CUTERA INC
Form 10-Q
November 04, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period _____ to_____.

Commission file number: 000-50644

Cutera, Inc.
(Exact name of registrant as specified in its charter)

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

3240 Bayshore Blvd., Brisbane, California 94005
(Address of principal executive offices)

(415) 657-5500
(Registrant’s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

(§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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 o Accelerated filer x Non-accelerated filer o Smaller reporting company o

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

The number of shares of Registrant’s common stock issued and outstanding as of October 31, 2013 was 14,121,674.

CUTERA, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CUTERA, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

(unaudited)

	September 30, 2013	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$ 15,160	$ 23,546
Marketable investments	67,121	62,026
Accounts receivable, net	7,494	8,841
Inventories	10,421	11,114
Deferred tax asset	38	40
Other current assets and prepaid expenses	1,583	1,439
Total current assets	101,817	107,006
Property and equipment, net	1,461	933
Deferred tax asset, net of current portion	503	553
Intangibles, net	2,044	2,566
Goodwill	1,339	1,339
Other long-term assets	348	397
Total assets	$ 107,512	$ 112,794
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,100	$ 2,107
Accrued liabilities	7,784	9,493
Deferred revenue	7,195	6,618
Total current liabilities	17,079	18,218
Deferred revenue, net of current portion	3,395	2,102
Income tax liability	69	412
Other long-term liabilities	1,353	1,288
Total liabilities	21,896	22,020
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: 14,121,070 and 14,233,476 shares at September 30, 2013 and December 31, 2012,	14	14

respectively		
Additional paid-in capital	99,899	100,552
Accumulated deficit	(14,342)	(9,873)
Accumulated other comprehensive income	45	81
Total stockholders' equity	85,616	90,774
Total liabilities and stockholders' equity	$ 107,512	$ 112,794

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

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CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net revenue:				
Products	$12,480	$15,128	$39,056	$42,138
Service	4,348	4,298	13,299	12,606
Total net revenue	16,828	19,426	52,355	54,744
Cost of revenue:				
Products	5,490	6,618	17,063	19,237
Service	2,161	2,210	6,447	6,710
Total cost of revenue	7,651	8,828	23,510	25,947
Gross profit	9,177	10,598	28,845	28,797
Operating expenses:				
Sales and marketing	6,554	7,014	20,180	21,563
Research and development	2,440	2,217	6,778	6,305
General and administrative	2,160	2,475	6,803	8,824
Total operating expenses	11,154	11,706	33,761	36,692
Loss from operations	(1,977)	(1,108)	(4,916)	(7,895)
Interest and other income, net	140	152	350	392
Loss before income taxes	(1,837)	(956)	(4,566)	(7,503)
Provision (benefit) for income taxes	(169)	(64)	(97)	122
Net loss	$(1,668)	$(892)	$(4,469)	$(7,625)
Net loss per share:				
Basic and Diluted	$(0.11)	$(0.06)	$(0.31)	$(0.54)
Weighted-average number of shares used in per share calculations:				
Basic and Diluted	14,541	14,127	14,558	14,061

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

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(in thousands)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net loss	$(1,668)	$(892)	$(4,469)	$(7,625)
Other comprehensive income (loss):				
Available-for-sale investments				
Net change in unrealized gain (loss) on available-for-sale investments	94	273	(27)	822
Less: Reclassification adjustment for gains on investments recognized during the year	(9)	(6)	(9)	(18)
Net change in unrealized gain (loss) on available-for-sale investments	85	267	(36)	804
Tax provision (benefit)	—	102	—	123
Other comprehensive income (loss), net of tax	85	165	(36)	681
Comprehensive loss	$(1,583)	$(727)	$(4,505)	$(6,944)

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

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CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended September 30	
	2013	2012
Cash flows from operating activities:		
Net loss	$(4,469)	$(7,625)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Stock-based compensation	2,370	2,334
Depreciation and amortization	973	1,186
Other	43	(113)
Changes in assets and liabilities:		
Accounts receivable	1,347	(2,698)
Inventories	693	(196)
Other current assets and prepaid expenses	212	717
Other long-term assets	49	(31)
Accounts payable	(7)	(276)
Accrued liabilities	(1,877)	(163)
Other long-term liabilities	233	(24)
Deferred revenue	1,870	905
Income tax liability	(343)	(7)
Net cash provided by (used in) operating activities	1,094	(5,991)
Cash flows from investing activities:		
Acquisition of property, equipment and software	(979)	(358)
Business acquisition	—	(5,091)
Proceeds from sales of marketable and long-term investments	12,108	26,361
Proceeds from maturities of marketable investments	26,315	34,445
Purchase of marketable investments	(43,901)	(39,864)
Net cash provided by (used in) investing activities	(6,457)	15,493
Cash flows from financing activities:		
Repurchase of common stock	(7,623)	—
Proceeds from exercise of stock options and employee stock purchase plan	4,600	812
Net cash provided by (used in) financing activities	(3,023)	812
Net increase (decrease) in cash and cash equivalents	(8,386)	10,314
Cash and cash equivalents at beginning of period	23,546	14,020
Cash and cash equivalents at end of period	$15,160	$24,334

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

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CUTERA, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Description of Operations 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 the CoolGlide, Xeo, Solera, GenesisPlus, ExcelV, VariLite (acquired in 2012) and truSculpt (introduced in 2012) 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’s products offer multiple hand pieces and applications, which allow customers to upgrade their systems. The sales of systems, hand pieces, hand piece refills, upgrades, and the distribution of third party manufactured dermal fillers and cosmeceuticals are classified as Product revenue. In addition to Product revenue, the Company generates Service revenue from the sale of post-warranty service contracts, providing services for products that are out of warranty.

Headquartered in Brisbane, California, the Company has wholly-owned subsidiaries in Australia, Canada, France and Japan, that market, sell and service its products outside of the United States. The 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 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, 2012 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 financial statements and the notes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2012 filed with the Securities and Exchange Commission (the “SEC”), on March 15, 2013.

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, 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.

Note 2. Cash and Cash Equivalents and Marketable Securities

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

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The following tables summarize unrealized gains and losses related to our marketable investments, designated as available-for-sale (in thousands):

September 30, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
Cash and cash equivalents:				
Cash	$ 1,830	$ —	$ —	$ 1,830
Money market funds	12,180	—	—	12,180
Commercial paper	1,150	—	—	1,150
Total cash and cash equivalents	15,160	—	—	15,160
Marketable securities:				
U.S. government notes	5,997	14	—	6,011
U.S. government agencies	30,499	40	(13)	30,526
Municipal securities	2,604	2	(4)	2,602
Commercial paper	9,357	4	—	9,361
Corporate debt securities	18,570	56	(5)	18,621
Total marketable investments	67,027	116	(22)	67,121
Total cash, cash equivalents and marketable investments	$ 82,187	$ 116	$ (22)	$ 82,281

December 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
Cash and cash equivalents:				
Cash	$ 2,198	$ —	$ —	$ 2,198
Money market funds	17,348	—	—	17,348
Commercial paper	4,000	—	—	4,000
Total cash and cash equivalents	23,546	—	—	23,546
Marketable securities:				
U.S. government notes	4,005	4	—	4,009
U.S. government agencies	24,910	48	—	24,958
Municipal securities	4,184	23	(1)	4,206
Commercial paper	10,515	4	—	10,519
Corporate debt securities	18,281	59	(6)	18,334
Total marketable investments	61,895	138	(7)	62,026
Total cash, cash equivalents and marketable investments	$ 85,441	$ 138	$ (7)	$ 85,572

As of September 30, 2013 and December 31, 2012, the total gross unrealized losses were $22,000 and $7,000, respectively, and were related to interest rate changes on short-term marketable investments. The Company has concluded that it is more-likely-than-not that the securities will be held until maturity or a recovery of the cost basis. No securities were in unrealized loss positions for more than 12 months.

The following table summarizes the estimated fair value of our securities available-for-sale and classified as cash and cash equivalents and marketable investments classified by the contractual maturity date of the security as of September 30, 2013 (in thousands):

	Amount
Due in less than one year	$31,472
Due in 1 to 3 years	36,799
	$68,271

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:

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- 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 September 30, 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):

September 30, 2013	Level 1	Level 2	Level 3	Total
Cash equivalents:				
Money market funds	$12,180	—	—	$12,180
Commercial paper	—	1,150	—	1,150
Short-term marketable investments:				
U.S. government notes	—	6,011	—	6,011
U.S. government agencies	—	30,526	—	30,526
Municipal securities	—	2,602	—	2,602
Commercial paper	—	9,361	—	9,361
Corporate debt securities	—	18,621	—	18,621
Total assets at fair value	$12,180	$68,271	$ —	$80,451

As of December 31, 2012, 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, 2012	Level 1	Level 2	Level 3	Total
Cash equivalents:				
Money market funds	$17,348	—	—	$17,348
Commercial paper	—	4,000	—	4,000
Short-term marketable investments:				
U.S. government notes	—	4,009	—	4,009
U.S. government agencies	—	24,958	—	24,958
Municipal securities	—	4,206	—	4,206
Commercial paper	—	10,519	—	10,519
Corporate debt securities	—	18,334	—	18,334
Total assets at fair value	$17,348	$66,026	$ —	$83,374

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 September 30, 2013 is less than 36 months and all of these investments are rated by S&P and Moody's at A or better.

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Note 4. Inventories

Inventories consist of the following (in thousands):

	September 30, 2013	December 31, 2012
Raw materials	$ 6,368	$ 7,221
Finished goods	4,053	3,893
Total	$ 10,421	$ 11,114

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 nine-month period ended September 30, 2013 (in thousands):

	Amount
Beginning Balance – December 31, 2012	$1,212
Add: Accruals for warranties issued during the period	2,403
Less: Settlements made during the period	(2,557)
Ending Balance –September 30, 2013	$1,058

Note 6. Deferred Service Contract Revenue

Service contract revenue is recognized on a straight-line basis over the period of the applicable extended warranty contract.

The following table provides changes in deferred service contract revenue for the nine-month periods ended September 30, 2013 and 2012 (in thousands):

		September 30,	
		2013	2012
Beginning Balance		$8,539	$5,838
Add:	Payments received	10,869	9,335
Add:	Contract revenue assumed with business acquisition	—	780
Less:	Revenue recognized	(8,937)	(8,359)
Ending Balance		$10,471	$7,594

Costs incurred under service contracts were $5.2 million and $5.4 million for the nine-month periods ended September 30, 2013 and 2012, which were recognized as incurred.

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

Share Repurchase Program

On August 5, 2013, the Company's Board of Directors modified Cutera, Inc.'s stock buyback program, originally adopted in November 2012, to permit an additional $10 million of its issued and outstanding common shares to be repurchased. As modified, the stock buyback program permits the Company to purchase an aggregate of $20 million of its common stock through a 10b5-1 program based on predetermined pricing and volume parameters, as well as open-market purchases that are subject to management discretion and regulatory restrictions.

In the quarter ended September 30, 2013, the Company repurchased 796,919 shares of its common stock for approximately $7.6 million. As of September 30, 2013, there remained an additional $12.4 million of the Company's common stock to be purchased under the modified stock buyback program. The number of shares to be repurchased and the timing of such repurchases will be based on several factors, including the price of the Company's common stock, regulatory restrictions, and general market and business conditions.

Stock-based Compensation Expense

Stock-based compensation expense by department recognized during the three and nine-month periods ended September 30, 2013 and 2012 were as follows (in thousands):

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	Three Months Ended September 30, 2013	2012	Nine Months Ended September 30, 2013	2012
Cost of revenue	$159	$169	$484	$480
Sales and marketing	182	177	579	476
Research and development	103	126	293	419
General and administrative	304	337	1,014	959
Total stock-based compensation expense	$748	$809	$2,370	$2,334

Under the 2004 Equity Incentive Plan, the Company issued 556,674 shares of common stock during the nine-month period ended September 30, 2013, in conjunction with stock options exercised.

During the nine-month period ended September 30, 2013, the following number of equity awards of the Company's common stock was granted (in thousands):

	Shares
Stock options	1,007
Restricted stock units	189
Performance stock units	34
Total	1,230

As of September 30, 2013, there was $5.1 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 2.8 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 number 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 September 30, 2013	2012	Nine Months Ended September 30, 2013	2012
Options to purchase common stock	4,134	3,910	3,799	3,680
Restricted stock units	206	132	168	79
Performance stock units	34	16	34	14
Employee stock purchase plan shares	27	30	60	52
Total	4,401	4,088	4,061	3,825

Note 9. Income Taxes

For the three months ended September 30, 2013 and 2012, the Company’s tax benefit was $169,000 and $64,000, respectively. For the nine months ended September 30, 2013 and 2012, the Company’s tax benefit was $97,000 and tax expense was $122,000 respectively. The Company’s income tax benefit for the three and nine-month periods ended September 30, 2013 was primarily attributable to a release of uncertain tax position reserves, partially offset by income taxes of the Company’s international operations. The Company’s income tax benefit for the three-month period ended September 30, 2012 was primarily related to gains and losses on marketable and long term investments recorded in other comprehensive loss partially offset by income taxes of the Company’s international operations. The Company’s tax expense for the nine-month period ended September 30, 2012 was primarily related to income taxes of the Company’s international operations partially offset by benefits for income taxes related to gains and losses on marketable and long term investments recorded in other comprehensive loss.

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 September 30, 2013 and December 31, 2012, 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.

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On January 2, 2013, the President signed into law The American Taxpayer Relief Act of 2012, or ATRA. Under prior law, a taxpayer was entitled to a research tax credit for qualifying amounts incurred through December 31, 2011. The ATRA extends the research credit for two years for qualified research expenditures incurred through the end of 2013. The extension of the research credit is retroactive and includes amounts incurred after 2011. The benefit of the reinstated credit did not impact the Company’s statement of operations for the three and nine months ended September 30, 2013, as the research and development credit carryforwards are offset by a full valuation allowance.

Note 10. Commitments and Contingencies

Capital Lease Obligation

During 2013, the Company financed vehicles for some of its sales employees in North America. As of September 30, 2013 the gross capitalized value of the leased vehicles was $487,000 and the related accumulated depreciation was $64,000. As of September 30, 2013 the minimum lease payments are as follows (in thousands):

Fiscal Year Ending December 31,	Amount
2013(remainder)	$ 33
2014	130
2015	130
2016	142
Total	$ 435

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 September 30, 2013, the Company had accrued approximately $0.1 million related to pending product liability and contractual lawsuits.

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, 2012 as contained in our annual report on Form 10-K filed with the SEC on March 15, 2013. 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,” “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 22 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.

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 United States, Canada, Japan, France and Australia. Sales and Service outside of these direct markets are made through a worldwide distributor network in over 60 countries.

Products

Our Product revenue is derived from the sale of Products and upgrades, Service, Titan and truSculpt hand piece refills, and Dermal fillers and cosmeceuticals. Product revenue includes the sales of systems. 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:

- ExcelV™
- Xeo®
- GenesisPlus™
- truSculpt™
- CoolGlide®
- Solera®
- myQ™
- VariLite™

We offer our customers the ability to select the system that best fits their practice at the time of purchase and then to cost-effectively add applications to their system as their practice grows, resulting in Upgrade revenue. 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 Merz Pharma GmbH’s (“Merz”) Radiesse® dermal filler product and Obagi Medical Products, Inc.’s (“Obagi”) cosmeceutical products. We have entered into a contract with ZO Medical Health Inc. (“ZO”) and with effect from the fourth quarter of 2013, plan to discontinue sales of some of the Obagi cosmeceutical products in favor of comparable ZO products.
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Significant Business Trends

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

- Consumer demand for the application of 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.
- Our ability to hire, train and retain sales and other key employees.
- 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.
- Customer demand for our products.
- Generating ongoing revenue from our growing installed base of customers through the sale of Service, Upgrade, Titan and truSculpt hand piece refills, and Dermal fillers and cosmeceuticals.

Revenue by Geography

Our U.S. revenue decreased by $795,000, or 10%, in the three-month period ended September 30, 2013, and decreased by $792,000, or 4%, in the nine-month period ended September 30, 2013, compared to the same periods in 2012. The decrease in the three and nine-month periods ended September 30, 2013, compared to the same periods 2012, was due primarily to a decline in the U.S. product revenue. These declines were due primarily to:

- Reduction in our GenesisPlus revenue due in part to the disruption caused by the reorganization and consolidation of the podiatry sales team into the general aesthetics sales force;
- Decline of our truSculpt product revenue during the quarter ended September 30, 2013, compared to the same period in 2012;
- Reduced productivity of our U.S. sales force, caused in part by field sales and sales management turnover; which was partially offset by
- Continued improvement in revenue from our ExcelV product.

Our international revenue decreased by $1.8 million, or 16%, in the three-month period ended September 30, 2013, and decreased by $1.6 million, or 5%, in the nine-month period ended September 30, 2013, compared to the respective periods in 2012. These revenue declines resulted primarily from lower sales in Canada, Australia and Japan, offset in part by higher revenue from several of our Asian and European distributor countries and our direct operations in France. The decline in the Japanese Yen versus the U.S. Dollar in each of the three quarters ended September 30, 2013, compared to the respective periods in 2012, was the primary driver of the reduced revenue sourced from our Japanese customers. In the three and nine month periods ended September 30, 2013, compared to the respective periods in 2012, our Japanese sourced revenue was negatively impacted by approximately $0.6 million and $1.4 million, respectively.

Revenue by Product Category

Significant changes in revenue by product category were:

- An increase in our worldwide Service revenue by 5% in the nine months ended September 30, 2013, compared to the same period in 2012. This was primarily due to an expanded customer base as well as there being nine months of service revenue for the Iridex aesthetic business in 2013, versus eight months in 2012, as the acquisition of the Iridex aesthetic business occurred in February 2012;
- A decline in our product and upgrade revenue as a result of reduced revenue from GenesisPlus by approximately $1.0 million in the three months and $2.8 million in the nine months ended September 30, 2013, compared to the same periods in 2012. In addition, our truSculpt revenue declined in the three months ended September 30, 2013. These declines were partialy offset by the continued improvement in revenue from our ExcelV product;
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- Reduced revenue from Dermal filler and cosmeceutical products in Japan, due primarily to the decline in the Japanese Yen versus the U.S. Dollar;
- Decline in Titan and truSculpt refill revenue in the three and nine months ended September 30, 2013, due to decline in the Japanese Yen versus the U.S. Dollar as well as the repositioning of our truSculpt product. We have repositioned our truSculpt product to include hand piece refills to be covered as part of our system warranty and service contracts, enabling our customers unlimited hand piece refills.

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.

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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, 2012 filed with the SEC on March 15, 2013. 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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net revenue	100%	100%	100%	100%
Cost of revenue	45%	45%	45%	47%
Gross margin	55%	55%	55%	53%
Operating expenses:				
Sales and marketing	39%	36%	39%	39%
Research and development	15%	11%	13%	12%
General and administrative	13%	13%	13%	16%
Total operating expenses	67%	60%	65%	67%
Loss from operations	(12)%	(5)%	(10)%	(14)%
Interest and other income, net	1%	—%	1%	—%
Loss before income taxes	(11)%	(5)%	(9)%	(14)%
Provision (benefit) for income taxes	(1)%	—%	—%	—%
Net loss	(10)%	(5)%	(9)%	(14)%

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Total Net Revenue

	Three Months Ended September 30,			Nine Months Ended September 30,		
(Dollars in thousands)	2013	% Change	2012	2013	% Change	2012
Revenue mix by geography:						
United States	$7,001	(10)%	$7,796	$21,149	(4)%	$21,941
International	9,827	(16)%	11,630	31,206	(5)%	32,803
Consolidated total revenue	$16,828	(13)%	$19,426	$52,355	(4)%	$54,744
United States as a percentage of total revenue	42 %		40 %	40 %		40 %
International as a percentage of total revenue	58 %		60 %	60 %		60 %
Revenue mix by product category:						
Products and upgrades	$10,440	(17)%	$12,534	$32,671	(5)%	$34,279
Titan and truSculpt hand piece refills	927	(24)%	1,226	3,223	(10)%	3,572
Dermal fillers and cosmeceuticals	1,113	(19)%	1,368	3,162	(26)%	4,287
Total Product Revenue	12,480	(18)%	15,128	39,056	(7)%	42,138
Service	4,348	1 %	4,298	13,299	5 %	12,606
Consolidated total revenue	$16,828	(13)%	$19,426	52,355	(4)%	$54,744

Discussion of Revenue by Product Type:

Product and Upgrade Revenue

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 $2.1 million, or 17%, in the three-month period ended September 30, 2013, compared to the same period in 2012, and by $1.6 million, or 5%, in the nine-month period ended September 30, 2013, compared to the same period in 2012. The declines were attributable primarily to:

- Reduced revenue from GenesisPlus by approximately $1.0 million and $2.8 million in the three and nine months ended September 30, 2013, compared to the same periods in 2013, respectively, due in part to the distraction caused by the sales employee attrition in the podiatry sales team and the consolidation of the remaining podiatry sales employees into the aesthetic sales team;
- Decline in revenue due to the devaluation of the Japanese Yen versus the U.S. Dollar;
- Decline in our truSculpt product revenue during the quarter ended September 30, 2013, compared to the same period in 2012;
- Reduction in revenue from our legacy products caused in part by competitive pricing declines; which was offset partially by
- The continued improvement in revenue from our ExcelV product.

Titan and truSculpt Hand Piece Refill Revenue

Our Titan and truSculpt hand piece refill revenue decreased by $299,000, or 24%, in the three-month period ended September 30, 2013, compared to the same period in 2012, and by $349,000, or 10%, in the nine-month period ended September 30, 2013, compared to the same period in 2012. This decrease was 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, which was offset in part by an increase in revenue from truSculpt refills that started shipping from the fourth quarter ended December 31, 2012. Commencing with the third quarter of 2013 we have repositioned our truSculpt product to include hand piece refills to be covered as part of our system warranty and service contracts, enabling our customers unlimited hand piece refills.

Dermal Filler and Cosmeceuticals Revenue

Our dermal filler and cosmeceuticals revenue decreased by $255,000, or 19%, in the three-month period ended September 30, 2013, compared to the same period in 2012, and by $1.1 million, or 26%, in the nine-month period ended September 30, 2013, compared to the same period in 2012. This decrease was due primarily to the weakening of the Japanese Yen, versus the U.S. Dollar, and some volume discounting.

Service Revenue

Our worldwide Service revenue increased by $50,000, or 1%, in the three-month period ended September 30, 2013, compared to the same period in 2012, and by $693,000, or 5%, in the nine-month period ended September 30, 2013, compared to the same period in 2012. This increase was primarily due to an expanded customer base as well as one additional month of service revenue in 2013 relating to the acquisition of the Iridex aesthetic business in February 2012.

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Discussion of Revenue by Geography:

Refer to the discussion of Revenue by Geography in Significant Business Trends above.

Gross Profit

	Three Months Ended September 30,			Nine Months Ended September 30,		
(Dollars in thousands)	2013	% Change	2012	2013	% Change	2012
Gross profit	$9,177	(13 %)	$10,598	$28,845	— %	$28,797
Gross margin (Gross profit as a percentage of total net revenue)	55 %		55 %	55 %		53 %

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

Gross margin remained flat at 55% in the three-month period ended September 30, 2013, compared to the same period in 2012. The gross margin was 55% in the nine-month period ended September 30, 2013, compared to 53% for the same period in 2012. This improvement was due primarily to:

- a partial shift in product mix towards higher margin products;
- improved gross margin from our Service business, due primarily to reduced material expenses resulting from improved reliability of our products;
- results of cost reduction initiatives; and
- reduced amortization of intangibles related to the acquisition of Iridex's aesthetic business.

Sales and Marketing

Three Months Ended September 30,