activities was \$0.1 million, which was used to pay for the net share settlement of equity awards and the related payroll taxes.

We believe our existing cash and cash equivalents will be sufficient to meet our anticipated cash needs over the next 12 months.

Contractual Obligations and Commitments.

Our contractual obligations and commitments as of March 31, 2018 are as follows:

(in thousands)	Total	Less than 1 Year	1-3 years	3-5 years	More than 5 years
Operating leases payments	\$5,424	\$1,127	\$4,248	\$ 49	\$ —
Purchase commitments	11,251	7,059	4,192	—	—
Total obligations	\$16,675	\$8,186	\$8,440	\$ 49	\$ —

Our operating lease commitments consist primarily of our facility lease and various office and computer equipment leases.

Our purchase commitments consist primarily of non-cancellable purchase commitments with vendors to manufacture certain components and ophthalmic instrumentation.

Off-Balance Sheet Arrangements.

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Other Information

IRIDEX Corporation was incorporated in California in February 1989 as IRIS Medical Instruments, Inc. In November 1995, we changed our name to IRIDEX Corporation and reincorporated in Delaware. Our executive offices are located at 1212 Terra Bella Avenue, Mountain View, California 94043-1824, and our telephone number is (650) 940-4700. We can also be reached at our website at www.IRIDEX.com. Investors and others should note that we announce material financial information to our investors using SEC filings, press releases, our investor relations website, public conference calls and webcasts. We use these channels as well as social media to communicate with investors, customers and the public about our company, our products and other issues. It is possible that the information we post on social media channels could be deemed to be material information. We encourage investors, our customers, and others interested in our company to review the information we post on our Facebook page (www.facebook.com/IRIDEX) and Twitter feed (<https://twitter.com/IRIDEX>). Any information on, or that can be accessed through, our website and social media channels is not part of this report.

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. Our international revenues and costs for the three months ended March 31, 2018 were primarily denominated in U.S. dollars and therefore changes in foreign currency rates will not have an impact on our income statement or cash flows. However, increases in the value of the U.S. dollars 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-U.S. dollar denominated revenue and our exposure to gains and losses on international currency transactions may increase. Sales to direct end users transacted through our German office are denominated in Euros and will be subject to risks associated with the currency fluctuations. We currently do not engage in transactions to hedge against the risk of the currency fluctuation, but we may do so in the future.

Interest Rate Risk.

Our exposure to interest rate risk as of March 31, 2018 is related to our cash equivalent holdings, which is not material given the nature of our cash equivalent holdings. Since we have no fixed or variable interest rate debt outstanding, our interest expense is not affected by changes in interest rates. In the event we issue any new variable-rate debt in the future, increases in interest rates would increase the interest expense associated with the debt.

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 our 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 our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of March 31, 2018. Based on the foregoing, our Chief Executive Officer and our 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

In January 2018, we filed a lawsuit against Quantel Medical, S.A., Quantel USA, Inc., and Quantel, S.A. (collectively, “Quantel”) in the U.S. District Court for the Northern District of California. The lawsuit alleges that Quantel products infringe U.S. Patent No. 7,771,417, that Quantel breached an earlier agreement between Quantel and the Company, and that Quantel has infringed upon the Company’s MicroPulse® trademark, Registration No. 4550188 on the principal register. Quantel previously had a limited license to the asserted Company patent and trademark. Our complaint filed in connection with this matter asserts that the license was terminated in early 2017 for material breach, but that Quantel continued to use our intellectual property without authorization. If we are unsuccessful in prosecuting our claims against Quantel, this could have a material adverse effect on our business, results of operations and financial condition.

In addition, from time to time, we may be involved in legal proceedings arising in the ordinary course of business. Although the results of litigation and claims cannot be predicted with certainty, we currently believe that the final outcome of these ordinary course matters will not have a material adverse effect on our business, operating results, financial condition or cash flows. Regardless of the outcome, litigation can have an adverse impact on us because of defense and settlement costs, diversion of management resources and other factors.

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 operations. You should carefully consider the risks described below before making an investment decision.

If applicable, we have marked with an asterisk (*) those risk factors below that reflect substantive changes to the text of the risk factors included in our Annual Report on Form 10-K for the year ended December 30, 2017, which was filed with the SEC on March 14, 2018.

Risks Relating to our Business

We face quality control and other production issues that could materially and adversely impact our sales and financial results and the acceptance of our products.

The manufacture of our infrared and visible laser consoles and related delivery devices is a highly complex and precise process. We may experience manufacturing difficulties, quality control issues or assembly constraints.

If our sales increase substantially, we may need to increase our production capacity and may not be able to do so in a timely, effective or cost-efficient manner. We may not be able to manufacture sufficient quantities of our products, which may require that we qualify other manufacturers for our products. Furthermore, we may experience delays, disruptions, capacity constraints or quality control problems in our manufacturing operations.

In the past several years, we have experienced supply chain, production and training issues as we have expanded our product lines and sales volumes, and may experience similar issues in the future as we continue to grow our business. These issues have caused, and may in the future cause, us to reduce or delay the shipment of our products and incur costs to service or replace products already shipped to customers. We have also incurred, and may in the future incur, additional costs to rectify or prevent similar issues in the future. Our efforts to address these supply chain, production and training issues may not be successful, and if we are unable to address these issues in a timely and cost-effective manner, product shipments to our customers could be delayed, our sales levels may suffer and manufacturing and operational costs may increase, any of which would negatively impact our business, results of operations and financial condition.

Some of our laser systems are complex in design and may contain defects that are not detected until deployed by our customers, which could increase our costs and reduce our revenues.

Laser systems are inherently complex in design and require regular maintenance. The manufacture of our lasers, laser products and systems involves a highly complex and precise process. As a result of the technical complexity of our

products, changes in our or our suppliers' manufacturing processes or the inadvertent use of defective materials by us or our suppliers could result in a material adverse effect on our ability to achieve acceptable manufacturing yields and product reliability. To the extent that we do not achieve such yields or product reliability, our business, operating results, financial condition and customer relationships would be adversely affected. We provide warranties on certain of our product sales, and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires us to make estimates of failure rates and expected costs to repair or replace the products under warranty. We currently establish warranty reserves based on historical warranty costs. If actual return rates and/or repair and replacement costs differ significantly from our estimates, adjustments to recognize additional cost of revenues may be required in future periods.

Our customers may discover defects in our products after the products have been fully deployed and operated under peak stress conditions. In addition, some of our products are combined with products from other vendors, which may contain defects. As a result, should problems occur, it may be difficult to identify the source of the problem. If we are unable to identify and fix defects or other problems, we could experience, among other things:

- loss of customers;
- increased costs of product returns and warranty expenses;
- damage to our brand reputation;
- failure to attract new customers or achieve market acceptance;
- diversion of development and engineering resources; and
- legal actions by our customers.

The occurrence of any one or more of the foregoing factors could seriously harm our business, financial condition and results of operations.

We rely on our direct and independent sales forces and network of international distributors to sell our products and any failure to maintain our sales force and distributor relationships could harm our business.

Our ability to sell our products and generate revenues depends upon our direct and independent sales forces within the United States, relationships with independent distributors outside the United States, and the establishment of our direct sales capabilities in Germany. Currently our direct and independent sales forces within the United States consist of approximately 20 employees and one independent representative, respectively. Our international independent distributors are managed by a team of five people. We generally grant our distributors exclusive territories for the sale of our products in specified countries. The amount and timing of resources dedicated by our distributors to the sales of our products is not within our control. Our international sales are largely dependent on the efforts of these third parties. If any distributor breaches the terms of its distribution agreement with us or fails to generate sales of our products, we may be forced to replace the distributor and our ability to sell our products into that exclusive sales territory would be adversely affected.

We do not have any long-term employment contracts with the members of our direct sales force. We may be unable to replace our direct sales force personnel with individuals of equivalent technical expertise and qualifications, which may harm our revenues and our ability to maintain market share. Similarly, our independent and distributor agreements are generally terminable at will by either party and independents and distributors may terminate their relationships with us, which would affect our sales and results of operations. As we establish our direct sales capabilities in Germany, we may be unable to recruit and retain qualified personnel in this region. Any loss of the members of our existing direct or indirect sales organizations, or any failure to execute on our plans to further develop our sales function, could have an adverse impact on our business, results of operations and financial condition.

Growth in our sales and marketing organization may create operational challenges without immediately offsetting benefits.

We have increased and continue to increase our internal sales and marketing functions. This growth may place a significant strain on our management, operating and financial systems and our sales, marketing, training and administrative resources. As a result of our growth, our operating costs may escalate even faster than planned, and some of our internal systems may need to be enhanced or replaced. For example, if we are unable to provide adequate training for our expanding sales force, our ability to fully utilize new sales and marketing resources may be adversely impacted, we could suffer reputational harm and our ability to maintain our installed base of customers may be negatively impacted. If we cannot effectively manage our expanding operations and our costs, we may not be able to grow effectively or we may grow at a slower pace, and our business could be adversely affected.

It can take six months or longer before our internal sales representatives are fully trained and productive in selling our solution to prospective clients. This ramp period presents a number of operational challenges as the cost of recruiting, hiring and carrying new sales representatives cannot be offset by the revenue such new sales representatives produce until after they complete their ramp periods. If we cannot reliably develop our sales representatives to a productive level, or if we lose productive representatives in whom we have heavily invested, our future growth rates and revenue will suffer.

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 first quarter of fiscal 2018, our international sales were \$4.6 million, or 48.9% of total revenues. We anticipate that international sales will continue to account for a significant portion of our revenues in the foreseeable future. All of our international revenues and costs for the quarter ended March 31, 2018 have been denominated in U.S. dollars except for a sale transacted through our German subsidiary. As a result, an increase in the value of the U.S. dollar relative to foreign currencies makes our U.S. dollar-denominated our products more

expensive and thus less competitive in foreign markets and may negatively affect our reported revenue in any particular reporting period. Our international operations and sales are subject to a number of risks and potential costs, including:

- fluctuations in foreign currency exchange rates;
- product and production issues;
- performance of our international channel of distributors;
- longer accounts receivable collection periods;
- impact of recessions in global economies and availability of credit;
- political and economic instability;
- trade sanctions and embargoes;
- impact of international conflicts, terrorist and military activity, civil unrest;
- foreign certification requirements, including continued ability to use the “CE” mark in Europe, and other local regulatory requirements;
- differing local product preferences and product requirements;
- cultural differences;
 - changes in foreign medical reimbursement and coverage policies and programs;
- reduced or limited protections of intellectual property rights in jurisdictions outside the United States;
- potentially adverse tax consequences;
- protectionist, adverse and changing foreign governmental laws and regulations;
- greater risk of our employees failing to comply with both U.S. and foreign laws, including anti-trust regulations, the U.S. Foreign Corrupt Practices Act, the U.K. Bribery Act of 2010 and any trade regulations designed to ensure fair trade practices; and
- compliance costs and risks of non-compliance with multiple regulatory regimes governing the production, marketing, sale and use of our products.

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 in addition to the above factors. 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 these relationships, we may not be able to grow sales in these geographic regions. These or other similar risks could adversely affect our revenues, profitability and the price of our common stock.

If we fail to develop and successfully introduce new products and applications, our business prospects and operating results may suffer.

Our ability to generate incremental revenue growth will depend, in part, on the successful outcome of research and development activities, which may include clinical trials that lead to the development of new products and new applications using our products. Our research and development process is expensive, prolonged, and entails considerable uncertainty. Due to the complexities and uncertainties associated with ophthalmic research and development, products we are currently developing may not complete the development process or obtain the regulatory approvals required to market such products successfully.

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 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 is 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 could 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.

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:

- changes in the prices at which we can sell our products, including the impact of changes in exchange rates;
- general economic uncertainties and political concerns;
- introduction of new products, product enhancements and new applications by our competitors, including new drugs, entry of new competitors into our markets, pricing pressures and other competitive factors;
- any delays or reductions in product shipments, or product recalls, resulting from manufacturing, distribution or other operational issues;
- 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 maintain sales volumes at a level sufficient to cover fixed manufacturing and operating costs;
- 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;
- our long and highly variable sales cycle;
- 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;
- variances in shipment volumes as a result of product, supply chain and training issues; 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 quarters. 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.

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 these medical laser systems is dependent upon a number of factors including the following:

- acceptance of product performance, features, ease of use, scalability and durability, including with respect to our MicroPulse laser photocoagulation systems;
- recommendations and opinions by ophthalmologists, other clinicians, and their associated opinion leaders;
- marketing and 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 MP3 and EndoProbe devices. 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, 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 consoles, 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 laser systems and delivery devices used for ophthalmic treatment procedures is intense and is expected to increase. This market is also characterized by technological innovation and change. We compete by providing features and services that are valued by our customers such as: enhanced product performance, and clinical outcomes, ease of use, durability, versatility, customer training services and rapid repair of equipment.

Our principal ophthalmic laser competitors are Alcon Inc. (Novartis AG), Bausch and Lomb (Valeant), Carl Zeiss Meditec AG, Ellex Medical Lasers, Ltd., Lumenis Ltd., Nidek Co. Ltd., Quantel Medical SA, and Topcon Corporation. We also compete with alternative glaucoma surgical device companies such as Alcon, Allergan, and Glaukos. Pharmaceuticals represent alternative treatments to our laser procedures. Some of our principal pharmaceutical competitors are Alcon, Allergan, OSI Pharmaceuticals (Astellas), Pfizer, Regeneron, Roche (Genentech), and Valeant Pharmaceuticals. Some of our competitors have substantially greater financial, engineering, product development, manufacturing, marketing and technical resources than we do. Some companies also have greater name recognition than us and long-standing customer relationships. In addition, other medical companies, academic and research institutions, or others, may develop new technologies or therapies, including medical devices,

surgical procedures or pharmacological treatments and obtain regulatory approval for products utilizing such techniques that are more effective in treating the conditions targeted by us, or are less expensive than our current or future products. Our technologies and products could be rendered obsolete by such developments. Any such developments could have a material adverse effect on our business, financial condition and results of operations.