CUTERA INC
Form 10-Q
August 04, 2014

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 June 30, 2014

OR

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

For the transition period _____ to_____.

Commission file number: 000-50644

Cutera, Inc.

(Exact name of registrant as specified in its charter)

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

3240 Bayshore Blvd., Brisbane, California 94005

(Address of principal executive offices)

(415) 657-5500

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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 Registrant's common stock issued and outstanding as of July 31, 2014 was 14,313,189.

CUTERA, INC.

FORM 10-Q

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CUTERA, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

(unaudited)

	June 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$ 10,902	$ 16,242
Marketable investments	70,696	66,831
Accounts receivable, net	7,596	9,679
Inventories	10,030	9,006
Deferred tax asset	32	31
Other current assets and prepaid expenses	1,772	1,507
Total current assets	101,028	103,296
Property and equipment, net	1,329	1,362
Deferred tax asset, net of current portion	342	329
Intangibles, net	1,632	2,019
Goodwill	1,339	1,339
Other long-term assets	15	324
Total assets	$ 105,685	$ 108,669
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,028	$ 1,820
Accrued liabilities	7,473	9,328
Deferred revenue	8,561	7,494
Total current liabilities	18,062	18,642

Deferred revenue, net of current portion	4,578	4,340
Income tax liability	144	108
Other long-term liabilities	1,141	1,314
Total liabilities	23,925	24,404
Commitments and Contingencies (Note 10)		
Stockholders' equity:		
Convertible preferred stock, $0.001 par value; authorized: 5,000,000 shares; none issued and outstanding	—	—
Common stock, $0.001 par value; authorized: 50,000,000 shares; issued and outstanding: 14,311,168 and 13,931,833 shares at June 30, 2014 and December 31, 2013, respectively	14	14
Additional paid-in capital	102,649	98,820
Accumulated deficit	(20,971)	(14,620)
Accumulated other comprehensive income	68	51
Total stockholders' equity	81,760	84,265
Total liabilities and stockholders' equity	$ 105,685	$ 108,669

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended June 30, 2014	2013	Six Months Ended June 30, 2014	2013
Net revenue:				
Products	$13,171	$15,053	$24,923	$26,576
Service	4,553	4,507	8,990	8,951
Total net revenue	17,724	19,560	33,913	35,527
Cost of revenue:				
Products	5,917	6,151	10,994	11,573
Service	1,931	2,291	4,157	4,286
Total cost of revenue	7,848	8,442	15,151	15,859
Gross profit	9,876	11,118	18,762	19,668
Operating expenses:				
Sales and marketing	7,754	7,170	15,085	13,626
Research and development	2,622	2,217	5,266	4,338
General and administrative	2,335	2,354	4,899	4,643
Total operating expenses	12,711	11,741	25,250	22,607
Loss from operations	(2,835)	(623)	(6,488)	(2,939)
Interest and other income, net	138	75	218	210
Loss before income taxes	(2,697)	(548)	(6,270)	(2,729)
Provision for income taxes	44	90	81	72
Net loss	$(2,741)	$(638)	$(6,351)	$(2,801)
Net loss per share:				
Basic and Diluted	$(0.19)	$(0.04)	$(0.45)	$(0.19)
Weighted-average number of shares used in per share calculations:				
Basic and Diluted	14,231	14,723	14,127	14,566

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(in thousands)

(unaudited)

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Net loss	$(2,741)	$(638)	$(6,351)	$(2,801)
Other comprehensive income (loss):				
Available-for-sale investments				
Net change in unrealized gain (loss) on available-for-sale investments	26	(125)	28	(121)
Less: Reclassification adjustment for gains on investments recognized during the year	(1)	—	(1)	—
Net change in unrealized gain (loss) on available-for-sale investments	25	(125)	27	(121)
Tax provision (benefit)	9	(2)	10	—
Other comprehensive income (loss), net of tax	16	(123)	17	(121)
Comprehensive loss	$(2,725)	$(761)	$(6,334)	$(2,922)

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended June 30, 2014	2013
Cash flows from operating activities:		
Net loss	$(6,351)	$(2,801)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Stock-based compensation	1,318	1,622
Depreciation and amortization	660	646
Other	93	50
Changes in assets and liabilities:		
Accounts receivable	2,079	1,299
Inventories	(1,024)	596
Other current assets and prepaid expenses	(99)	242
Other long-term assets	309	49
Accounts payable	208	323
Accrued liabilities	(1,885)	(1,952)
Other long-term liabilities	(141)	(112)
Deferred revenue	1,305	1,117
Income tax liability	36	(87)
Net cash provided by (used in) operating activities	(3,492)	992
Cash flows from investing activities:		
Acquisition of property, equipment and software	(283)	(306)
Proceeds from sales of marketable investments	4,681	4,975
Proceeds from maturities of marketable investments	19,165	16,200
Purchase of marketable investments	(27,850)	(37,243)
Net cash used in investing activities	(4,287)	(16,374)
Cash flows from financing activities:		
Proceeds from exercise of stock options and employee stock purchase plan	2,511	3,781
Payments on capital lease obligations	(72)	(60)
Net cash provided by financing activities	2,439	3,721
Net decrease in cash and cash equivalents	(5,340)	(11,661)

Cash and cash equivalents at beginning of period	16,242	23,546
Cash and cash equivalents at end of period	$10,902	$11,885

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

CUTERA, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Description of Operations and Principles of Consolidation

Cutera, Inc. *("Cutera" or the "Company")* is a global provider of laser and other energy-based aesthetic systems for practitioners worldwide. The Company designs, develops, manufactures, and markets laser and other energy-based product platforms for use by physicians and other qualified practitioners which enable them to offer safe and effective aesthetic treatments to their customers. The Company currently markets the following key product platforms: CoolGlide, Xeo, Solera, GenesisPlus, Excel V, VariLite, truSculpt and Excel HR. The Company's products offer multiple hand pieces and applications, which allow customers to upgrade their systems. The sales of systems, upgrades, hand pieces, hand piece refills (Titan and truSculpt) and the distribution of third party manufactured dermal fillers and cosmeceuticals are classified as "Product and upgrade" revenue. In the second quarter of 2014, the Company terminated its agreement with Merz Pharma GmbH's *("Merz")* for the distribution of its Radiesse® dermal filler product. In addition to Product and upgrade revenue, the Company generates revenue from the sale of post-warranty service contracts, parts, detachable hand piece replacements (except for Titan and truSculpt) and service labor for the repair and maintenance of products that are out of warranty, all of which is classified as "Service revenue."

Headquartered in Brisbane, California, the Company has wholly-owned subsidiaries that are currently operational in Australia, Belgium, Canada, France, Japan and Switzerland, that market, sell and service its products outside of the United States. The Condensed Consolidated Financial Statements include the accounts of the Company and its subsidiaries. All inter-company transactions and balances have been eliminated.

Unaudited Interim Financial Information

The interim financial information filed is unaudited. The Condensed Consolidated Financial Statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for the fair statement of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The December 31, 2013 Condensed Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles in the United States of America *("GAAP")*. The results for interim periods are not necessarily indicative of the results for the entire year or any other interim period. The Condensed Consolidated Financial Statements should be read in conjunction with the Company's previously filed audited financial statements and the notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2013 filed with the Securities and Exchange Commission (the *"SEC"*), on March 18, 2014.

Use of Estimates

The preparation of interim Condensed Consolidated Financial Statements in conformity with GAAP requires the Company's management to make estimates and assumptions that affect the amounts reported and disclosed in the Condensed Consolidated Financial Statements and the accompanying notes. Actual results could differ materially from those estimates. On an ongoing basis, the Company evaluates these estimates, including those related to warranty obligation, sales commission, accounts receivable and sales allowances, provision for excess and obsolete inventories, fair values of marketable investments, fair values of acquired intangible assets, useful lives of intangible assets and property and equipment, fair value of options to purchase the Company's stock, recoverability of deferred tax assets, and effective income tax rates, among others. Management bases these estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Recent Accounting Pronouncements

In May 2014, the Financial Accountings Standards Board issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, or ASU 2014-09, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and shall take effective on January 1, 2017. The standard permits the use of either the retrospective or cumulative effect transition method and the early application of it is not permitted. The Company is presently evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures and has not yet selected a transition method.

Note 2. Cash, Cash Equivalents and Marketable Investments

The Company invests its cash primarily in money market funds, commercial paper, corporate notes and bonds, municipal bonds, and debt securities issued by the U.S. government and its agencies. The Company considers all highly liquid investments, with an original maturity of three months or less at the time of purchase, to be cash equivalents. Investments with maturities of greater than three months at the time of purchase are accounted for as "available-for-sale," are carried at fair value with unrealized gains and losses reported as a component of stockholders' equity, held for use in current operations and classified in current assets as "marketable investments."

The following tables summarize the components, and the unrealized gains and losses position, related to the Company's cash and cash equivalents and marketable investments (in thousands):

June 30, 2014	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Market Value**
Cash and cash equivalents:				
Cash	$ 5,154	$ —	$ —	$ 5,154
Money market funds	2,749	—	—	2,749
Commercial paper	2,999	—	—	2,999
Total cash and cash equivalents	10,902	—	—	10,902
Marketable investments:				
U.S. government notes	17,109	28	—	17,137
U.S. government agencies	21,040	39	—	21,079
Municipal securities	3,830	5	(3)	3,832
Commercial paper	9,834	4	—	9,838
Corporate debt securities	18,755	56	(1)	18,810
Total marketable investments	70,568	132	(4)	70,696
Total cash, cash equivalents and marketable investments	$ 81,470	$ 132	$ (4)	$ 81,598

December 31, 2013	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Market Value**
Cash and cash equivalents:				
Cash	$ 3,816	$ —	$ —	$ 3,816
Money market funds	9,926	—	—	9,926
Commercial paper	2,500	—	—	2,500
Total cash and cash equivalents	16,242	—	—	16,242
Marketable investments:				
U.S. government notes	10,516	11	(5)	10,522
U.S. government agencies	25,823	38	(3)	25,858
Municipal securities	2,043	1	(5)	2,039
Commercial paper	10,239	3	—	10,242
Corporate debt securities	18,109	61	—	18,170
Total marketable investments	66,730	114	(13)	66,831

Total cash, cash equivalents and marketable investments	$ 82,972	$ 114	$ (13)	$ 83,073

As of June 30, 2014 and December 31, 2013, the total gross unrealized losses were $4,000 and $13,000, respectively, and were related to interest rate changes on available-for-sale marketable investments. The Company has concluded that it is more-likely-than-not that the securities will be held until maturity or the recovery of their cost basis. No securities were in unrealized loss positions for more than 12 months.

The following table summarizes the contractual maturities of the Company’s available-for-sale securities, classified as marketable investments as of June 30, 2014 (in thousands):

	Amount
Due in less than one year	$ 33,828
Due in 1 to 3 years	36,868
	$ 70,696

Note 3. Fair Value of Financial Instruments

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.

As of June 30, 2014, financial assets 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):

June 30, 2014	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash equivalents:				
Money market funds	$2,749	$—	$ —	$2,749
Commercial paper	—	2,999	—	2,999
Marketable investments:				
Available-for-sale securities	—	70,696	—	70,696
Total assets at fair value	$2,749	$73,695	$ —	$76,444

As of December 31, 2013, financial assets measured and recognized at fair value on a recurring basis and classified under the appropriate level of the fair value hierarchy as described above was as follows (in thousands):

December 31, 2013	Level 1	Level 2	Level 3	Total
Cash equivalents:				
Money market funds	$9,926	$—	$ —	$9,926
Commercial paper	—	2,500	—	2,500
Marketable investments:				
Available-for-sale securities	—	66,831	—	66,831
Total assets at fair value	$9,926	$69,331	$ —	$79,257

The Company’s Level 2 investments include U.S. government-backed securities and corporate securities that are valued based upon observable inputs that may include benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data including market research publications. The average remaining maturity of the Company’s Level 2 investments as of June 30, 2014 is less than 36 months and all of these investments are rated by S&P and Moody’s at A or better.

Note 4. Inventories

As of June 30, 2014 and December 31, 2013, inventories consist of the following (in thousands):

	June 30, 2014	December 31, 2013
Raw materials	$6,296	$ 5,989
Finished goods	3,734	3,017
Total	$10,030	$ 9,006

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Note 5. Warranty

The Company provides a standard one-year warranty on all systems. Warranty coverage provided is for labor and parts necessary to repair the systems during the warranty period. The Company accounts for the estimated warranty cost of the standard warranty coverage as a charge to costs of revenue when revenue is recognized. The estimated warranty cost is based on historical product performance. To determine the estimated warranty reserve, the Company utilizes historical service costs to calculate the expected service expense per system and applies this to the equivalent number of units exposed under warranty. The Company updates these estimated charges every quarter.

The following table provides the changes in the product warranty accrual for the three and six months ended June 30, 2014 and 2013 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Beginning Balance	$1,071	$1,059	$1,202	$1,212
Add: Accruals for warranties issued during the period	591	811	1,047	1,712
Less: Settlements made during the period	(582)	(821)	(1,169)	(1,875)
Ending Balance	$1,080	$1,049	$1,080	$1,049

Note 6. Deferred Service Contract Revenue

The Company generates Service revenue from the sale of extended service contracts and from time and material services provided to customers who are not under a warranty or extended service contract. Service contract revenue is recognized on a straight-line basis over the period of the applicable contract. Service revenue, from customers whose systems are not under a service contract, is recognized as the services are provided.

The following table provides changes in the deferred service contract revenue balance for the three and six months ended June 30, 2014 and 2013 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013

Beginning Balance	$12,292	$9,151	$11,637	$8,539
Add: Payments received	3,856	3,538	7,567	7,140
Less: Revenue recognized	(3,147)	(2,974)	(6,203)	(5,964)
Ending Balance	$13,001	$9,715	$13,001	$9,715

Costs for extended service contracts were $1.8 million and $3.5 million for both the three and six months ended June 30, 2014 and 2013, respectively.

Note 7. Stockholders' Equity and Stock-based Compensation Expense

Stock-based Compensation Expense

Stock-based compensation expense by department recognized during the three and six months ended June 30, 2014 and 2013 were as follows (in thousands):

	Three Months Ended		**Six Months Ended**	
	June 30,		**June 30,**	
	2014	**2013**	**2014**	**2013**
Cost of revenue	$139	$166	$271	$325
Sales and marketing	148	198	219	397
Research and development	115	89	239	190
General and administrative	291	349	589	710
Total stock-based compensation expense	$693	$802	$1,318	$1,622

Under the 2004 Equity Incentive Plan, as amended, the Company issued 291,089 shares of common stock during the six months ended June 30, 2014, in conjunction with stock options exercised.

During the six months ended June 30, 2014, the following number of equity awards of the Company's common stock was granted (in thousands):

	Shares
Stock options	177
Restricted stock units	49
Total	226

As of June 30, 2014, there was $3.5 million of unrecognized compensation expense, net of projected forfeitures, related to non-vested stock awards. The expense is expected to be recognized over the remaining weighted-average period of 2.3 years.

Note 8. Net Loss Per Share

Basic net loss per share is calculated by dividing net loss by the weighted-average number of common shares outstanding during the year. Diluted net loss per common share is the same as basic net loss per common share, as the effect of the potential common stock equivalents is anti-dilutive and as such is excluded from the calculations of the diluted net loss per share.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Options to purchase common stock	3,414	3,519	3,553	3,628
Restricted stock units	149	140	161	144
Performance stock units	6	34	6	34
Employee stock purchase plan shares	54	60	54	60
Total	3,623	3,753	3,774	3,866

Note 9. Income Taxes

The Company's quarterly income taxes reflect an estimate of the corresponding year's annual effective tax rate and include, when applicable, adjustments from discrete tax items. For the three and six months ended June 30, 2014, the Company's tax provision was $44,000 and $81,000, compared to $90,000 and $72,000 for the three and six months ended June 30, 2013. The Company's income tax provision for the three and six month ended June 30, 2014 and 2013 primarily related to income taxes for the Company's non-U.S. operations as the Company's U.S. operations were in a loss position and it maintains a 100% valuation allowance for its U.S. deferred tax assets.

The Company utilizes the asset and liability method of accounting for income taxes, under which deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized. As of June 30, 2014 and December 31, 2013, the Company had a 100% valuation allowance against its U.S. deferred tax assets. Significant management judgment is required in determining any valuation allowance recorded against deferred tax assets. In evaluating the ability to recover deferred tax assets, the Company considered available positive and negative evidence giving greater weight to its recent cumulative losses and its ability to carry-back losses against prior taxable income and lesser weight to its projected financial results due to the challenges of forecasting future periods. The Company also considered, commensurate with its objective verifiability, the forecast of future taxable income including the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies.

Note 10. Commitments and Contingencies

Litigation and Litigation Settlements

The Company is named from time to time as a party to product liability and contractual lawsuits in the normal course of business. The Company routinely assesses the likelihood of any adverse judgments or outcomes related to legal matters and claims, as well as ranges of probable losses. A determination of the amount of the reserves required, if any, for these contingencies is made after analysis of each known issue, historical experience, whether it is more likely than not that the Company shall incur a loss, and whether the loss is estimable. As of June 30, 2014 and December 31, 2013, the Company was not subject to any material litigation.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Caution Regarding Forward-Looking Statements

The following discussion should be read in conjunction with the attached condensed consolidated financial statements and notes thereto, and with our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2013 as contained in our annual report on Form 10-K filed with the SEC on March 18, 2014. This quarterly report, including the following sections, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Throughout this report, and particularly in this Item 2, the forward-looking statements are based upon our current expectations, estimates and projections and reflect our beliefs and assumptions based upon information available to us at the date of this report. In some cases, you can identify these statements by words such as "may," "might," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential" or "continue," and other similar terms. These forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties, and assumptions that are difficult to predict. Our actual results, performance or achievements could differ materially from those expressed or implied by the forward-looking statements. These forward-looking statements include, but are not limited to, statements relating to our future financial performance, the ability to grow our business, increase our revenue, manage expenses, generate additional cash, achieve and maintain profitability, develop and commercialize existing and new products and applications, and improve the performance of our worldwide sales and distribution network, and the outlook regarding long term prospects. These forward-looking statements involve risks and uncertainties. The cautionary statements set forth below and those contained in Part II, Item 1A – "Risk Factors" commencing on page 20 identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. We caution you to not place undue reliance on these forward-looking statements, which reflect management's analysis and expectations only as of the date of this report. We undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this Form 10-Q.

Introduction

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

- ***Executive Summary.*** This section provides a general description and history of our business, a brief discussion of our product lines and the opportunities, trends, challenges and risks we focus on in the operation of our business.
- ***Critical Accounting Policies and Estimates.*** This section describes the key accounting policies that are affected by critical accounting estimates.
- ***Results of Operations.*** This section provides our analysis and outlook for the significant line items on our Consolidated Statements of Operations.
- ***Liquidity and Capital Resources.*** This section provides an analysis of our liquidity and cash flows, as well as a discussion of our commitments.

Executive Summary

Company Description.

We are a leading medical device company specializing in the research, development, manufacture, marketing and servicing of laser and other energy-based aesthetics systems for practitioners worldwide. We offer easy-to-use products which enable physicians and other qualified practitioners to perform safe and effective aesthetic procedures, including vascular and benign pigmented lesions, hair-removal, skin rejuvenation, body contouring, skin resurfacing, tattoo removal and toenail fungus. Our platforms are designed to be easily upgradeable to add additional applications and hand pieces, which provide flexibility for our customers as they expand their practices. In addition to systems and upgrade revenue, we generate revenue from the sale of post warranty service contracts, providing services for products that are out of warranty, hand piece refills, and third-party manufactured dermal fillers and cosmeceuticals. In the second quarter of 2014, we terminated our agreement with Merz for the distribution of its Radiesse® dermal filler product.

Our corporate headquarters and U.S. operations are located in Brisbane, California, from where we conduct our manufacturing, warehousing, research and development, regulatory, sales and marketing, service, and administrative activities. We market, sell and service our products through direct sales and service employees in the U.S., Australia, Belgium, Canada, France, Japan, and Switzerland. Sales and Service outside of these direct markets are made through a worldwide distributor network in over 60 countries.

Products

Our revenue is derived from the sale of Products and upgrades, Service, Titan hand piece refills, and Dermal fillers and cosmeceuticals. Product and upgrade revenue includes the sales of new systems and additional applications that customers purchase as their practice grows. A system consists of a console that incorporates a universal graphic user interface, a laser and/or other energy-based module, control system software, high voltage electronics and one or more hand pieces.

Our broad portfolio of Product brands include:

- Excel V™
- Excel HR™
- Xeo®
- truSculpt™
- GenesisPlus™
- CoolGlide®
- Solera®
- myQ™
- VariLite™

Service revenue relates to amortization of prepaid service contracts, direct billings for detachable hand piece replacements (except for Titan and truSculpt) and revenue for parts and labor on out-of-warranty products. For our Titan and truSculpt hand pieces, after a set number of treatments have been performed, the customer is required to send the hand piece back to the factory for refurbishment, which we refer to as "*refilling*" the hand piece. In Japan, we distribute ZO Medical Health Inc. *("ZO")* cosmeceutical products and through the second quarter of 2014, we also distributed Merz's Radiesse® dermal filler product.

Significant Business Trends

We believe that our ability to grow revenue will be primarily dependent on the following:

- Consumer demand for the applications of our products.
- Customer (physician) demand for our products.
- Continuing to expand our product offerings both through internal development and sourcing from other vendors.
- Ongoing investment in our global sales and marketing infrastructure.

Use of clinical results to support new aesthetic products and applications.
Enhanced luminary development and reference selling efforts (to develop a location where our products can be displayed and used to assist in selling efforts).
Marketing to physicians in the core dermatology and plastic surgeon specialties, as well as outside those specialties.
Generating ongoing revenue from our growing installed base of customers through the sale of Service, Products and upgrades, Titan hand piece refills, and Cosmeceutical products.

For a detailed discussion of the significant business trends impacting our business, please see the section titled “Results of Operations” below.

Factors that May Impact Future Performance.

Our industry is impacted by numerous competitive, regulatory, macroeconomic and other significant factors. Our industry is highly competitive and our future performance depends on our ability to compete successfully. Additionally, our future performance is dependent upon our ability to continue to expand our product offerings, develop innovative technologies, obtain regulatory clearances for our products, protect the proprietary technology of our products and our manufacturing processes, manufacture our products cost-effectively, and successfully market and distribute our products in a profitable manner. If we fail to execute on the aforementioned initiatives, our business would be adversely affected. A detailed discussion of these and other factors that could impact our future performance are provided in Part II, Item 1A “Risk Factors” section below.

Critical Accounting Policies and Estimates.

The preparation of our Condensed Consolidated Financial Statements and related disclosures in conformity with GAAP requires us to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. These estimates, judgments and assumptions are based on historical experience and on various other factors that we believe are reasonable under the circumstances. We periodically review our estimates and make adjustments when facts and circumstances dictate. To the extent that there are material differences between these estimates and actual results, our financial condition or results of operations will be affected.

Critical accounting estimates, as defined by the SEC, are those that are most important to the portrayal of our financial condition and results of operations and require our management's most difficult and subjective judgments and estimates of matters that are inherently uncertain. The accounting policies and estimates that we consider to be critical, subjective, and requiring judgment in their application are summarized in "Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2013 filed with the SEC on March 18, 2014. There have been no significant changes to the accounting policies and estimates disclosed in our Form 10-K.

Results of Operations

The following table sets forth selected consolidated financial data for the periods indicated, expressed as a percentage of total revenue, net. Percentages in this table and throughout our discussion and analysis of financial condition and results of operations may reflect rounding adjustments.

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2014	**2013**	**2014**	**2013**
Net revenue	100 %	100 %	100 %	100 %
Cost of revenue	44 %	43 %	45 %	45 %
Gross margin	56 %	57 %	55 %	55 %
Operating expenses:				
Sales and marketing	44 %	37 %	44 %	38 %
Research and development	15 %	11 %	16 %	12 %
General and administrative	13 %	12 %	14 %	13 %
Total operating expenses	72 %	60 %	74 %	63 %

Loss from operations	(16)%	(3)%	(19)%	(8)%
Interest and other income, net	1 %	— %	1 %	1 %
Loss before income taxes	(15)%	(3)%	(18)%	(7)%
Provision (benefit) for income taxes	— %	— %	— %	— %
Net loss	(15)%	(3)%	(18)%	(7)%

Total Net Revenue

	Three Months Ended June 30,			Six Months Ended June 30,		
(Dollars in thousands)	**2014**	**% Change**	**2013**	**2014**	**% Change**	**2013**
Revenue mix by geography:						
United States	$8,109	6 %	$7,660	$14,126	—	$14,148
International	9,615	(19 %)	11,900	19,787	(7 %)	21,379
Consolidated total revenue	$17,724	(9 %)	$19,560	$33,913	(5 %)	$35,527
United States as a percentage of total revenue	*46 %*		*39 %*	*42 %*		*40 %*
International as a percentage of total revenue	*54 %*		*61 %*	*58 %*		*60 %*
Revenue mix by product category:						
Products and upgrades	$11,366	(13 %)	$13,034	$20,850	(6 %)	$22,231
Titan and truSculpt hand piece refills	1,005	(9 %)	1,106	2,046	(11 %)	2,296
Dermal fillers and cosmeceuticals	800	(12 %)	913	2,027	(1 %)	2,049
Total Products revenue	13,171	(13 %)	15,053	24,923	(6 %)	26,576
Service	4,553	1 %	4,507	8,990	—	8,951
Consolidated total revenue	$17,724	(9 %)	$19,560	$33,913	(5 %)	$35,527

Discussion of Revenue by Geography:

Our U.S. revenue increased by $449,000, or 6%, in the three months ended June 30, 2014, compared to the same period in 2013. This increase was due primarily to an increase in sales of our Excel V and our recently launched Excel HR products, which was partially offset by declines in sales of our truSculpt and GenesisPlus products. Our U.S. revenue remained flat in the six months ended June 30, 2014, compared to the same period in 2013.

Our international revenue decreased by $2.3 million, or 19%, and by $1.6 million, or 7%, in the three and six months ended June 30, 2014, respectively, compared to the same periods in 2013. These decreases were due primarily to decreases in revenue from our direct business in Japan and Canada and a decline in our revenue from Asia Pacific and European distributor countries, which was partially offset by an increase in our revenue from our direct business in Europe.

Discussion of Revenue by Product Type:

<u>Product and Upgrade Revenue</u>

As explained in more detail in the Products section of the Executive Summary above, some of our products consist of a configurable system platform that includes a console and one or more hand pieces. Each product is configured to give our customers the ability to select the combination of platform and hand pieces that provides the applications that best fit their practice.

Product and upgrade revenue decreased by $1.7 million, or 13%, in the three months ended June 30, 2014, compared to the same period in 2013 and by $1.4 million, or 6%, in the six months ended June 30, 2014, compared to the same period in 2013. These decreases were attributable primarily to:

Reduction in revenue from our Xeo, Genesis Plus and truSculpt products; which were offset partly by;
The continued improvement in revenue from our Excel V product; and
Revenue from our newly introduced Excel HR product

<u>Titan and truSculpt Hand Piece Refill Revenue</u>

Our Titan and truSculpt hand piece refill revenue decreased by $101,000, or 9%, in the three months ended June 30, 2014, and by $250,000, or 11%, in the six months ended June 30, 2014, compared to the same periods in 2013. These decreases were due primarily to declines in Titan hand piece refill revenue, caused partially by reduced utilization and partly due to the decline in the Japanese Yen versus the U.S. Dollar. In addition, there was a decrease in revenue from truSculpt refills due to a repositioning of the product to include hand piece refills as part of the warranty of the product.

Dermal Filler and Cosmeceuticals Revenue

Our dermal filler and cosmeceuticals revenue decreased by $113,000, or 12%, in the three months ended June 30, 2014, compared to the same period in 2013. This decrease was due primarily to the advance purchasing of products in the first quarter of 2014 to avoid the impact of the impending increase in the Japanese consumption tax rate effective April 1, 2014 as well as reduced selling prices of our filler product in the second quarter of 2014 as we exited from that business.

Our dermal filler and cosmeceuticals revenue decreased by $22,000, or 1%, in the six months ended June 30, 2014, compared to the same period in 2013. This net decline was due primarily to an increased volume of products sold in the first quarter of 2014 resulting from the advance purchasing of product in the first quarter of 2014 to avoid the impending increase in the Japanese consumption tax rate effective April 1, 2014, offset by reduced selling prices of our filler product in the second quarter of 2014 as we exited from that business.

In the second quarter of 2014, we terminated our agreement with Merz for the distribution of their Radiesse® dermal filler product. As a consequence, we expect future revenue from the Dermal Filler and Cosmeceuticals product category to decline for the remainder of 2014, compared to the same period in 2013.

Service Revenue

Our worldwide Service revenue increased by 1% in the three months ended June 30, 2014, and was flat in the six months ended June 30, 2014, compared to the same periods in 2013.

Gross Profit

(Dollars in thousands)	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	**% Change**	**2013**	**2014**	**% Change**	**2013**
Gross profit	$9,876	(11)%	$11,118	$18,762	(5)%	$19,668
As a percentage of total net revenue	56 %		57 %	55 %		55 %

Our cost of revenue consists primarily of material, personnel expenses, royalty expense, product warranty costs, amortization of intangibles and manufacturing overhead expenses.

Gross margin was 56% in the three months ended June 30, 2014, compared to 57% for the same period in 2013. Gross margin was 55% in both of the six months ended June 30, 2014 and 2013. The decline in the three months ended June 30, 2014 was due primarily to:

- Lower revenue that resulted in reduced leverage;
- A shift in the product mix towards lower margin products; partially offset by
- Improved gross margin from our Service business, due primarily to reduced material expenses resulting from improved reliability of our products; and
- Reduced amortization of intangibles related to the acquisition of Iridex's aesthetic business.

Sales and Marketing

(Dollars in thousands)	Three Months Ended June 30,			Six Months Ended June 30,		
	2014	**% Change**	**2013**	**2014**	**% Change**	**2013**
Sales and marketing	$7,754	8 %	$7,170	$15,085	11 %	$13,626
As a percentage of total net revenue	44 %		37 %	44 %		38 %

Sales and marketing expenses consist primarily of personnel expenses, expenses associated with customer-attended workshops and trade shows, post-marketing studies, and advertising. Sales and marketing expenses increased by $584,000, and represented 44% of total net revenue in the three months ended June 30, 2014, compared to 37% in the same period in 2013. This increase was due primarily to $559,000 net increase in personnel related expenses, which were driven primarily by the costs associated with expansion of our North America and Europe direct sales organization, offset by reduced personnel expenses in Japan and the marketing department.

Sales and marketing expenses increased by $1.5 million, and represented 44% of total net revenue in the six months ended June 30, 2014, compared to 38% in the same period in 2013. The $1.5 million increase was due primarily to:

$1.3 million net increase in personnel related expenses, which were driven primarily by the North American sales force realignment and expansion, offset by reduced personnel expenses in Japan and the marketing department; and
$229,000 of increased marketing and promotional expenses.

Research and Development ("R&D")

	Three Months Ended June 30,			**Six Months Ended June 30,**		
(Dollars in thousands)	**2014**	**% Change**	**2013**	**2014**	**% Change**	**2013**
Research and development	$2,622	18 %	$2,217	$5,266	21 %	$4,338
As a percentage of total net revenue	15 %		11 %	16 %		12 %

R&D expenses consist primarily of personnel expenses, clinical research, regulatory and material costs. R&D expenses increased by $405,000, and represented 15% of total net revenue in the three months ended June 30, 2014, compared to 11% for the same period in 2013. This increase was due primarily to:

$306,000 of increased material spending, which is project timing dependent, related to new product development; and
$125,000 of increased personnel related expenses due to increased headcount.

R&D expenses increased by $928,000, and represented 16% of total net revenue in the six months ended June 30, 2014, compared to 12% for the same period in 2013. The increase was due primarily to:

$748,000 of increased material spending, which is project timing dependent and related to new product development;
$287,000 of increased personnel related expenses due to increased headcount; partially offset by
$123,000 of decreased expensed tools and equipment.

General and Administrative ("G&A")

(Dollars in thousands)	Three Months Ended June 30, 2014	% Change	2013	Six Months Ended June 30, 2014	% Change	2013
General and administrative	$2,335	(1 %)	$2,354	$4,899	6 %	$4,643
As a percentage of total net revenue	13 %		12 %	14 %		13 %

G&A expenses consist primarily of personnel expenses, legal fees, accounting, audit and tax consulting fees, U.S. medical device excise tax and other general and administrative expenses. G&A expenses were flat and represented 13% of total net revenue in the three months ended June 30, 2014, compared to 12% for the same period in 2013.

G&A expenses increased $256,000, and represented 14% of total net revenue in the six months ended June 30, 2014, compared to 13% for the same period in 2013. This increase was due primarily to $200,000 of non-recurring management consulting fees incurred in the first quarter of 2014.

Interest and Other Income, Net

Interest and other income, net, consist of the following:

(Dollars in thousands)	Three Months Ended June 30, 2014	% Change	2013	Six Months Ended June 30, 2014	% Change	2013
Interest income	$99	(10 %)	$110	$193	(12 %)	$219
Other income, net	39	(211 %)	(35)	25	(378 %)	(9)
Total interest and other income, net	$138	84 %	$75	$218	4 %	$210

Interest and other income, net, increased $63,000 for the three months ended June 30, 2014, and increased by $8,000 for the six months ended June 30, 2014, compared to the same periods in 2013. These increases were primarily attributable to a reduction in net foreign exchange losses, partially offset by a decrease in interest income attributable primarily to a decrease in the invested cash balance.

Provision (Benefit) for Income Taxes

	Three Months Ended June 30,			Six Months Ended June 30,		
(Dollars in thousands)	**2014**	**% Change**	**2013**	**2014**	**% Change**	**2013**
Loss before income taxes	$(2,697)	392 %	$(548)	$(6,270)	130 %	$(2,729)
Provision for income taxes	44	(51 %)	90	81	13 %	72

We recorded an income tax provision for the three and six months ended June 30, 2014 of $44,000 and $81,000 respectively, compared to $90,000 and $72,000 for the three and six months ended June 30, 2013 respectively. Our income tax provision for the three and six months ended June 30, 2014 and 2013 was primarily related to income taxes of our non U.S. operations as our U.S. operations were in a loss position and we maintain a 100% valuation allowance for our U.S. deferred tax assets.

Liquidity and Capital Resources

Liquidity is the measurement of our ability to meet potential cash requirements, fund the planned expansion of our operations and acquire businesses. Our sources of cash include operations and stock option exercises. We actively manage our cash usage and investment of liquid cash to ensure the maintenance of sufficient funds to meet our daily needs. The majority of our cash and investments are held in U.S. banks and our foreign subsidiaries maintain a limited amount of cash in their local banks to cover their short-term operating expenses.

Cash, Cash Equivalents and Marketable Investments

The following table summarizes our cash, cash equivalents and marketable investments:

(Dollars in thousands)	**June 30, 2014**	**December 31, 2013**	**Change**
Cash and cash equivalents	$10,902	$ 16,242	$(5,340)
Marketable investments	70,696	66,831	3,865
Total	$81,598	$ 83,073	$(1,475)

Cash Flows

(Dollars in thousands)	Six Months Ended June 30, 2014	2013
Net cash flow provided by (used in):		
Operating activities	$(3,492)	$992
Investing activities	(4,287)	(16,374)
Financing activities	2,439	3,721
Net decrease in cash and cash equivalents	$(5,340)	$(11,661)

Cash Flows from Operating Activities

Net cash used in operating activities in the six months ended June 30, 2014 was $3.5 million, which was due primarily to:

$4.3 million used due to the net loss of $6.4 million, reduced by non-cash related items of $2.1 million consisting primarily of stock-based compensation expense of $1.3 million and depreciation and amortization expenses of $0.7 million;
$1.9 million used to pay off the high year-end accrued liabilities balance;
$1.0 million used to increase inventory for the anticipated new product launch; offset by
$2.1 million generated from the collection of cash from the high accounts receivable balance as of December 31, 2013; and
$1.3 million generated by an increase in deferred service revenue primarily from the sale of service contracts to an increasing installed base of customers.

Net cash generated by operating activities in the six months ended June 30, 2013 was $1.0 million, which was due primarily to:

$0.5 million used due to the net loss of $2.8 million, reduced by non-cash related items of $2.3 million consisting primarily of stock-based compensation expense of $1.6 million and depreciation and amortization expenses of $0.6 million;
$2.0 million used to pay down accrued liabilities as of December 31, 2012; partially offset by
$1.3 million generated from the collection of cash from the high accounts receivable balance as of December 31, 2012;
$1.1 million generated by an increase in deferred service revenue primarily from the sale of service contracts to an increasing installed base of customers; and
$0.6 million generated by a reduction in inventories.

Cash Flows from Investing Activities

We used net cash of $4.3 million in our investing activities in the six months ended June 30, 2014, which was attributable primarily to:

$27.9 million of cash used to purchase marketable investments;
$0.3 million used to acquire property and equipment; partially offset by
$23.8 million in net proceeds from the sales and maturities of marketable investments.

We used net cash of $16.4 million from investing activities in the six months ended June 30, 2013, which was attributable primarily to:

$37.2 million of cash used to purchase marketable investments;
$0.3 million used to acquire property and equipment; partially offset by
$21.2 million in net proceeds from the sales and maturities of marketable investments.

Cash Flows from Financing Activities

Net cash provided by financing activities was $2.4 million and $3.7 million in the six months ended June 30, 2014 and 2013, respectively, and primarily consisted of proceeds from the issuance of common stock due to employees exercising their stock options and purchasing stock through the Employee Stock Purchase Plan (or “ESPP”) program.

Adequacy of cash resources to meet future needs

We had cash, cash equivalents, and marketable investments of $81.6 million as of June 30, 2014. For the first six months of 2014, we financed our operations through the sales and maturities of marketable investments and cash from the sale of stock due to employees exercising their stock options and shares issued pursuant to our ESPP program. We believe the existing capital resources, including cash and cash equivalents and marketable investments of $81.6 million, are sufficient to meet our operating and capital requirements for the next several years, and enable us to repurchase up to the remaining $10.0 million of our stock pursuant to the $20.0 million share buy-back program approved by our Board.

Except for the recent trend of cash used to fund our operating activities, purchase fixed assets and repurchase our common stock, we are unaware of any other known trends or any known demands, commitments, events or uncertainties, including collectability of our accounts receivable, that will result in, or that are reasonably likely to result in, liquidity increasing or decreasing in any material way.

Commitments and Contingencies

There have been no material changes to our commitments and contingencies from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC on March 18, 2014.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

A summary of the key market risks facing the Company is disclosed below. For a detailed discussion, please see our Annual Report on Form 10K for the year ended December 31, 2013, filed with the SEC on March 18, 2014.

Our exposure to interest rate risk relates primarily to our investment portfolio, which includes primarily debt instruments of the U.S. Government and its agencies, municipal bonds, corporate bonds and commercial paper. Fixed rate securities may have their fair market value adversely impacted if there is an increase in interest rates. While it is our intent to hold these securities to maturity, if for some reason we need to sell a security that has declined in market value due to changes in interest rates, then we may suffer losses in principal. To minimize the exposure due to adverse shifts in interest rates, we maintain investments at a weighted average maturity of generally less than eighteen months. Based on discounted cash flow modeling with respect to our total investment portfolio as of June 30, 2014, assuming a hypothetical increase in interest rates of one percentage point (or 100 basis points), the fair value of our total investment portfolio would have potentially declined by approximately $381,000.

We do not actively hedge our exposure to currency rate fluctuations. While we transact business primarily in U.S. Dollars, and a significant proportion of our revenue is denominated in U.S. Dollars, a portion of our costs and revenue is denominated in other currencies, such as the Euro, Japanese Yen, Australian Dollar and Canadian Dollar. As a result, changes in the exchange rates of these currencies to the U.S. Dollar will affect our results from operations.

In the six months ended June 30, 2014, versus the same period in 2013, the average exchange rate of the Japanese Yen versus the U.S. Dollar declined by approximately 7%. While the effect of this foreign exchange rate decline was not significant to our net operating results, it negatively impacted our Japanese Yen denominated revenue, which was offset by a favorable impact on our cost of revenue and operating expenses.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Attached as exhibits to this Quarterly Report are ce