ITT EDUCATIONAL SERVICES INC
Form 10-Q
July 29, 2005
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended June 30, 2005**

**OR**

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

**For the transition period from ______ to ______**

**Commission file number 1-13144**

# ITT EDUCATIONAL SERVICES, INC.

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware**<br>**(State or other jurisdiction of**<br>**incorporation or organization)** | **36-2061311**<br>**(I.R.S. Employer**<br>**Identification No.)** |
| **13000 North Meridian Street**<br>**Carmel, Indiana**<br>**(Address of principal executive offices)** | **46032-1404**<br>**(Zip Code)** |

**Registrant s telephone number, including area code: (317) 706-9200**

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes x No ¨

**46,246,482**

Number of shares of Common Stock, $.01 par value, outstanding at June 30, 2005

**ITT EDUCATIONAL SERVICES, INC.**

Carmel, Indiana

Quarterly Report to Securities and Exchange Commission

June 30, 2005

PART I

FINANCIAL INFORMATION

**Item 1. FINANCIAL STATEMENTS.**

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**ITT EDUCATIONAL SERVICES, INC.**

**CONSOLIDATED BALANCE SHEETS**

**(Dollar amounts in thousands, except per share data)**

| | As of | | |
|---|---|---|---|
| | **June 30, 2005** | **December 31, 2004** | **June 30, 2004** |
| | **(unaudited)** | | **(unaudited)** |
| **Assets** | | | |
| Current assets | | | |
| Cash and cash equivalents | $ 37,283 | $ 9,389 | $ 17,967 |
| Restricted cash | | 8,194 | |
| Short-term investments | 312,734 | 332,570 | 248,482 |
| Accounts receivable, net | 13,722 | 10,430 | 11,320 |
| Deferred and prepaid income tax | 6,746 | 6,587 | 4,399 |
| Prepaids and other current assets | 14,966 | 5,611 | 6,910 |
| Total current assets | 385,451 | 372,781 | 289,078 |
| Property and equipment, net | 119,829 | 98,746 | 88,464 |
| Direct marketing costs | 16,497 | 14,713 | 12,926 |
| Investments | 3,055 | 6,363 | 18,509 |
| Other assets | 561 | 786 | 959 |
| Total assets | $ 525,393 | $ 493,389 | $ 409,936 |
| **Liabilities and Shareholders Equity** | | | |
| Current liabilities | | | |
| Accounts payable | $ 39,688 | $ 33,769 | $ 59,347 |
| Accrued compensation and benefits | 12,534 | 16,122 | 14,623 |
| Other accrued liabilities | 25,941 | 26,418 | 20,838 |
| Deferred revenue | 140,346 | 156,792 | 122,521 |
| Total current liabilities | 218,509 | 233,101 | 217,329 |
| Deferred income tax | 10,580 | 12,842 | 4,431 |
| Minimum pension liability | 9,101 | 9,101 | 7,012 |
| Other liabilities | 7,121 | 3,271 | 2,985 |
| Total liabilities | 245,311 | 258,315 | 231,757 |
| Shareholders equity | | | |
| Preferred stock, $.01 par value, 5,000,000 shares authorized, none issued or outstanding | | | |
| Common stock, $.01 par value, 300,000,000 shares authorized, 54,068,904 issued and outstanding | 540 | 540 | 540 |
| Capital surplus | 62,914 | 59,657 | 57,332 |
| Retained earnings | 330,325 | 293,910 | 242,303 |
| Accumulated other comprehensive loss | (5,532) | (5,532) | (4,263) |
| Treasury stock, 7,822,422, 8,074,919 and 8,331,843 shares, at cost | (108,165) | (113,501) | (117,733) |

| | | | |
|---|---|---|---|
| Total shareholders equity | 280,082 | 235,074 | 178,179 |
| Total liabilities and shareholders equity | $ 525,393 | $ 493,389 | $ 409,936 |

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

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**ITT EDUCATIONAL SERVICES, INC.**

**CONSOLIDATED STATEMENTS OF INCOME**

**(Dollar amounts in thousands, except per share data)**

**(unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2005** | **2004** | **2005** | **2004** |
| **Revenue** | $ 168,782 | $ 150,931 | $ 328,935 | $ 292,661 |
| **Costs and expenses** | | | | |
| Cost of educational services | 81,795 | 78,010 | 161,916 | 154,503 |
| Student services and administrative expenses | 52,165 | 45,045 | 101,359 | 86,494 |
| Special legal and other investigation costs | | 5,606 | 7,712 | 15,306 |
| Total costs and expenses | 133,960 | 128,661 | 270,987 | 256,303 |
| **Operating income** | 34,822 | 22,270 | 57,948 | 36,358 |
| Interest income, net | 2,205 | 648 | 3,919 | 1,357 |
| Income before income taxes | 37,027 | 22,918 | 61,867 | 37,715 |
| Income taxes | 14,626 | 8,938 | 24,438 | 14,709 |
| **Net income** | $ 22,401 | $ 13,980 | $ 37,429 | $ 23,006 |
| **Earnings per share:** | | | | |
| Basic | $ 0.49 | $ 0.31 | $ 0.81 | $ 0.50 |
| Diluted | $ 0.48 | $ 0.30 | $ 0.79 | $ 0.49 |
| **Weighted average shares:** | | | | |
| Basic | 46,181 | 45,726 | 46,134 | 45,667 |
| Diluted | 47,134 | 46,770 | 47,107 | 46,767 |

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

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**ITT EDUCATIONAL SERVICES, INC.**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Dollar amounts in thousands)**

**(unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2005** | **2004** | **2005** | **2004** |
| **Cash flows from operating activities:** | | | | |
| Net income | $ 22,401 | $ 13,980 | $ 37,429 | $ 23,006 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 4,442 | 4,921 | 8,738 | 9,788 |
| Provision for doubtful accounts | 3,028 | 2,400 | 5,899 | 4,901 |
| Deferred income taxes | 1,184 | 2,169 | (2,420) | (1,753) |
| Changes in operating assets and liabilities: | | | | |
| Short-term investments | | 13,161 | | 11,343 |
| Accounts receivable | (3,965) | (5,201) | (9,191) | (6,823) |
| Prepaids and other assets | 352 | 64 | (9,130) | (3,424) |
| Direct marketing costs | (888) | (947) | (1,784) | (2,082) |
| Accounts payable and accrued liabilities | 58 | 19,949 | 5,724 | 22,714 |
| Deferred revenue | (10,317) | (5,164) | (16,446) | (7,843) |
| Net cash flows from operating activities | 16,295 | 45,332 | 18,819 | 49,827 |
| **Cash flows from investing activities:** | | | | |
| Facility expenditures and land purchases | (10,232) | (6,798) | (19,816) | (6,798) |
| Capital expenditures, net | (6,859) | (6,927) | (10,005) | (9,951) |
| Proceeds from sales and maturities of investments | 116,331 | 385,447 | 310,078 | 626,433 |
| Purchase of investments | (106,375) | (422,698) | (286,934) | (702,131) |
| Net cash flows from investing activities | (7,135) | (50,976) | (6,677) | (92,447) |
| **Cash flows from financing activities:** | | | | |
| Exercise of stock options | 2,548 | 555 | 7,558 | 9,049 |
| Net cash flows from financing activities | 2,548 | 555 | 7,558 | 9,049 |
| Net change in cash, cash equivalents and restricted cash | 11,708 | (5,089) | 19,700 | (33,571) |
| Cash, cash equivalents and restricted cash at beginning of period | 25,575 | 23,056 | 17,583 | 51,538 |
| **Cash, cash equivalents and restricted cash at end of period** | $ 37,283 | $ 17,967 | $ 37,283 | $ 17,967 |

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

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**ITT EDUCATIONAL SERVICES, INC.**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

**(Dollar and share amounts in thousands)**

| | Common Stock | | | | Compre- | Accumulated Other | Treasury Stock | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | Capital | Retained | hensive | Comprehensive | | | |
| | Shares | Amount | Surplus | Earnings | Income | Loss | Shares | Amount | Total |
| **Balance as of December 31, 2003** | 54,069 | $ 540 | $ 52,688 | $ 221,400 | | $ (4,263) | (8,638) | $ (124,241) | $ 146,124 |
| For the six months ended June 30, 2004 (unaudited): | | | | | | | | | |
| Exercise of stock options | | | 178 | (2,103) | | | 306 | 6,508 | 4,583 |
| Tax benefit from exercise of stock options | | | 4,466 | | | | | | 4,466 |
| Net income | | | | 23,006 | $ 23,006 | | | | 23,006 |
| **Balance as of June 30, 2004** | 54,069 | 540 | 57,332 | 242,303 | | (4,263) | (8,332) | (117,733) | 178,179 |
| For the six months ended December 31, 2004 (unaudited): | | | | | | | | | |
| Exercise of stock options | | | 436 | (650) | | | 257 | 4,232 | 4,018 |
| Tax benefit from exercise of stock options | | | 1,889 | | | | | | 1,889 |
| Net income | | | | 52,257 | 52,257 | | | | 52,257 |
| Other comprehensive income, net of tax: | | | | | | | | | |
| Minimum pension liability adjustment | | | | | (1,269) | (1,269) | | | (1,269) |
| Other comprehensive income | | | | | (1,269) | | | | |
| Comprehensive income for year ended December 31, 2004 | | | | | $ 73,994 | | | | |
| **Balance as of December 31, 2004** | 54,069 | 540 | 59,657 | 293,910 | | (5,532) | (8,075) | (113,501) | 235,074 |
| For the six months ended June 30, 2005 (unaudited): | | | | | | | | | |
| Exercise of stock options | | | 274 | (1,014) | | | 252 | 5,330 | 4,590 |
| Tax benefit from exercise of stock options | | | 2,969 | | | | | | 2,969 |
| Issue treasury stock for Directors Deferred Compensation Plan | | | 14 | | | | 1 | 6 | 20 |
| Net income | | | | 37,429 | | | | | 37,429 |
| **Balance as of June 30, 2005** | 54,069 | $ 540 | $ 62,914 | $ 330,325 | | $ (5,532) | (7,822) | $ (108,165) | $ 280,082 |

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

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**ITT EDUCATIONAL SERVICES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2005**

**(Dollar amounts in thousands, except per share data and unless otherwise stated)**

1. **Basis of Presentation**

The accompanying unaudited consolidated financial statements include the accounts of ITT Educational Services, Inc. and its wholly-owned subsidiaries. We prepared the accompanying unaudited consolidated financial statements in accordance with U.S. generally accepted accounting principles for interim periods and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures, including significant accounting policies, normally included in a complete presentation of financial statements prepared in accordance with and pursuant to those principles, rules and regulations have been omitted. In the opinion of our management, the financial statements contain all adjustments necessary to fairly state our financial condition and results of operations. The interim financial information should be read in conjunction with the audited financial statements and notes thereto contained in our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2004.

2. **Summary of Certain Accounting Principles and Policies**

*Revision in the Classification of Certain Cash Equivalents and Investments*. Certain cash equivalents and investments reclassifications have been made to the 2004 financial statements to conform to the 2005 presentation. Previously, some of our investments in auction rate debt securities and variable rate demand notes were recorded in cash and cash equivalents instead of short-term investments, based on their interest reset dates rather than their remaining contractual maturity dates. In addition, we had classified some of our investments in auction rate debt securities, variable rate demand notes and auction rate preferred equity securities as held-to-maturity securities instead of available-for-sale securities.

As a result, our Consolidated Balance Sheets were affected as follows:

- cash and cash equivalents decreased and short-term investments increased by $165,360 as of June 30, 2004; and

- investments as of June 30, 2004 did not change.

We also made corresponding adjustments to our Consolidated Statements of Cash Flows for the three and six months ended June 30, 2004, as follows:

- net cash provided by proceeds from sales and maturities of investments increased $349,145 for the three months ended June 30, 2004 and $567,231 for the six months ended June 30, 2004;

net cash used for purchase of investments increased $351,133 for the three months ended June 30, 2004 and $607,360 for the six months ended June 30, 2004; and

net change in cash, cash equivalents and restricted cash decreased $1,988 for the three months ended June 30, 2004 and $40,129 for the six months ended June 30, 2004.

The reclassifications had no impact on our total current assets, cash flows from operating activities, or total consolidated results reported in any period presented.

*Stock Options.* We adopted and our stockholders approved the ITT Educational Services, Inc. 1994 Stock Option Plan ( 1994 Stock Plan ) and the 1997 ITT Educational Services, Inc. Incentive Stock Plan ( 1997 Stock Plan ). We also established the 1999 Outside Directors Stock Option Plan ( 1999 Directors Stock Plan ), which provides for awards of non-qualified stock options to non-employee Directors. The 1994 Stock Plan, the 1997 Stock Plan and the 1999 Directors Stock Plan are referred to herein collectively as the Plans. We have adopted the disclosure only provisions of Statements of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation. Accordingly, no compensation cost has been recognized in the financial statements for the Plans. We have elected, as permitted by the standard, to continue following the intrinsic value based method of accounting for stock options consistent with Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees. Under the intrinsic method, compensation cost for stock options is measured as the excess, if any, of the quoted market price of our common stock at the measurement date over the exercise price.

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If compensation costs for the Plans had been determined based on the fair value of the stock options at grant date consistent with SFAS No. 123, our compensation costs would have increased and our net income and earnings per share would have been reduced to the pro forma amounts indicated below:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Net income as reported | $ 22,401 | $ 13,980 | $ 37,429 | $ 23,006 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method for stock options, net of tax | (1,984) | (2,139) | (3,926) | (4,061) |
| Pro forma net income | $ 20,417 | $ 11,841 | $ 33,503 | $ 18,945 |
| Earnings per share: | | | | |
| Basic as reported | $ 0.49 | $ 0.31 | $ 0.81 | $ 0.50 |
| Impact of stock options | (0.05) | (0.05) | (0.08) | (0.09) |
| Basic pro forma | $ 0.44 | $ 0.26 | $ 0.73 | $ 0.41 |
| Diluted as reported | $ 0.48 | $ 0.30 | $ 0.79 | $ 0.49 |
| Impact of stock options | (0.05) | (0.05) | (0.08) | (0.08) |
| Diluted pro forma | $ 0.43 | $ 0.25 | $ 0.71 | $ 0.41 |

We changed our fair value option pricing model from the Black-Scholes model to a binomial model for all stock options granted on or after January 1, 2005. The fair value of stock options granted prior to January 1, 2005 was determined using the Black-Scholes model. We believe that the binomial model considers characteristics of fair value option pricing that are not available under the Black-Scholes model. Similar to the Black-Scholes model, the binomial model takes into account variables such as volatility, dividend yield rate and risk free interest rates. The binomial model, however, also considers the contractual term of the option, the probability that the option will be exercised prior to the end of its contractual life and the probability of termination or retirement of the option holder in computing the value of the option. The fair value of each option grant was estimated on the date of grant using the following assumptions:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Risk free interest rates | 3.8% | 4.0% | 3.8% | 3.3% |
| Expected lives (in years) | 4.9 | 5.0 | 4.9 | 5.0 |
| Volatility | 45% | 59% | 46% | 58% |
| Dividend yield | None | None | None | None |

*Leases*. We lease our non-owned facilities under operating lease agreements. Certain of our lease agreements contain: renewal options, which can be exercised after the initial lease term; rent holidays; tenant improvement allowances; and/or rent escalation clauses. We record rent expense associated with each lease agreement evenly over the term of the lease in accordance with SFAS No. 13, Accounting for Leases. The difference between rent expense recorded and amounts paid is recorded as accrued rent on our Consolidated Balance Sheets. We amortize leasehold improvements using the straight-line method over the shorter of the life of the improvement or the remaining term of the lease.

3. **New Accounting Pronouncements**

In June 2004, the Financial Accounting Standards Board s ( FASB ) Emerging Issues Task Force ( EITF ) issued EITF 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. EITF 03-1 provides further guidance on the meaning of other-than-temporary impairment and its application to debt and equity securities in accordance with APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, and SFAS No. 115, Accounting for

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Certain Investments in Debt and Equity Securities. In September 2004, the FASB issued FASB Staff Position EITF 03-1-1, which delays the effective date until additional guidance is issued for the application of the recognition and measurement provisions of EITF 03-1 to investments in securities that are impaired. The disclosure requirements of EITF 03-1, however, are effective for annual periods ending after June 15, 2004. Until further guidance is provided by the FASB, we are unable to determine the effect, if any, that EITF 03-1 will have on our financial condition or results of operations. See Note 5 for additional disclosures regarding our investments.

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment, that revises SFAS No. 123, Accounting for Stock-Based Compensation, and supercedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Under this revised standard, all share-based payments to employees, including grants of employee stock options, must be reflected in the financial statements using the fair value method with the related expenses recognized over the service period. SFAS No. 123R will be effective for fiscal years beginning after June 15, 2005 and allows for several alternative transition methods. We expect to adopt SFAS No. 123R in our 2006 fiscal year on a modified-prospective basis without restating prior periods, which will require that we recognize compensation expense for all stock option and other equity-based awards that vest or become exercisable after the effective date. We are currently evaluating the impact that SFAS No. 123R will have on our financial condition or results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, that replaces APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. Under this new standard, voluntary changes in accounting principles must be applied retrospectively with all prior period financial statements presented. SFAS No. 154 also requires that any change in the method of depreciation, amortization or depletion for long-lived non-financial assets must be accounted for prospectively as a change in accounting estimate, and corrections of errors in previously issued financial statements should be termed a restatement. SFAS No. 154 is effective for changes in accounting principles and correction of errors made in fiscal years beginning after December 15, 2005. We do not believe that SFAS No. 154 will have a material impact on our consolidated financial statements.

4. **Special Legal and Other Investigation Costs**

Consistent with our accounting policy for contingent liabilities (pursuant to which we accrue probable legal costs associated with a claim or a potential claim), no charge was recorded in the three months ended June 30, 2005 for estimated legal costs associated with the investigation of us by the U.S. Department of Justice ( DOJ ), the inquiry initiated by the SEC into the allegations being investigated by the DOJ, and the securities class action, shareholder derivative and books and records inspection lawsuits filed against us, certain of our current and former executive officers and each of our Directors (collectively, the Actions ), as described below in Note 10. We did record a charge, however, of $5,606 in the three months ended June 30, 2004 for estimated legal costs associated with the Actions. We recorded a charge of $7,712 in the six months ended June 30, 2005 and $15,306 in the six months ended June 30, 2004 for estimated legal costs associated with the Actions. We were billed $4,064 of those legal costs in the six months ended June 30, 2005 and $15,950 of those legal costs in the year ended December 31, 2004. We regularly evaluate the reasonableness of our estimate of the probable legal costs associated with the Actions and make any adjustments considered necessary. We believe that it is probable that we will incur at least $28,417 in legal costs related to these matters ($20,705 recorded in the year ended December 31, 2004 and $7,712 recorded in the six months ended June 30, 2005). Due to the uncertainty regarding the outcomes of these matters, however, we cannot estimate the maximum amount of costs that we could potentially incur with respect to these matters. In accordance with the financial accounting standards for loss contingencies, we have accrued what we believe to be a reasonable estimate of costs that are probable we will incur. If our estimate proves to be inadequate, however, it is possible that we could subsequently be required to record a charge to earnings which could have a material adverse effect on our results of operations.

We did not incur any non-legal costs related to the Actions during the three and six months ended June 30, 2005 or 2004. We incurred $4,438 of non-legal costs related to the Actions during the year ended December 31, 2004.

5. **Investments**

We have investments in marketable debt and auction rate preferred equity securities, which are classified as available-for-sale or held-to-maturity, depending on our investment intentions with regard to those securities. Marketable debt securities classified as available-for-sale securities that have remaining contractual maturity dates in excess of 90 days at the time of purchase are recorded at their market value. Marketable debt securities classified as held-to-maturity securities are recorded at their amortized cost, because we have the intent and ability to hold those investments until they mature. Auction rate preferred equity securities classified as available-for-sale securities are recorded at their market value. Investments that we intend to hold for more than one year are recorded as non-current investments.

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Our investments included auction rate debt securities, variable rate demand notes and auction rate preferred equity securities that were classified as available-for-sale securities and recorded in short-term investments and investments on our Consolidated Balance Sheets as of June 30, 2005, December 31, 2004 and June 30, 2004. Despite the long-term nature of the contractual maturities of our auction rate debt securities and variable rate demand notes, we have the ability to quickly liquidate those investments. We also had no material gross unrealized holding or realized gains (losses) from our investments in auction rate debt securities and variable rate demand notes for the three and six months ending June 30, 2005 and 2004. All income generated from those investments was recorded as interest income.

The cost of securities sold is based on the first-in, first-out method. All of our investments are in marketable debt and auction rate preferred equity securities.

| | As of: | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | June 30, 2005 | | | December 31, 2004 | | | June 30, 2004 | | | | |
| | Available-For-Sale | Held-to-Maturity | Total | Available-For-Sale | Held-to-Maturity | Total | Trading Securities | Available-For-Sale | Held-to-Maturity | Total |
| Short-term investments | $ 299,989 | $ 12,745 | $ 312,734 | $ 309,567 | $ 23,003 | $ 332,570 | $ 2,004 | $ 233,902 | $ 12,576 | $ 248,482 |
| Non-current investments | 1,002 | 2,053 | 3,055 | 1,000 | 5,363 | 6,363 | | 11,999 | 6,510 | 18,509 |
| | $ 300,991 | $ 14,798 | $ 315,789 | $ 310,567 | $ 28,366 | $ 338,933 | $ 2,004 | $ 245,901 | $ 19,086 | $ 266,991 |

The contractual maturities of our marketable debt securities classified as available-for-sale as of June 30, 2005 were as follows:

| Available-For-Sale | Fair Value |
|---|---|
| Due within five years | $ |
| Due after five years through ten years | 5,932 |
| Due after ten years | 208,363 |
| | $ 214,295 |

The above table excludes $86,696 of auction rate preferred equity securities that were classified as available-for-sale securities as of June 30, 2005. Our non-current investments that were classified as held-to-maturity securities as of June 30, 2005 had remaining contractual maturities between one and two years.

6. **Property and Equipment**

During the three months ended June 30, 2005, we:

- purchased one facility for $7,423;
- purchased for $1,155 one parcel of land on which we intend to build a facility;
- expended $1,531 as we continued building facilities on four other parcels of land; and
- incurred $123 of initial acquisition costs for one facility and two parcels of land on which we intend to build facilities.

During the six months ended June 30, 2005, we:

- purchased two facilities for $12,164;
- purchased for $1,155 one parcel of land on which we intend to build a facility;
- expended $6,374 as we continued building facilities on four other parcels of land; and
- incurred $123 of initial acquisition costs for one facility and two parcels of land on which we intend to build facilities.

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7. **Earnings Per Common Share**

Earnings per common share for all periods have been calculated in conformity with SFAS No. 128, Earnings Per Share. This data is based on the weighted average number of shares of our common stock outstanding during each period as set forth in the following table:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (In thousands) | | | |
| Shares: | | | | |
| Weighted average number of shares of common stock outstanding | 46,181 | 45,726 | 46,134 | 45,667 |
| Shares assumed issued (less shares assumed purchased for treasury) on stock options | 953 | 1,044 | 973 | 1,100 |
| Outstanding shares for diluted earnings per share calculation | 47,134 | 46,770 | 47,107 | 46,767 |

Shares underlying outstanding stock options with exercise prices greater than the average market price of our common stock (1,092 at June 30, 2005 and 761 at June 30, 2004) have been excluded from the calculation of our earnings per share, because the effect would be antidilutive.

8. **Employee Pension Benefits**

The net periodic benefit costs for the ESI Pension Plan ( Pension Plan ) and the ESI Excess Pension Plan are as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Service cost | $ 1,800 | $ 1,765 | $ 3,600 | $ 3,530 |
| Interest cost | 725 | 570 | 1,450 | 1,140 |
| Expected return on assets | (800) | (550) | (1,600) | (1,100) |
| Recognized net actuarial loss | 325 | 250 | 650 | 500 |
| Amortization of prior service cost | (22) | (25) | (44) | (50) |
| Net periodic pension cost | $ 2,028 | $ 2,010 | $ 4,056 | $ 4,020 |

In January 2005, we contributed $11,795 to the Pension Plan. This amount represents the total amount we intend to contribute to the Pension Plan in 2005.

9. **Letters of Credit**

During the six months ended June 30, 2005, we continued to provide a $7,000 irrevocable standby letter of credit to one of our insurers to secure the surety bonds issued by that insurer which are required as part of our normal course of operations by various education authorities that regulate us. This letter of credit is collateralized by our investments. As of June 30, 2005, the total face value of those surety bonds was $8,505. In addition, we have continued to provide irrevocable letters of credit in the total amount of $2,117 to our workers compensation insurance providers to secure the payment of our workers compensation claims.

10. **Contingencies**

On February 25, 2004, federal agents executed search warrants at our corporate headquarters and at ten of our 79 ITT Technical Institutes nationwide. On that same date, our Directors and executive officers and some of our other employees each received a federal grand jury subpoena that was issued, along with the search warrants, by the U.S. District Court, Southern District

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of Texas, located in Houston, Texas. The search warrants and subpoenas sought broad categories of documents, including documents containing information relating to our figures and rates for placement, retention, graduation and attendance, recruitment and admissions materials, student grades, graduate salaries, transferability of credits to other institutions, and personnel records. Although no formal charges have been filed, we believe that the DOJ is investigating claims alleging, among other matters, falsification of records relating to student attendance, grades and academic progress and graduate job placement statistics, and fraudulent misrepresentations regarding the transferability of credits, graduation rates and graduates salaries.

In a letter dated June 24, 2005, the DOJ advised us that its investigation of us has not revealed evidence sufficient to continue the designation of us or any of our senior management (defined as the executives at our headquarters) as targets or subjects. We did not pay any fines or penalties in connection with this action. We will continue to cooperate with the DOJ as its investigation of the conduct of other individuals continues. The costs that we have incurred in connection with the DOJ investigation have had a material adverse effect on our financial condition and results of operations, and we cannot assure you that the costs associated with our continued cooperation with the DOJ will not have a further material adverse effect on our financial condition and results of operations.

On March 4, 2004, we were notified by the Fort Worth, Texas regional office of the SEC that it had initiated an inquiry into the allegations being investigated by the DOJ as described above in this Note 10. In a letter dated July 25, 2005, the SEC advised us that it had terminated its investigation of us and recommended that no enforcement action be taken against us. We did not pay any fines or penalties in connection with the termination of the SEC s investigation of us.

In October 2002, the Office of Attorney General for the State of California ( CAG ) informed us that it had initiated an investigation of our ITT Technical Institutes in California. We believe that the CAG s investigation is in response to one or more qui tam actions filed against us under the state and/or federal False Claims Acts. The CAG has not asserted any claims against us. Based on the information that the CAG has requested, however, we believe that the CAG is investigating, among other matters, whether one or more of our California ITT Technical Institutes:

- falsified records relating to student attendance, grades and academic progress;
- falsified student grade point average calculations used to qualify students for financial aid under the State s Cal Grant Program; and
- retaliated against employees who may have complained about those alleged acts.

We are cooperating with the CAG in its investigation, and we have been conducting our own investigation of the same matters. While we cannot assure you of the ultimate outcome of the CAG investigation, based on the results of our investigation to date, we do not believe that the CAG investigation and any qui tam actions that may be associated with the investigation will have a material adverse effect on our financial condition, results of operations or cash flows.

A qui tam action is a civil lawsuit brought by one or more individuals (a qui tam relator ) on behalf of the federal or state government for an alleged submission to the government of a false claim for payment. A qui tam action is always filed under seal and remains under seal until the government decides whether to intervene in the litigation. Whenever a relator files a qui tam action, the government typically initiates an investigation in order to determine whether to intervene in the litigation. If the government intervenes, it has primary control over the litigation. If the government declines to intervene, the relator may pursue the litigation on behalf of the federal or state government and, if successful, receives a portion of the government s recovery.

On August 19, 2004, a consolidated complaint in a securities class action lawsuit was filed against us and ten of our current and former Directors and executive officers in the U.S. District Court for the Southern District of Indiana under the following caption: *City of Austin Police Retirement System, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc., et al.* This action is a result of the court s June 18, 2004 order to consolidate 13 separate securities class action lawsuits filed from February 26, 2004 through April 23, 2004. The consolidated complaint alleges, among other things, that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended ( Exchange Act ), and Rule 10b-5 promulgated thereunder, by engaging in an unlawful course of conduct, pursuant to which the defendants knowingly or recklessly engaged in acts, transactions, practices and courses of business to conceal adverse material information about our financial condition, and that this conduct operated as a fraud and deceit upon the plaintiffs. The complaint also alleges that the defendants made various deceptive and untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading to the plaintiffs, causing the plaintiffs to purchase our securities at artificially inflated prices. The putative class period in this action is from October 17, 2002 through March 8, 2004. The plaintiffs seek, among other things, an award of unspecified compensatory damages, interest, costs, expenses and attorney s fees. All of the defendants intend to defend themselves vigorously against the allegations made in the complaint. We cannot assure you, however, that the ultimate outcome of this or other actions (including other actions under federal or state securities laws) will not have a material adverse effect on our financial condition or results of operations.

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On or about April 29, 2004, a consolidated complaint in a shareholder derivative lawsuit was filed against five of our current and former executive officers, ten of our current and former Directors and PricewaterhouseCoopers LLP ( PWC ), our independent registered public accounting firm, in the Superior Court of Hamilton County, Indiana under the following caption: *In Re ITT Educational Services, Inc. Derivative Litigation*. This action is a result of the court s March 30, 2004 order to consolidate two separate shareholder derivative lawsuits filed on or about February 27, 2004. On December 1, 2004, the court dismissed the consolidated complaint without prejudice and gave the plaintiffs 30 days to replead their complaint. On January 3, 2005, the plaintiffs filed an amended consolidated complaint. The amended consolidated complaint alleges, among other things, that:

- certain individual defendants breached a fiduciary duty by selling our common stock and misappropriating our information;
- all defendants breached their fiduciary duties to us, abused their ability to control and influence us, grossly mismanaged us, caused us to waste corporate assets and were unjustly enriched; and
- PWC breached a duty of care and professional competence to us and breached its contracts with us.

The amended consolidated complaint seeks unspecified damages, extraordinary equitable and/or injunctive relief, disgorgement of profits, benefits and other compensation, costs and attorneys fees. All of the individual defendants intend to defend themselves vigorously against the allegations in the complaint.

On September 7, 2004, a shareholder derivative lawsuit was filed against five of our current and former executive officers, ten of our current and former Directors and PWC, in the U.S. District Court for the Southern District of Indiana under the following caption: *Alaska Electrical Pension Fund Derivatively on Behalf of ITT Educational Services, Inc. v. Rene R. Champagne, et al.* The complaint alleges, among other things, that the defendants caused us to violate state and federal education finance laws and regulations by falsifying our student records and federal securities laws by falsifying our accounting, auditing and financial reporting between October 2002 and April 2004. As a result, the complaint alleges, among other things, that the individual defendants:

- breached and/or aided and abetted in the breach of:
  - a duty to disseminate accurate information about us;
  - fiduciary duties of care, candor and loyalty to us and disclosure to our shareholders;
  - a duty to test, oversee and monitor our system of internal controls, governance procedures and disclosure procedures; and
  - a duty to ensure that our internal controls, governance procedures and disclosure procedures were functioning in an effective manner and in compliance with Pub. L. 107-204, 116 Stat. 745 (2002);
- abused their ability to control and influence us;
- grossly mismanaged us;

committed constructive fraud;

will be and have been unjustly enriched at our expense; and

violated Section 10(b) of the Exchange Act and Rule 10-5 promulgated thereunder by:

disseminating or approving false statements that they knew or recklessly disregarded were misleading;

failing to disclose material facts necessary in order to make those statements not misleading; and

misappropriating our proprietary information.

In addition, the complaint alleges, among other things, that PWC:

violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by:

disseminating or approving false statements that it knew or recklessly disregarded were misleading; and

failing to disclose material facts necessary in order to make those statements not misleading;

was negligent and committed accounting malpractice by failing to conduct its audits of our 2002 and 2003 fiscal year financial statements in accordance with generally accepted accounting principles, generally accepted auditing standards and SEC rules;

aided and abetted the individual defendants :

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breach of fiduciary duties to us;

abuse of their control of us; and

gross mismanagement of us; and

violated their duty of candor to our shareholders.

The complaint seeks unspecified damages, extraordinary equitable and/or injunctive relief, punitive damages, costs and expenses, attorneys fees, pre-judgment interest, an order directing the defendants to account for all damages caused by them and all profits, special benefits and unjust enrichment they obtained, and an order directing us to reform and improve our corporate governance and internal control procedures. On December 8, 2004, the parties agreed to stay this action pending the entry of a final judgment in the *In Re ITT Educational Services, Inc. Derivative Litigation* action, except that the stay will be lifted if a subsequently filed shareholder derivative lawsuit is filed in the Southern District of Indiana and the defendants are unable to enter into a similar stay of that action. All of the individual defendants intend to defend themselves vigorously against the allegations in the complaint.

On November 17, 2004, a shareholder derivative lawsuit was filed against ten of our current and former Directors, in the Chancery Court of New Castle County, Delaware under the following caption: *Albert Reitan, derivatively on behalf of nominal defendant ITT Educational Services, Inc. v. Rand V. Araskog, et al.* The complaint alleges, among other things, that the defendants abdicated their fiduciary duty of good faith to us by making no effort to oversee our operations and business practices to ensure that we comply with all applicable laws, rules and regulations. The complaint seeks unspecified damages, equitable relief, attorneys fees, accountants fees, experts fees, costs and expenses. On March 31, 2005, in response to the parties request, the court issued an order staying this action until the entry of a final judgment in the *City of Austin Police Retirement System, Individually and on Behalf of All Others Similarly Situated v. ITT Educational Services, Inc. et al*. action. All of the defendants intend to defend themselves vigorously against the allegations in the complaint.

On July 7, 2004, we received a derivative demand letter pursuant to Del. Ct. Ch. R. 23.1 on behalf of Arthur Stein, a purported shareholder, demanding that our Board of Directors commence a civil action against each of our current Directors, one former Director and four of our current and former executive officers to recover for our benefit the amount of damages sustained by us as a result of the misconduct alleged in the letter. The misconduct alleged in the letter is similar to the type of misconduct alleged against the individual defendants in the consolidated shareholder derivative lawsuit described above. The demand letter indicates that Mr. Stein will commence a shareholder s derivative action on our behalf, if our Board does not commence an action as demanded therein within a reasonable period of time. We have informed Mr. Stein that our Board has deferred its decision with respect to Mr. Stein s demand until the conclusion of the DOJ investigation of us, the inquiry initiated by the SEC into the allegations being investigated by the DOJ and the securities class action lawsuits filed against us, or until the receipt of additional information concerning the allegations made in the demand.

On October 26, 2004, a lawsuit was filed against us in the Chancery Court of New Castle County, Delaware under the following caption: *Arthur Stein v. ITT Educational Services, Inc.* The complaint alleges that we violated Section 220 of the Delaware General Corporation Law by refusing to allow Mr. Stein to inspect and make copies of our books and records relating to the misconduct alleged in his derivative demand letter described above. The complaint seeks an order compelling us to permit Mr. Stein to inspect and make copies of our books and records, and to pay his costs, expenses and attorney s fees to prosecute this action. On May 9, 2005, the plaintiff voluntarily dismissed the complaint with prejudice.

Although the derivative actions are brought nominally on behalf of us, we expect to incur defense costs and other expenses in connection with the derivative lawsuits, and we cannot assure you that the ultimate outcome of these or other actions will not have a material adverse effect on our financial condition or results of operations.

The current and former executive officers named in one or more of the securities class action and shareholder derivative lawsuits and derivative demand letter described above include: Gene A. Baugh, Rene R. Champagne, Clark D. Elwood, Eugene W. Feichtner, Martin A. Grossman, Thomas W. Lauer, Kevin M. Modany and Omer E. Waddles.

Certain of our current and former officers and Directors are or may become a party in certain of the actions described above. Our By-Laws and Restated Certificate of Incorporation obligate us to indemnify our officers and Directors to the fullest extent permitted by Delaware law, provided that their conduct complied with certain requirements. We are obligated to advance defense costs to our officers and Directors, subject to the individual s obligation to repay such amount if it is ultimately determined that the individual was not entitled to indemnification. In addition, our indemnity obligation can, under certain circumstances, include indemnifiable judgments, penalties, fines and amounts paid in settlement in connection with those actions.

As previously disclosed, on March 4, 2004, our Board of Directors appointed a Special Committee of independent Directors.

The Special Committee has completed its investigation relating to the conduct and integrity of our senior management. In late June 2004, the Special Committee reported to our Board of Directors that it had found no evidence that our senior management had engaged in any violations of our policies and procedures or any wrongful or criminal conduct related to the matters that are the subject of the DOJ and CAG investigations and the securities class action lawsuit described above. The Special Committee also reported that when allegations of possible violations have been brought to the attention of our senior management, we have investigated those allegations and our senior management has taken appropriate action when responding to those allegations and any violations found.

On March 4, 2005, we were served with a qui tam action that was filed on April 8, 2004 in the United States District Court for the Southern District of Indiana by a former employee ( relator ) on behalf of himself and the federal government under the following caption: *United States of America ex rel. Robert Olson v. ITT Educational Services, Inc. d/b/a ITT Technical Institute* (the Olson Action ). We were served with the Olson Action after the DOJ declined to intervene in the litigation. On June 24, 2005 the relator filed an amended complaint in the Olson Action. In the amended complaint, the relator alleges that we violated the False Claims Act, 31 U.S.C. § 3729, *et seq*., by knowingly making and using false records and statements relating to, among other things, student recruitment, admission, enrollment, attendance, grading, testing, graduate placement, programs of study and course materials in order to fraudulently obtain student loans and tuition from the federal government. The complaint seeks an unspecified judgment and attorney s fees and costs. We intend to defend ourselves vigorously against the allegations made in the complaint.

**Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

**Forward-Looking Statements**

*All statements, trend analyses and other information contained in this report that are not historical facts are forward-looking statements within the meaning of the safe harbor provision of the Private Securities Litigation Reform Act of 1995 and as defined in Section 27A of the Securities Act of 1933 and Section 21E of the Exchange Act. Forward-looking statements are made based on our management s current expectations and beliefs concerning future developments and their potential effects on us. You can identify these statements by the use of words such as could, should, would, may, will, project, believe, anticipate, expect, plan, estimate, forecast, potential, intend, continue, and contemplate, as well as similar words and expressions. Forward-looking statements involve risks and uncertainties and do not guarantee future performance. We cannot assure you that future developments affecting us will be those anticipated by our management. Among the factors that could cause actual results to differ materially are the following:*

- *business conditions and growth in the postsecondary education industry and in the general economy;*
- *changes in federal and state governmental regulations with respect to education and accreditation standards, or the interpretation or enforcement thereof, including, but not limited to, the level of government funding for, and our eligibility to participate in, student financial aid programs utilized by our students;*
- *effects of any change in our ownership resulting in a change in control, including, but not limited to, the consequences of such changes on the accreditation and federal and state regulation of our institutes;*
- *our ability to implement our growth strategies;*
- *receptivity of students and employers to our existing program offerings and new curricula;*

*loss of lender access by our students for student loans; and*

*the results of the securities class action and shareholder derivative lawsuits filed against us, which, if adversely determined, could have a material adverse effect on our financial condition and results of operations.*

*Readers are also directed to other risks and uncertainties discussed in other documents we file with the SEC, including, without limitation, those discussed in Item 1. Business Risk Factors of our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2004. We undertake no obligation to update or revise any forward-looking information, whether as a result of new information, future developments or otherwise.*

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**Overview**

You should keep in mind the following points as you read this report:

- References in this document to we, us, our and ITT/ESI refer to ITT Educational Services, Inc. and its subsidiaries.
- The terms ITT Technical Institute or institute (in singular or plural form) refer to an individual school owned and operated by ITT/ESI, including its learning sites, if any. The terms institution or campus group (in singular or plural form) mean a main campus and its additional locations, branch campuses and/or learning sites, if any.

This management s discussion and analysis of financial condition and results of operations should be read in conjunction with the same titled section contained in our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2004 for discussion of, among other matters, the following items:

- cash receipts from financial aid programs;
- nature of capital additions;
- seasonality of revenue;
- components of income statement captions;
- federal regulations regarding:
  - timing of receipt of funds from the federal student financial aid programs under Title IV of the Higher Education Act of 1965, as amended (the Title IV Programs );
  - percentage of applicable revenue that may be derived from the Title IV Programs;
  - return of Title IV Program funds for withdrawn students; and
  - default rates;
- private loan programs;
- investments;

- repurchase of shares of our common stock;
- minimum pension liability; and
- our hybrid education delivery model, pursuant to which certain program courses are taught in residence on campus and others are taught online over the Internet (the Hybrid Delivery Model ).

Among the factors that could cause our actual results to differ materially are the Actions, as described in Note 10 of the Notes to Consolidated Financial Statements set forth elsewhere in this report. The results of the SEC inquiry into the allegations investigated by the DOJ could result in the restatement of our financial statements, monetary fines or penalties or other sanctions that could materially adversely affect our financial condition and operations. The results of the securities class action and shareholder derivative lawsuits filed against us, if adversely determined, could have a material adverse effect on our financial condition and results of operations.

We are a leading provider of technology-oriented postsecondary degree programs in the United States based on revenue and student enrollment. As of June 30, 2005, we were offering associate, bachelor and master degree programs to more than 41,000 students. We currently have 79 institutes located in 31 states. Each of our institutes is (a) authorized by the applicable education authorities of the states in which it operates and recruits and (b) accredited by an accrediting commission recognized by the U.S. Department of Education. We design our education programs, after consultation with employers, to help graduates prepare for careers in various fields involving their areas of study. As of June 30, 2005, all of our program offerings were degree programs. We have provided career-oriented education programs since 1969 under the ITT Technical Institute name.

In the second quarter of 2005, we opened one new institute and added two new learning sites to existing institutes. A learning site is an institute location where educational activities are conducted and student services are provided away from the institute s campus. We plan to open up to three additional new institutes and add up to two new learning sites in the remainder of 2005. We intend to continue expanding by:

- opening new institutes;
- adding learning sites to existing institutes;
- offering a broader range of technology and non-technology programs both in residence on campus and online at our existing institutes;
- increasing the number of our institutes that offer bachelor degree programs; and
- pursuing new and expanded alliances with both domestic and international educators.

We also intend to further expand our Hybrid Delivery Model by teaching more of the courses in each of our programs online over the Internet.

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**Critical Accounting Policies and Estimates**

This management s discussion and analysis of financial condition and results of operations is based on our consolidated financial statements, which have been prepared in conformity with generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenue and expenses and contingent assets and liabilities. Actual results may differ from those estimates and judgments under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant estimates and judgments used in the preparation of our consolidated financial statements. These policies should be read in conjunction with Note 1 of the Notes to Consolidated Financial Statements contained in our Annual Report on Form 10-K as filed with the SEC for the year ended December 31, 2004.

*Property and Equipment.* We include all property and equipment in the financial statements at cost and make provisions for depreciation of property and equipment using the straight-line method. Estimated useful lives generally range from:

- three to ten years for our furniture and equipment;
- three to 14 years for leasehold and building improvements;
- 20 to 40 years for the buildings; and
- three to eight years for capitalized software.

Changes in circumstances, such as changes in our curricula and technological advances, may result in the actual useful lives of our property, equipment and capitalized software differing from our estimates. We regularly review and evaluate the estimated useful lives of our property, equipment and capitalized software. Although we believe our assumptions and estimates are reasonable, deviations from our assumptions and estimates could produce a materially different result.

*Recognition of Revenue.* Tuition revenue is recorded on a straight-line basis over the length of the applicable course. If a student withdraws from an institute, the standards of most state education authorities that regulate our institutes, the accrediting commission that accredits our institutes and our own internal policy limit a student s obligation for tuition and fees to the institute depending on when the student withdraws during an academic quarter ( Refund Policies ). The terms of the Refund Policies vary by state, and the limitations imposed by the Refund Policies are generally based on the portion of the academic quarter that has elapsed at the time the student withdraws. The greater the portion of the academic quarter that has elapsed at the time the student withdraws, the greater the student s obligation is to the institute for the tuition and fees related to that academic quarter. We record revenue net of any refunds paid as a result of any applicable Refund Policy. On an individual student basis, tuition earned in excess of cash received is recorded as accounts receivable, and cash received in excess of tuition earned is recorded as deferred revenue.

The cost of the textbooks is included in the tuition and is amortized on a straight-line basis over the applicable course length and the deferral of textbook costs is recorded in prepaids and other current assets. Tool kit sales and the related cost of the tool kits are recognized at the beginning of each academic quarter. Laptop computer sales and the related cost of the laptop computers are recognized when the student receives the laptop computer. Academic fees (which are charged only one time to students on their first day of class attendance) and admission processing fees (which, prior to their discontinuance in 2003, were charged only one time to students upon being evaluated for admission to their programs of study) are recognized as revenue on a straight-line basis over the average course length of 24 months. If a student withdraws from an institute, all unrecognized revenue relating to his or her fees, net of any refunds paid as a result of any applicable Refund Policy, is recognized upon the student s departure. Administrative fees, which are charged to students when they withdraw or graduate from their programs of study at an institute, are recognized when the students withdraw or graduate from their programs of study.

More than 97% of our revenue represents tuition charges (which include the cost of textbooks and other course materials distributed to students) and less than 3% of our revenue represents tool kit sales, laptop computer sales and student fees. The amount of tuition earned depends on the cost per credit hour of the courses in the program, the number of courses in the program, how long a student remains enrolled in the program, how many program courses a student takes during each period of enrollment in the program, and the total number of students enrolled in each program. Each of these factors is known at the time our tuition revenue is calculated and is not subject to estimation.

*Direct Marketing Costs.* Direct costs incurred relating to the enrollment of new students are capitalized using the successful efforts method. Direct marketing costs subject to capitalization include salaries and employee benefits of recruiting representatives and other direct costs less admission processing fees, if any. Successful efforts is the ratio of students enrolled to prospective students interviewed. The higher the rate of interviewed students who enroll, the greater the percentage of our direct marketing costs that are capitalized. We amortize our direct marketing costs on a cost-pool-by-cost-pool basis over the period that we expect to receive revenue streams associated with those assets. The direct costs subject to capitalization are readily quantifiable and are not subject to estimation. The amortization method is based on historical trends of student enrollment and retention activity and is not subject to significant assumptions. We regularly evaluate the future recoverability of these deferred costs.

*Contingent Liabilities.* We are subject to litigation in the ordinary course of our business. When we are aware of a claim or potential claim, we assess the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, we record a liability for the loss. The liability recorded includes probable and estimable legal costs associated with the claim or potential claim. If the loss is not probable or the amount of the loss cannot be reasonably estimated, we disclose the claim if the likelihood of a potential loss is reasonably possible and the amount involved is material. Although we believe our estimates are reasonable, deviations from our estimates could produce a materially different result.

**New Accounting Pronouncements**

In June 2004, the FASB s Emerging Issues Task Force ( EITF ) issued EITF 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. EITF 03-1 provides further guidance on the meaning of other-than-temporary impairment and its application to debt and equity securities in accordance with APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, and SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. In September 2004, the FASB issued FASB Staff Position EITF 03-1-1, which delays the effective date until additional guidance is issued for the application of the recognition and measurement provisions of EITF 03-1 to investments in securities that are impaired. The disclosure requirements of EITF 03-1, however, are effective for annual periods ending after June 15, 2004. Until further guidance is provided by the FASB, we are unable to determine the effect, if any, that EITF 03-1 will have on our financial condition or results of operations. See Note 5 of the Notes to Consolidated Financial Statements set forth elsewhere in this report for additional disclosures regarding our investments.

In December 2004, the FASB issued SFAS No. 123R, Share-Based Payment that revises SFAS No. 123, Accounting for Stock-Based Compensation and supercedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Under this revised standard, all share-based payments to employees, including grants of employee stock options, must be reflected in the financial statements using the fair value method with the related expenses recognized over the service period. SFAS No. 123R will be effective for fiscal years beginning after June 15, 2005 and allows for several alternative transition methods. We expect to adopt SFAS No. 123R in our 2006 fiscal year on a modified-prospective basis without restating prior periods, which will require that we recognize compensation expense for all stock option and other equity-based awards that vest or become exercisable after the effective date. We are currently evaluating the impact that SFAS No. 123R will have on our financial condition or results of operations.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, that replaces APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. Under this new standard, voluntary changes in accounting principles must be applied retrospectively with all prior period financial statements presented. SFAS No. 154 also requires that any change in the method of depreciation, amortization or depletion for long-lived non-financial assets must be accounted for prospectively as a change in accounting estimate, and corrections of errors in previously issued financial statements should be termed a restatement. SFAS No. 154 is effective for changes in accounting principles and correction of errors made in fiscal years beginning after December 15, 2005. We do not believe that SFAS No. 154 will have a material impact on our consolidated financial statements.

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**Results of Operations**

The following table sets forth the percentage relationship of certain statement of income data to revenue for the periods indicated:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Revenue | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of educational services | 48.5 | 51.7 | 49.2 | 52.8 |
| Student services and administrative expenses | 30.9 | 29.8 | 30.8 | 29.6 |
| Special legal and other investigation costs | | 3.7 | 2.4 | 5.2 |
| | —— | (196) | | (3,211) |

| | | |
|---|---|---|
| Other current assets and prepaid expenses | 717 | 1,951 |
| Other long-term assets | (31) | (493) |
| Accounts payable | (276) | 855 |
| Accrued liabilities | (163) | 1,086 |
| Deferred rent | (24) | (10) |
| Deferred revenue | 905 | (698) |
| Income tax liability | (7) | 12 |
| Net cash used in operating activities | (5,991) | (5,753) |
| | | |
| Cash flows from investing activities: | | |
| Acquisition of property and equipment | (358) | (421) |
| Disposal of property and equipment | — | 36 |
| Business acquisition | (5,091) | — |
| Proceeds from sales of marketable and long-term investments | 26,361 | 17,597 |
| Proceeds from maturities of marketable investments | 34,445 | 35,085 |
| Purchase of marketable investments | (39,864) | (46,255) |
| Net cash provided by investing activities | 15,493 | 6,042 |
| | | |
| Cash flows from financing activities: | | |
| Proceeds from exercise of stock options and employee stock purchase plan | 812 | 1,045 |
| Excess tax benefit related to stock-based compensation | — | 21 |
| Net cash provided by financing activities | 812 | 1,066 |
| | | |
| Net increase in cash and cash equivalents | 10,314 | 1,355 |
| Cash and cash equivalents at beginning of period | 14,020 | 12,519 |
| Cash and cash equivalents at end of period | $ 24,334 | $ 13,874 |

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 light-based aesthetic systems for practitioners worldwide. The Company designs, develops, manufactures, and markets the CoolGlide, Xeo, Solera, GenesisPlus, Excel V and truSculpt product platforms for use by physicians and other qualified practitioners to allow its customers to offer safe and effective aesthetic treatments to their customers. The Xeo and Solera platforms offer multiple hand pieces and applications, which allow customers to upgrade their systems (Upgrade revenue). In addition to systems and Upgrade revenue, the Company generates revenue from the sale of post warranty service contracts, providing services for products that are out of warranty, and Titan hand piece refills. In Japan the Company also distributes third party manufactured dermal fillers, cosmeceuticals and a Q-switched laser system called myQ.

In February 2012, the Company acquired the global aesthetic business unit of IRIDEX Corporation (or Iridex), which included various laser systems (such as the VariLite and Gemini) and an installed base of customers, whose products are being serviced by the Company.

Headquartered in Brisbane, California, the Company has wholly-owned subsidiaries in Australia, Canada, and France and Japan that market, sell and service its products outside of the United States. Effective March 31, 2012, the Company decided to discontinue its direct operations in Spain and the United Kingdom and instead plans on seeking a distributor to market its products in these countries. The Condensed Consolidated Financial Statements include the accounts of the Company and its subsidiaries and 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, 2011 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, 2011 filed with the Securities and Exchange Commission, or SEC, on March 15, 2012.

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 and long-term 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, Marketable Securities and Long-Term Investments

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

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

| September 30, 2012 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Market Value |
|---|---|---|---|---|
| Cash and cash equivalents: | | | | |
| Cash | $ 1,853 | $ — | $ — | $ 1,853 |
| Money market funds | 14,577 | — | — | 14,577 |
| Commercial paper | 7,904 | — | — | 7,904 |
| Total cash and cash equivalents | 24,334 | — | — | 24,334 |
| | | | | |
| Marketable securities: | | | | |
| U.S. government agencies | 23,884 | 51 | (1) | 23,934 |
| Municipal securities | 6,046 | 32 | (1) | 6,077 |
| Commercial paper | 7,507 | 2 | — | 7,509 |
| Corporate debt securities | 18,215 | 61 | (1) | 18,275 |
| Total marketable investments | 55,652 | 146 | (3) | 55,795 |
| | | | | |
| Long-term investment in auction rate securities | 1,200 | — | (150) | 1,050 |
| Total cash, cash equivalents, marketable investments and long-term investments | $ 81,186 | $ 146 | $ (153) | $ 81,179 |

| December 31, 2011 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Market Value |
|---|---|---|---|---|
| Cash and cash equivalents: | | | | |
| Cash | $ 2,153 | $ — | $ — | $ 2,153 |
| Money market funds | 7,318 | — | — | 7,318 |
| Commercial paper | 4,549 | — | — | 4,549 |
| Total cash and cash equivalents | 14,020 | — | — | 14,020 |
| | | | | |
| Marketable securities: | | | | |
| U.S. government notes | 3,655 | 10 | — | 3,665 |
| U.S. government agencies | 41,535 | 44 | (14) | 41,565 |
| Municipal securities | 6,091 | 44 | (1) | 6,134 |
| Commercial paper | 4,747 | 1 | (1) | 4,747 |
| Corporate debt securities | 18,574 | 15 | (34) | 18,555 |
| Total marketable investments | 74,602 | 114 | (50) | 74,666 |
| | | | | |
| Long-term investment in auction rate securities | 3,900 | — | (873) | 3,027 |
| Total cash, cash equivalents, marketable investments and long-term investments | $ 92,522 | $ 114 | $ (923) | $ 91,713 |

As of September 30, 2012 and December 31, 2011, the total gross unrealized losses were $153,000 and $923,000 respectively and were primarily related to long-term investments in auction rate securities (ARS), which were in an unrealized loss position for 12 months or greater. No other securities were in unrealized loss positions for more than 12 months.  The unrealized losses in the ARS securities are not attributed to changes in credit risk and the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity.

Since February 2008, uncertainties in the credit markets affected the majority of ARS investments and auctions for the Company’s investments in these securities have failed to settle on their respective settlement dates. However, since 2009 $12.2 million of ARS were redeemed at full par value. The maturity date for the one remaining ARS investment in the Company’s portfolio is 2041.

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The following table summarizes the estimated fair value of our securities available-for-sale and classified as cash and cash equivalents, marketable investments and long-term investments classified by the contractual maturity date of the security as of September 30, 2012 (in thousands):

| | Amount |
|---|---|
| Due in less than one year | $ 35,073 |
| Due in 1 to 5 years | 28,626 |
| Due in 5 to 10 years | — |
| Due in greater than 10 years | 1,050 |
| | $ 64,749 |

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 September 30, 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):

| September 30, 2012 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Cash equivalents: | | | | |
| Money market funds | $ 14,577 | — | — | $ 14,577 |
| Commercial paper | — | 7,904 | — | 7,904 |
| Short-term marketable investments: | | | | |
| U.S. government agencies | — | 23,934 | — | 23,934 |
| Municipal securities | — | 6,077 | — | 6,077 |
| Commercial paper | — | 7,509 | — | 7,509 |
| Corporate debt securities | — | 18,275 | — | 18,275 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Long-term investments: | | | | | | | | |
| Available-for-sale auction rate securities | | — | | — | | 1,050 | | 1,050 |
| Total assets at fair value | $ | 14,577 | $ | 63,699 | $ | 1,050 | $ | 79,326 |

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As of December 31, 2011, 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, 2011 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Cash equivalents: | | | | |
| Money market funds | $ 7,318 | — | — | $ 7,318 |
| Commercial paper | — | 4,549 | — | 4,549 |
| Short-term marketable investments: | | | | |
| U.S. government notes | — | 3,665 | — | 3,665 |
| U.S. government agencies | — | 41,565 | — | 41,565 |
| Municipal securities | — | 6,134 | — | 6,134 |
| Commercial paper | — | 4,747 | — | 4,747 |
| Corporate debt securities | — | 18,555 | — | 18,555 |
| Long-term investments: | | | | |
| Available-for-sale auction rate securities | — | — | 3,027 | 3,027 |
| Total assets at fair value | $ 7,318 | $ 79,215 | $ 3,027 | $ 89,560 |

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, 2012 is less than 36 months and all of these investments are rated by S&P and Moody's at A or better.

At September 30, 2012, observable market information was not available to determine the fair value of the Company's ARS investments. Therefore, the fair value was based on broker-provided valuation models that relied on Level 3 inputs including those that are based on expected cash flow streams and collateral values, assessments of counterparty credit quality, default risk underlying the security, market discount rates and overall capital market liquidity. The expected future cash flows of the ARS were discounted using a risk adjusted discount rate that compensated for the illiquidity. Projected future cash flows over the economic life of the ARS (of approximately 12.5 years) were modeled based on the contractual penalty rates for the security added to a tax adjusted LIBOR interest rate curve. The discount rates that were applied to the cash flows were based on a premium over the projected yield curve and included an adjustment for credit, illiquidity, and other risk factors. The valuation of the Company's ARS investment is subject to uncertainties that are difficult to predict. Factors that may impact the valuation in the future include changes to credit ratings of the security, as well as to the underlying assets supporting that security, rates of default of the underlying assets, underlying collateral value, discount rates, counterparty risk and ongoing strength and quality of market credit and liquidity. This financial instrument is classified within Level 3 of the fair value hierarchy.

The table presented below summarizes the change in carrying value associated with Level 3 financial assets, which represents the Company's investment in long term ARS, for the nine months ended September 30, 2012 (in thousands):

| | Amount |
|---|---|
| Balance at December 31, 2011 | $3,027 |
| Total gains and losses included in other comprehensive loss | 723 |
| Settlements | (2,700) |
| Balance at September 30, 2012 | $1,050 |

Note 4. Inventories

Inventories consist of the following (in thousands):

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Raw materials | $ 8,077 | $ 6,587 |
| Finished goods | 4,400 | 4,142 |
| Total | $ 12,477 | $ 10,729 |

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Note 5. Acquisition

On February 2, 2012, Cutera acquired certain assets and liabilities of Iridex's global aesthetics business unit for $5.1 million in cash. This business is engaged in developing, manufacturing, marketing and servicing laser-based medical systems and delivery devices. The business purpose of this transaction was to acquire access to an expanded installed base of customers, add to Cutera's product offerings and acquire a recurring stream of service revenue. This acquisition was considered a business combination for accounting purposes, and as such, in addition to valuing all the assets, the Company recorded goodwill associated with the expected synergies from leveraging the customer relationships and integrating new product offerings into the Company's business.

The fair values of the assets acquired were determined to be $4.8 million of net tangible and intangible assets and $1.3 million of goodwill. The customer relationship intangible assets are being amortized over 5 years on a straight-line basis. Other intangible assets are being amortized over 11 months to 5 years from the date of acquisition on a straight-line basis.

The recorded purchase price amounts are preliminary and subject to change as the Company is awaiting additional information related to inventory.

The following table summarizes the fair value as of February 2, 2012 of the net assets acquired (in thousands):

| | | |
|---|---|---|
| Purchase price paid | $ | 5,091 |
| | | |
| Assets (liabilities acquired) | | |
| Inventory | | 1,552 |
| Customer relationship intangible assets | | 2,510 |
| Other identified intangible assets | | 780 |
| Goodwill | | 1,339 |
| Deferred service revenue | | (780) |
| Accrued warranty liability | | (310) |
| Total | $ | 5,091 |

Disclosure of the amounts of revenue and earnings of the asset and liabilities of the acquired Iridex aesthetics business is not practicable because the acquired business was immediately integrated into Cutera's operations.

Note 6. Goodwill and Other Intangible Assets

Goodwill and other intangible assets comprise a patent sublicense acquired from Palomar in 2006; a technology sublicense acquired in 2002; and, intangible assets and goodwill related to the acquisition of Iridex's aesthetic business unit. The components of intangible assets were as follows (in thousands):

| | September 30, 2012 | | |
|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization Amount | Net Carrying Amount |
| Patent sublicense | $ 1,218 | $ 896 | $ 322 |
| Technology sublicense | 538 | 538 | — |
| Customer relationship intangible related to acquisition | 2,510 | 335 | 2,175 |
| Other identified intangible assets related to acquisition | 780 | 401 | 379 |
| Goodwill | 1,339 | — | 1,339 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total | $ | 6,385 | $ | 2,170 | $ | 4,215 |

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| | December 31, 2011 | | |
|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization Amount | Net Carrying Amount |
| Patent sublicense | $ 1,218 | $ 793 | $ 425 |
| Technology sublicense | 538 | 517 | 21 |
| Total | $ 1,756 | $ 1,310 | $ 446 |

Amortization expense for intangible assets was $860,000 and $144,000 for the nine-month periods ended September 30, 2012 and 2011 respectively.

Based on intangible assets recorded at September 30, 2012, and assuming no subsequent additions to, or impairment of the underlying assets, the remaining estimated annual amortization expense is expected to be as follows (in thousands):

| Fiscal Year Ending December 31, | Amount |
|---|---|
| 2012 (remainder) | $ 310 |
| 2013 | 696 |
| 2014 | 696 |
| 2015 | 569 |
| 2016 | 558 |
| Thereafter | 47 |
| Total | $ 2,876 |

Note 7. 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 actual service records to calculate the average 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, 2012 (in thousands):

| | Amount |
|---|---|
| Beginning Balance – December 31, 2011 | $1,121 |
| Add: Accruals for warranties issued during the period | 2,414 |
| Add: Warranties assumed with business acquisition | 310 |
| Less: Settlements made during the period | (2,599) |
| Ending Balance –September 30, 2012 | $1,246 |

Note 8. Deferred Service Contract Revenue

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

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The following table provides changes in deferred service contract revenue for the nine-month period ended September 30, 2012 and 2011 (in thousands):

| | | September 30 2012 | 2011 |
|---|---|---|---|
| Beginning Balance | | $ 5,838 | $ 6,765 |
| Add: | Payments received | 9,335 | 6,332 |
| Add: | Contract revenue assumed with business acquisition | 780 | — |
| Less: | Revenue recognized | (8,359) | (7,024) |
| Ending Balance | | $ 7,594 | $ 6,073 |

Costs incurred under service contracts were $5.4 million for the nine-month period ended September 30, 2012 and $3.1 million for the nine-month period ended September 30, 2011 which are recognized as incurred.

Note 9. Stock-based Compensation Expense

Stock-based compensation expense by department recognized during the three and nine-month periods ended September 30, 2012 and 2011 was as follows (in thousands):

| | Three Months Ended September 30, 2012 | 2011 | Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|---|---|
| Cost of revenue | $ 169 | $ 179 | $ 480 | $ 505 |
| Sales and marketing | 177 | 210 | 476 | 625 |
| Research and development | 126 | 184 | 419 | 524 |
| General and administrative | 337 | 321 | 959 | 1,451 |
| Total stock-based compensation expense | $ 809 | $ 894 | $ 2,334 | $ 3,105 |

Under the 2004 Equity Incentive Plan, the Company issued 178,949 shares of common stock during the nine-month period ended September 30, 2012, in conjunction with stock options exercised, restricted stock units released and purchases associated with the Employee Stock Purchase Plan.

During the nine-month period ended September 30, 2012, the following number of equity awards of the Company's common stock was granted (in thousands):

| | Shares | |
|---|---|---|
| Stock options | 898 | |
| Restricted stock Units | 148 | |
| Performance stock units | 42 | * |
| Total | 1,088 | |

* In the third quarter of 2012, the Company granted its executive officers 42,250 Performance Stock Units, or PSUs that shall vest on June 1, 2013, subject to the recipient's continued service through that date. At the vest date, the Company shall issue fully-paid up common stock based on the actual revenue achievement as a percentage of three revenue based performance goals. If the revenue achievement is below 50% for a performance goal, then zero (0) common stock shall be issued for that goal; and for achievement of greater than 50% the number of common stock to be issued shall be prorated but capped at 200% of the target.

As of September 30, 2012, there was $4.2 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 2.7 years.

Note 10. 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.

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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, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Options to purchase common stock | 3,910 | 3,990 | 3,680 | 3,619 |
| Restricted stock units | 132 | 56 | 79 | 62 |
| Performance stock units | 16 | — | 14 | — |
| Employee stock purchase plan shares | 30 | 30 | 52 | 51 |
| Total | 4,088 | 4,076 | 3,825 | 3,732 |

Note 11. Income Taxes

For the three months ended September 30, 2012 and 2011, the Company’s tax benefit was $64,000 and tax expense was $326,000, respectively. For the nine months ended September 30, 2012 and 2011, the Company’s income tax expense was $122,000 and $150,000, respectively. The Company’s income tax expense (benefit) was primarily attributable to income taxes of the Company’s international operations, offset by benefits for income taxes related to gains and losses on marketable and long term investments recorded in other comprehensive loss.

Included in the $326,000 expense for the three months ended September 30, 2011, was a discrete charge of $262,000 for the clearing of disproportionate tax effects in accumulated other comprehensive loss related to unrealized gains and losses on marketable and long term investments. Included in the $150,000 expense for the nine months ended September 30, 2011 was a discrete net charge of $194,000 for the clearing of disproportionate tax effects in other comprehensive income related to unrealized gains and losses on marketable investments, offset by a discrete tax benefit of $246,000 resulting from the carry-back of fiscal year 2010 federal losses to obtain a refund of alternative minimum taxes paid for fiscal year 2008.

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, 2012 and December 31, 2011, 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.

As of September 30, 2012, there were no material changes to either the nature or the amounts of the uncertain tax positions previously determined and disclosed pursuant to FASB ASC Topic 740 as of December 31, 2011.

Note 12. Commitments and Contingencies

Purchase Commitments
The Company maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply for key components. The Company’s liability in these purchase commitments is generally restricted

to a forecasted time-horizon as agreed between the parties. These forecasted time-horizons can vary among different suppliers. The Company's open inventory purchase commitments with its suppliers were not significant at September 30, 2012.

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, 2012, the Company had accrued $296,000 related to pending product liability and contractual lawsuits.

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## 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, 2011 as contained in our annual report on Form 10-K filed with the SEC on March 15, 2012. 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 25, 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 global medical device company specializing in the design, development, manufacture, marketing and servicing of laser and light-based aesthetics systems for practitioners worldwide. We offer easy-to-use products based on seven platforms — CoolGlide®, Xeo®, Solera®, GenesisPlusTM, Excel VTM, myQTM, and truSculptTM, each of which enables physicians and other qualified practitioners to perform safe and effective aesthetic procedures for their customers. The Xeo and Solera platforms offer multiple hand pieces and applications, which allow customers to upgrade their systems, which we treat as Upgrade revenue. 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; Titan hand piece refills; and third party manufactured dermal fillers and cosmeceutical products.

In February 2012, we acquired the global aesthetic business unit of Iridex Inc., which included various laser systems (such as the VariLite and Gemini) and an installed base of customers, whose products are serviced by us.

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. In the United States, we market, sell and service our products through direct sales and service employees, and a distribution relationship with PSS World Medical Shared Services, Inc. ("PSS"), a wholly owned subsidiary of PSS World Medical which has over 700 sales representatives serving physician offices throughout the United States. We also sell certain items such as our Titan hand piece refills and marketing brochures online.

International sales are generally made through direct sales employees and a worldwide distributor network in over 40 countries. Outside of the United States, we have a direct sales presence in Australia, Canada, France and Japan. Effective March 31, 2012, we decided to discontinue our direct operations in Spain and the United Kingdom and instead plan on seeking a distributor to market our products in these countries.

Products

Our revenue is derived from the sale of Products, Upgrades, Service, Titan hand piece refills, and Dermal fillers and cosmeceutical products. Product revenue represents the sale of a system. A system consists of a console that incorporates a universal graphic user interface, a laser and/or light-based module, control system software and high voltage electronics; as well as one or more hand pieces. However, depending on the application, the laser or light-based module is sometimes contained in the hand piece, such as with our Pearl and Pearl Fractional applications, instead of within the console.

We offer our customers the ability to select the system that best fits their practice at the time of purchase and then to cost-effectively add applications to their system as their practice grows. This provides customers the flexibility to upgrade their systems whenever they want and provides us with a source of recurring revenue which we classify as Upgrade revenue. Service revenue relates to amortization of prepaid service contracts, direct billings for detachable hand piece replacements and revenue for parts and labor on out-of-warranty products. Titan hand piece refill revenue is associated with our Titan hand piece which requires replacement of the optical source after a set number of pulses have been used. In Japan, we distribute Merz Pharma GmbH's (Merz) Radiesse® dermal filler product; and Obagi Medical Products, Inc.'s (Obagi) cosmeceutical products.

Significant Business Trends

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

- 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).
- Customer demand for our products.
- Consumer demand for the application of our products.
- 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, Upgrade, Titan hand piece refills, and Dermal fillers and cosmeceutical products.

Geographical Revenue

Our U.S. revenue increased by $1.8 million, or 29%, in the three-month period ended September 30, 2012, and by $6.0 million or 38%, in the nine-month period ended September 30, 3012, compared to the same periods in 2011. This increase was due primarily to our recent new product introductions (Excel V and truSculpt), acquisition of Iridex's aesthetic business in February 2012, increased promotional activities and improvements in the U.S. macroeconomic environment.

For the three and nine months ended September 30, 2012, our international revenue increased by $2.4 million, or 26%, and by $7.0 million, or 27%, respectively, compared to the same periods in 2011. Recently, we have decided to shift from a direct sales model to a distributor model in Spain, U.K. and Switzerland. In addition to France, where we continue to have a direct sales and service team, our European revenue is sourced from distributors. These changes have not negatively impacted our European sourced revenue in the three and nine months ended September 30, 2012, compared to the same periods in the prior year.

Upgrade Revenue

In the past, we introduced new products that allowed existing customers to upgrade their previously purchased systems to obtain benefits from the additional capabilities, which drove our Upgrade revenue. However, since 2008 we have not introduced any new products that our customers could purchase as an upgrade to their previously purchased system. Instead, we have launched new stand alone products (GenesisPlus, Excel V, myQ, truSculpt). As a result, our Upgrade revenue has declined since 2009.

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Iridex Aesthetic Business Acquisition

We acquired Iridex's aesthetic business unit in February 2012. This acquisition was the primary driver of the $1.1 million increase in our Service revenue in the three-month period ended September 30, 2012, and the $2.5 million increase in the nine-month period ended September 30, 2012, compared to the respective periods in 2011. For the three and nine-months ended September 30, 2012, we generated $491,000 and $1.1 million, respectively of Iridex product revenue, primarily from the sale of VariLite and Gemini systems. The VariLite is a small compact vascular product that complements our Excel V and other vascular products. We believe that our Product revenue will have a favorable impact from this acquisition for the remainder of 2012.

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 generally accepted accounting principles in the United States, or 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 Securities and Exchange Commission (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, 2011 filed with the SEC on March 15, 2012. There have been no significant changes to the accounting policies and estimates disclosed in our Form 10-K, except for the following:

Long-Lived Assets Impairment:

In February 2012, we acquired the global aesthetic business unit of IRIDEX Corporation, which included various laser systems (such as the VariLite and Gemini) and an installed base of customers, whose products are being serviced by us. This acquisition was considered a business combination for accounting purposes, and as such, in addition to valuing all the assets, we recorded goodwill associated with the expected synergies from leveraging the customer relationships and integrating new product offerings into our business. The fair values of the assets acquired were determined to be $4.8 million of net tangible and intangible assets and $1.3 million of goodwill. Long-lived assets, such as property and equipment, intangible assets and goodwill, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not ultimately be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its ultimate disposition. If the sum of the expected future cash flows is less than the carrying amount of those assets, we recognize an impairment loss based on the excess of the carrying amount over the fair value of the assets. Through September 30, 2012, there have been no such impairments.

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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, 2012 | Three Months Ended September 30, 2011 | Nine Months Ended September 30, 2012 | Nine Months Ended September 30, 2011 |
|---|---|---|---|---|
| Net revenue | 100% | 100% | 100% | 100% |
| Cost of revenue | 45% | 44% | 47% | 44% |
| Gross margin | 55% | 56% | 53% | 56% |
| | | | | |
| Operating expenses: | | | | |
| Sales and marketing | 36% | 42% | 39% | 45% |
| Research and development | 11% | 16% | 12% | 17% |
| General and administrative | 13% | 15% | 16% | 17% |
| Total operating expenses | 60% | 73% | 67% | 79% |
| | | | | |
| Loss from operations | (5)% | (17)% | (14)% | (23)% |
| Interest and other income, net | — | — | — | 1% |
| Loss before income taxes | (5)% | (17)% | (14)% | (22)% |
| Provision for income taxes | — | (2)% | — | — |
| Net loss | (5)% | (19)% | (14)% | (22)% |

Total Net Revenue

| (Dollars in thousands) | Three Months Ended September 30, 2012 | % Change | 2011 | Nine Months Ended September 30, 2012 | % Change | 2011 |
|---|---|---|---|---|---|---|
| Revenue mix by geography: | | | | | | |
| United States | $7,796 | 29 % | $6,037 | $21,941 | 38 % | $15,941 |
| International | 11,630 | 26 % | 9,195 | 32,803 | 27 % | 25,807 |
| Consolidated total revenue | $19,426 | 28 % | $15,232 | $54,744 | 31 % | $41,748 |
| | | | | | | |
| United States as a percentage of total revenue | 40 % | | 40 % | 40 % | | 38 % |
| International as a percentage of total revenue | 60 % | | 60 % | 60 % | | 62 % |
| Revenue mix by product category: | | | | | | |
| Products | $12,047 | 34 % | $8,975 | $32,170 | 43 % | $22,462 |
| Upgrades | 487 | (29 %) | 687 | 2,109 | (11 %) | 2,364 |
| Service | 4,298 | 33 % | 3,227 | 12,606 | 24 % | 10,149 |
| Titan hand piece refills | 1,226 | 19 % | 1,031 | 3,572 | 7 % | 3,336 |
| Dermal fillers and cosmeceuticals | 1,368 | 4 % | 1,312 | 4,287 | 25 % | 3,437 |
| Consolidated total revenue | $19,426 | 28 % | $15,232 | $54,744 | 31 % | $41,748 |

Discussion of Revenue by Product Type:

Product 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 revenue increased by $3.1 million or 34% in the three-month period ended September 30, 2012, compared to the same period in 2011, and by $9.7 million or 43% in the nine-month period ended September 30, 2012, compared to the same period in 2011. These increases in revenue were due primarily to Excel V shipments which began in the second quarter of 2011, the commencement of truSculpt shipments in August of 2012, incremental revenue from the Iridex aesthetic acquisition in February 2012 and improvement in the U.S. macroeconomic environment.

Upgrade Revenue

As explained in more detail in the Products section of the Executive Summary above, our configurable system platforms allow customers to add applications to their existing systems to meet the changing needs of their practices. In some cases, when certain applications are desired that are only available on a platform other than the one owned by the customer, the Upgrade revenue will include a platform exchange and additional hand pieces.

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Upgrade revenue decreased by $200,000, or 29%, in the three-month period ended September 30, 2012, and by $255,000, or 11%, in the nine-month period ended September 30, 2012, compared to the same periods in 2011. In the past, we introduced new products that allowed existing customers to upgrade their previously purchased systems to take advantage of the additional capabilities, which drove our Upgrade revenue. However, recently we have launched stand alone products (GenesisPlus, Excel V, myQ and truSculpt) versus products that can be an upgrade to an existing system, which has resulted in a decline of our upgrade revenue.

Service Revenue

Our worldwide Service revenue increased by $1.1 million, or 33%, in the three-month period ended September 30, 2012, compared to the same period in 2011, and by $2.5 million, or 24%, in the nine-month period ended September 30, 2012, compared to the same period in 2011. This increase was primarily the result of Service revenue from the Iridex business acquisition.

Titan Hand Piece Refill Revenue

Our Titan hand piece refill revenue increased by $195,000 or 19% in the three-month period ended September 30, 2012, and by $236,000, or 7%, in the nine-month period ended September 30, 2012, compared to the same periods in 2011. This increase was due primarily to the continued growth in Titan refill revenue in Japan and improvements in the U.S.

Dermal Filler and Cosmeceuticals Revenue

Our dermal filler and cosmeceuticals revenue increased by $56,000 or 4%, in the three-month period ended September 30, 2012 and by $850,000, or 25%, in the nine-month period ended September 30, 2012, compared to the same periods in 2011. This increase was due primarily to the higher number of customers purchasing Obagi and Merz distributed products in Japan, and due to the expansion of product lines being distributed.

Discussion of Revenue by Geography:

U.S. Revenue

Our U.S. revenue increased by $1.8 million, or 29%, in the three-month period ended September 30, 2012, and by $6.0 million or 38%, in the nine-month period ended September 30, 3012, compared to the same periods in 2011. This increase was primarily attributable to an increase in Product revenue due to the:

- Continued growth of Excel V shipments, which began shipping in the second quarter of 2011;
- Commencement of truSculpt shipments in August 2012;
- Incremental revenue from the Iridex aesthetic acquisition in February 2012; and
- Improvements in the U.S. macroeconomic environment.

International Revenue

International revenue increased by $2.4 million, or 26%, in the three-month period ended September 30, 2012, compared to the same period in 2011, and by $7.0 million, or 27%, in the nine-month period ended September 30, 2012, compared to the same period in 2011. This increase was primarily attributable to:

- Higher Product revenue from Canada, France, Japan and many distributor countries in our Asia Pacific region; and
- An increase in our Dermal filler and cosmeceuticals revenue in Japan, due primarily to additional Obagi and Merz product lines being added and a higher number of customers purchasing such products from Cutera.

Gross Profit

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | 2012 | % Change | 2011 | 2012 | % Change | 2011 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Gross profit | $ | 10,598 | 25% | $ | 8,460 | $ | 28,797 | 24% | $ | 23,276 |
| As a percentage of total net revenue | | 55% | | | 56% | | 53% | | | 56% |

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

Gross margin (which is gross profit divided by net revenue) was 55% in the three-month period ended September 30, 2012, compared to 56% for the same period in 2011. Gross margin was 53% in the nine-month period ended September 30, 2012, compared to 56% for the same period in 2011. This decline was due primarily to:

- A product mix shift towards lower margin products; and
- An increase in sales through our distributors, which typically have a lower margin than our direct revenue.

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Sales and Marketing

| (Dollars in thousands) | Three Months Ended September 30, 2012 | % Change | 2011 | Nine Months Ended September 30, 2012 | % Change | 2011 |
|---|---|---|---|---|---|---|
| Sales and marketing | $7,014 | 9 % | $6,426 | $21,563 | 15 % | $18,720 |
| As a percentage of total net revenue | 36 % | | 42 % | 39 % | | 45 % |

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 $588,000, and represented 36% of total net revenue, in the three-month period ended September 30, 2012, compared to 42% in the same period in 2011. The $588,000 increase was due primarily to:

$618,000 of higher personnel expenses attributable primarily to higher headcount and sales commission expenses associated with the higher revenue;
$187,000 of higher product demonstration related expenses; offset by
$81,000 of decreased travel, entertainment and sales meeting expenses; and
$71,000 of decreased promotional spending.

Sales and marketing expenses increased $2.8 million, and represented 39% of total net revenue, in the nine-month period ended September 30, 2012, compared to 45% in the same period in 2011. The $2.8 million increase was due primarily to:

$1.6 million of higher personnel expenses attributable primarily to higher headcount and sales commission expenses associated with the higher revenue;
$751,000 of higher product demonstration related expenses;
$344,000 of increased travel, entertainment and sales meeting expenses due to higher headcount; and
$208,000 of increased promotional and marketing expenses.

Research and Development (R&D)

| (Dollars in thousands) | Three Months Ended September 30, 2012 | % Change | 2011 | Nine Months Ended September 30, 2012 | % Change | 2011 |
|---|---|---|---|---|---|---|
| Research and development | $ 2,217 | (6%) | $ 2,352 | $ 6,305 | (8%) | $ 6,828 |
| As a percentage of total net revenue | 11% | | 16% | 12% | | 17% |

R&D expenses consist primarily of personnel expenses, clinical research, regulatory and material costs. R&D expenses decreased by $135,000, and represented 11% of total net revenue, in the three-month period ended September 30, 2012, compared to 16% for the same period in 2011. The decrease was due primarily to $117,000 of reduced prototype material expenses resulting from the timing of product development activities.

R&D expenses decreased by $523,000, and represented 12% of total net revenue, in the nine-month period ended September 30, 2012, compared to 17% for the same period in 2011. The decrease in expenses was due primarily to:

$289,000 of reduced prototype material expenses resulting from the timing of product development activities;
$110,000 of reduced personnel expenses due to lower headcount partially offset by severance expense; and
$93,000 of reduced travel and entertainment expenses.

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General and Administrative (G&A)

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | 2012 | % Change | 2011 | 2012 | % Change | 2011 |
| General and administrative | $ 2,475 | 7% | $ 2,310 | $ 8,824 | 22% | $ 7,226 |
| As a percentage of total net revenue | 13% | | 15% | 16% | | 17% |

General and administrative expenses consist primarily of personnel expenses, legal fees, accounting, audit and tax consulting fees, and other general and administrative expenses. G&A expenses increased $165,000, and represented 13% of total net revenue, in the three-month period ended September 30, 2012, compared to 15% for the same period in 2011. This increase was due primarily to $274,000 of higher personnel expenses, offset by a $92,000 reduction in office relocation expenses related to the 2011 move of our offices in Japan.

G&A expenses increased $1.6 million, and represented 16% of total net revenue, in the nine-month period ended September 30, 2012, compared to 17% for the same period in 2011. This increase was due primarily to:

$527,000 of non-recurring integration expenses associated with the Iridex business acquisition;
$505,000 of higher legal fees and costs of settlements;
$380,000 of higher accounting and tax consulting fees; and
$95,000 of higher personnel expenses.

Interest and Other Income, Net

Interest and other income, net consist of the following:

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | 2012 | % Change | 2011 | 2012 | % Change | 2011 |
| Interest income | $116 | (17%) | $139 | $373 | (18%) | $457 |
| Other income (expense), net | 36 | 175% | (48) | 19 | 12% | 17 |
| Total interest and other income, net | $152 | 67% | $91 | $392 | (17%) | $474 |

Interest and other income, net, increased $61,000 for the three-month period ended September 30, 2012, and decreased by $82,000 for the nine-month period ended September 30, 2012 compared to the same periods in 2011. The increase in the three-month period ended September 30, 2012, was primarily attributable to a $64,000 increase in net foreign exchange gains. The decrease in the nine-month period ended September 30, 2012, was primarily attributable to a $84,000 decrease in interest income resulting from a reduced investment balance and reduced yields.

Provision (Benefit) for Income Taxes

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | 2012 | % Change | 2011 | 2012 | % Change | 2011 |
| Loss before income taxes | $ (956) | (62%) | $ (2,537) | $ (7,503) | (17%) | $ (9,024) |
| Provision (benefit) for income taxes | (64) | NA | 326 | 122 | NA | 150 |

For the three months ended September 30, 2012 and 2011, the Company’s tax benefit was $64,000 and tax expense was $326,000, respectively. For the nine months ended September 30, 2012 and 2011, the Company’s income tax expense was $122,000 and $150,000, respectively. The Company’s income tax expense (benefit) was primarily attributable to income taxes of the Company’s international operations, offset by benefits for income taxes related to gains and losses on marketable and long-term investments recorded in other comprehensive loss.

Included in the $326,000 expense for the three months ended September 30, 2011, was a discrete charge of $262,000 for the clearing of disproportionate tax effects in accumulated other comprehensive loss related to unrealized gains and losses on marketable and long term investments. Included in the $150,000 expense for the nine months ended September 30, 2011 was a discrete net charge of $194,000 for the clearing of disproportionate tax effects in other comprehensive income related to unrealized gains and losses on marketable investments, offset by a discrete tax benefit of $246,000 resulting from the carry-back of fiscal year 2010 federal losses to obtain a refund of alternative minimum taxes paid for fiscal year 2008.

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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 and Cash Equivalents, Marketable Investments and Long-Term Investments Summary

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

| (Dollars in thousands) | September 30, 2012 | December 31, 2011 | Change |
|---|---|---|---|
| Cash and cash equivalents | $ 24,334 | $ 14,020 | $ 10,314 |
| Marketable investments | 55,795 | 74,666 | (18,871) |
| Long-term investments | 1,050 | 3,027 | (1,977) |
| Total | $ 81,179 | $ 91,713 | $ (10,534) |

Cash Flows

| (Dollars in thousands) | Nine Months Ended September 30, 2012 | 2011 |
|---|---|---|
| Net cash flow provided by (used in): | | |
| Operating activities | $ (5,991) | $ (5,753) |
| Investing activities | 15,493 | 6,042 |
| Financing activities | 812 | 1,066 |
| Net increase (decrease) in cash and cash equivalents | $ 10,314 | $ 1,355 |

Cash Flows from Operating Activities

Net cash used in operating activities in the nine-month period ended September 30, 2012 was $6.0 million, which was due primarily to:

- $4.2 million used due to the net loss of $7.6 million, after adjusting for non-cash related items of $3.4 million consisting primarily of stock-based compensation expense of $2.3 million and depreciation and amortization expenses of $1.2 million;
- $2.7 million used as a result of an increase in accounts receivable, primarily due to higher revenue, which was within normal payment terms;
- $276,000 used to reduce accounts payable;
- $196,000 used to increase inventory relating primarily to higher raw materials and finished goods associated with our increased revenue levels and higher demonstration inventories as a result of increased sales personnel;
- $163,000 used to reduce accrued liabilities; offset by
- $905,000 generated by an increase in deferred service revenue primarily as a result of the Iridex acquisition; and
- $717,000 generated by a reduction of other current assets, primarily relating to a $728,000 reduction in discounts and purchased interest with respect to our marketable investments.

Net cash used in operating activities in the nine-month period ended September 30, 2011 was $5.8 million, which was due primarily to:

$5.4 million used by the net loss of $9.2 million after adjusting for non-cash related items of $3.8 million consisting primarily of stock-based compensation expense of $3.1 million, depreciation and amortization of $483,000 and the tax on unrealized gains of marketable and long-term investments of $194,000;

$3.2 million used to increase inventory relating primarily to raw materials and finished goods associated with the ramp up of our recently introduced products — GenesisPlus and Excel V;

$698,000 used as a result of a decrease in deferred revenue due primarily to a decrease in unit sales volume of Products and Upgrades that included purchases of extended service contracts, a reduction in our service contract pricing, a shift by customers towards purchasing shorter term contracts, and fewer customers purchasing extended service contracts;
$493,000 used in other long-term assets, which was primarily related to a $443,000 lease deposit for our Japan facility; which was offset by
$2.0 million generated from the reduction of other current assets primarily from the receipt of a U.S. income tax refund of $1.2 million and $1.1 million amortization of discounts and purchased interest relating to our marketable investments, offset by an increase in prepaid expenses of $212,000;
$1.1 million generated by an increase in accrued liabilities relating primarily to an increase in customer deposits of $453,000, an increase in accrued royalties by $178,000, and accrued but unpaid personnel costs of $464,000; and

· $855,000 generated by an increase in accounts payable due primarily to higher inventory purchases.

Cash Flows from Investing Activities

We generated net cash of $15.5 million from investing activities in the nine-month period ended September 30, 2012, which was attributable primarily to:

$60.1 million in net proceeds from the sales and maturities of marketable investments; partially offset by
$39.9 million of cash used to purchase marketable investments; and
$5.1 million of cash used for the Iridex acquisition.

We generated net cash of $6.0 million from investing activities in the nine-month period ended September 30, 2011, which was attributable primarily to:

$52.7 million in net proceeds from the sales and maturities of marketable investments; and
$46.3 million of cash used to purchase marketable investments.

Cash Flows from Financing Activities

Net cash provided by financing activities was $812,000 in the nine-month period ended September 30, 2012 and $1.1 million in the nine-month period ended September 30, 2011, which primarily resulted from cash generated by the issuance of stock as a result of employees exercising their stock options and shares issued pursuant to our employee stock purchase plan.

Adequacy of cash resources to meet future needs

We had cash, cash equivalents, marketable investments, and long-term investments of $81.2 million as of September 30, 2012. Of this amount, we had $1.1 million of a long-term ARS investment. For the first nine months of 2012, we financed our operations through the sales and maturities of marketable investments and cash from the sale of stock through employee stock option exercises and our employee stock purchase plan. We believe the existing capital resources, including cash and cash equivalents and marketable investments of $80.1 million, are sufficient to meet our operating and capital requirements for the next 12 months. Except for the recent trend of cash used to fund our operating activities, 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.

Off-Balance Sheet Arrangements

We do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, variable interest or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

We have certain contractual arrangements that create potential risk for us and are not recognized in our Condensed Consolidated Balance Sheets. Discussed below are off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures, or capital resources.

We lease various real properties under operating leases that generally require us to pay taxes, insurance, maintenance, and minimum lease payments. Some of our leases have options to renew.

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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, 2011, filed with the SEC on March 15, 2012, except for those noted in Legal Proceedings in Part II, Item 1 below.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes to our market risks from those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on March 15, 2012.

## ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Attached as exhibits to this Quarterly Report are certifications of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended (Exchange Act). This Controls and Procedures section includes the information concerning the controls evaluation referred to in the certifications, and it should be read in conjunction with the certifications for a more complete understanding of the topics presented.

We conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in the Rules 13a-15(e) and 15d-15(e) under the Exchange Act) (Disclosure Controls) as of the end of the period covered by this Report required by Exchange Act Rules 13a-15(b) or 15d-15(b). The controls evaluation was conducted under the supervision and with the participation of our management, including the CEO and CFO. Based on this evaluation, the CEO and CFO have concluded that as of the end of the period covered by this report the disclosure controls and procedures were effective at a reasonable assurance level.

Definition of Disclosure Controls

Disclosure Controls are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed under the Exchange Act, such as this Report, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure Controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Our Disclosure Controls include components of internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of its financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles in the U.S. To the extent that components of our internal control over financial reporting are included within Disclosure Controls, they are included in the scope of our annual controls evaluation.

Limitations on the Effectiveness of Controls

Our management, including the CEO and CFO, does not expect that our disclosure controls or internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

We are named from time to time as a party to product liability and contractual lawsuits in the normal course of business. We routinely assess 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 we shall incur a loss, and whether the loss is estimable. As of September 30, 2012, we had accrued $296,000 related to pending product liability and contractual lawsuits.

### ITEM 1A. RISK FACTORS

We operate in a rapidly changing economic and technological environment that presents numerous risks, many of which are driven by factors that we cannot control or predict. The following discussion, as well as our discussion in Management's Discussion and Analysis of Financial Condition and Results of Operations (Item 7), highlights some of these risks. The risks described below are not exhaustive and you should carefully consider these risks and uncertainties before investing in our securities.

In the three and nine-month periods ended September 30, 2012, our U.S. revenue increased by approximately 29% and 38% respectively, compared to the same periods in 2011. Even though our U.S. revenue has increased in 2012, it continues to be significantly below the pre-2009 levels. If our U.S. revenue does not continue to improve, it could have a material adverse effect on our total revenue, profitability, employee retention and stock price.

In the three and nine-month periods ended September 30, 2012, our U.S. revenue increased by approximately 29% and 38% respectively, compared to the same periods in 2011. Even though our U.S. revenue has increased in 2012, it continues to be significantly below the pre-2009 levels due to several factors, some of which are:

Our Product and Upgrade ASPs were lower than the pre-2009 levels as a result of customers purchasing fewer applications for systems, lower pricing resulting from competitive discounting pressures and the impact of a shift in our product mix towards lower priced systems.

Historically, we have introduced a new product every year since 2000, with the exception of 2009, and our revenue increases following the introduction of new products. In 2010, we launched GenesisPlus, in 2011 Excel V, and in 2012 truSculpt. Even though we have introduced these new products and experienced sales increases as a result, there can be no assurance that we will continue to introduce a new product each year or that these products introduced will translate into increased revenue in the long term in the U.S.

Though our U.S. quarterly revenue has improved over the past six quarters ended September 30, 2012, compared with the respective quarters in the prior year, due primarily to new product introductions, this growth was partly attributable to the improved U.S. macroeconomic environment and availability of credit at reduced interest rates. The improved macroeconomic environment also contributed to increased corporate confidence and spending. If the current economic recovery does not hold, or there is another recession in the U.S., our future revenue growth would be adversely impacted.

If our U.S. revenue does not continue to improve, it could have a material adverse effect on our total revenue, profitability, employee retention and stock price.

We rely heavily on our sales professionals to market and sell our products worldwide. If we are unable to hire, effectively train, manage, improve the productivity of, and retain the sales professionals, our business will be harmed, which would impair our future revenue and profitability.

Our success largely depends on our ability to hire, train, manage and improve the productivity levels of our sales professionals worldwide. Because of our focus on the non-core market in the past, several of our sales professionals do not have established relationships with core market physicians (Dermatologists and Plastic Surgeons) or where those relationships exist, they are not very strong. In addition, we have lost some of our sales professionals in response to the decline in their earnings resulting from the decreases in their commissions.

We have been training our existing and recently recruited sales professionals to better understand our product technology and how it can be positioned against our competitors' products.  These initiatives are intended to improve the productivity of our sales professionals, our revenue and profitability.

We have experienced significant turnover of our European sales team. While we continue to have a direct sales and service organization in France, and have consolidated our operations with the newly acquired aesthetic business of Iridex there, we have restructured the rest of our European operation. We shut down our direct European hub in Switzerland in December 2011, and in March 2012 we decided to shut down our direct sales offices in Spain and the United Kingdom. We have engaged a distributor in Switzerland and are in the process of identifying new distributor partners in Spain and the United Kingdom. As we restructure parts of our European business towards a more distributor focus, there can be no assurance given that these initiatives will result in improved European-sourced revenue or profitability in the future.

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Measures we implement in an effort to retain, train and manage our sales professionals, strengthen their relationships with core market physicians, and improve their productivity may not be successful and may instead contribute to instability in our operations, additional departures from our sales organization, or further reduce our revenue and harm our business.

If our revenue does not continue to improve, or if our cost of revenue and/ or operating expenses increase by a greater percentage than our revenue, our gross margins and operating margins may be adversely impacted, our loss from operations will increase, and our cash used in operating activities will increase, which could reduce our assets and have a material adverse effect on our stock price.

Our gross margin declined to 53% in the nine-month period ended September 30, 2012, compared to 56% in the same period of 2011. Our gross margin is impacted by the revenue that we generate and the costs incurred to generate the revenue. Our future revenue may be adversely affected by a number of factors including, the competitive market environment in which we operate, which may result in a decrease in the number of units sold, a decrease in the number of applications per system purchased by customers, a decrease in the average selling prices achieved for our product sales, a shift in our product mix towards products with lower average selling prices, or a shift in our product mix towards products with lower margin (revenue less cost).

Our cost of revenue may also be adversely impacted by various factors such as obsolescence of our inventory, increased expenses associated with repairing defective products covered by our warranty program, utilization of our relatively fixed manufacturing costs, and a shift in our product mix towards products that have a higher cost of manufacturing. We have also been investing significant resources in our research and development activities and using cash in the process. We plan to continue making such investments in order to bring new products to market.

If our revenue does not continue to improve, or if our cost of revenue increases by a greater percentage than our revenue, or if we are not able to reduce expenses in the event of a decline in revenue, we may continue to generate losses from operations and use cash, which could reduce our assets and have a material adverse effect on our operations and stock price.

The aesthetic equipment market is characterized by rapid innovation. To compete effectively, we must develop and/or acquire new products, market them successfully, and identify new markets for our technology.

We have created products to apply our technology to hair removal, treatment of veins and skin rejuvenation, including the treating of diffuse redness, skin laxity, fine lines, wrinkles, skin texture, pore size and pigmented lesions. In 2012, we launched truSculpt for the body contouring market. In 2011, we launched our vascular laser product – Excel V – and began distribution of a Q-switched laser in Japan that Cutera is sourcing from a third party OEM for superficial and deep pigmented lesions (i.e., melasma), skin rejuvenation, laser skin toning and tattoo removal. Currently, these applications represent the majority of offered laser and light-based aesthetic procedures. Since the first quarter of 2010, we have been distributing cosmeceutical products and dermal fillers in the Japanese market. To grow in the future, we must continue to develop and acquire new and innovative aesthetic products and applications, identify new markets, and successfully launch the newly acquired or developed product offerings.

To successfully expand our product offerings, we must, among other things:

Develop and acquire new products that either add to or significantly improve our current product offerings;

Convince our existing and prospective customers that our product offerings would be an attractive revenue-generating addition to their practice;

Sell our product offerings to a broad customer base;

Identify new markets and alternative applications for our technology;

Protect our existing and future products with defensible intellectual property; and
Satisfy and maintain all regulatory requirements for commercialization.

Historically, product introductions have been a significant component of our financial performance. To be successful in the aesthetics industry, we need to continue to innovate. Our business strategy has therefore been based, in part, on our expectation that we will continue to increase our product offerings. We need to continue to devote substantial research and development resources to make new product introductions, which can be costly and time consuming to our organization.

We also believe that, to increase revenue from sales of new products, we need to continue to develop our clinical support, further expand and nurture relationships with industry thought leaders and increase market awareness of the benefits of our new products. However, even with a significant investment in research and development, we may be unable to continue to develop, acquire or effectively launch and market new products and technologies regularly, or at all. If we fail to successfully commercialize new products, our business may be harmed.

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While we attempt to protect our products through patents and other intellectual property, there are few barriers to entry that would prevent new entrants or existing competitors from developing products that compete directly with ours. We expect that any competitive advantage we may enjoy from current and future innovations may diminish over time as companies successfully respond to our, or create their own, innovations. Consequently, we believe that we will have to continuously innovate and improve our products and technology to compete successfully. If we are unable to innovate successfully, our products could become obsolete and our revenue could decline as our customers and prospects purchase our competitors' products.

Healthcare reform legislation could adversely affect our future profitability and financial condition.

In December 2009, the President and members of Congress passed legislation relating to healthcare reform. Our products are not reimbursed by insurance companies or federal or state governments and some of this legislation will, therefore, not affect us.
However, beginning in 2013, medical device manufacturers will have to pay an excise tax of 2.3% on certain U.S. medical device revenues. Though there are some exceptions, this excise tax will apply to all of our products manufactured and sold within the U.S. and will affect our profitability. While we are presently evaluating the full scope of how this legislation will impact our operations, including how to administer this tax, we believe this will adversely affect our future profitability and financial condition.

Demand for our products in any of our markets could be weakened by several factors, including:

Our ability to develop and market our products to the core market specialties of dermatologists and plastic surgeons;
Poor financial performance of market segments that try introducing aesthetic procedures to their businesses;
The inability to differentiate our products from those of our competitors;
Reduced patient demand for elective aesthetic procedures;
Failure to build and maintain relationships with opinion leaders within the various market segments;
An increase in malpractice lawsuits that result in higher insurance costs; and
The lack of credit financing for some of our potential customers.

If we do not achieve anticipated demand for our products, it could have a material adverse effect on our total revenue, profitability, employee retention and stock price.

We may face problems with the integration of our acquisition of IRIDEX Corporation's global aesthetic business.

On February 2, 2012, we completed our acquisition of certain assets of IRIDEX Corporation's (IRIDEX) global aesthetic business.
We cannot be certain that this integration will be successful or that we will realize the anticipated benefits of the acquisition. In particular, we may not be able to realize the strategic and operational benefits and objectives we had anticipated, including, greater revenue and marketing opportunities. In addition, the demand for our combined product offerings may fluctuate and we will face competition from new competitors in the market for our products. Our ability to realize the strategic and operational benefits and objectives of this acquisition may be impacted by several factors including:
The potential disruption of the company's ongoing business and diversion of management resources;
The difficulty of incorporating acquired products, technology and rights into the company's products and services;
Unanticipated expenses related to integration of operations;
Potential periodic impairment of goodwill and intangible assets acquired; and
Potential inability to retain, integrate and motivate key personnel.

Any of the above mentioned factors, as well as the inability to realize the long-term anticipated synergies of the acquisition of these assets, may have a material adverse effect on our business, operating results and financial condition.

Macroeconomic political and market conditions, and catastrophic events may adversely affect our business, results of operations, financial condition and stock price.

Our business is influenced by a range of factors that are beyond our control, including:

General economic and business conditions;

The overall demand for our products by the core market specialties of dermatologists and plastic surgeons;

Governmental budgetary constraints or shifts in government spending priorities;

General political developments;

Natural disasters, such as the March 2011 earthquake and tsunami in Japan; and

Currency exchange rate fluctuations.

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Macroeconomic developments like the global recession and the debt crisis in the U.S. and certain countries in the European Union, could negatively affect our business, operating results or financial condition which, in turn, could adversely affect our stock price. A general weakening of, and related declining corporate confidence in, the global economy or the curtailment in government or corporate spending could cause current or potential customers to reduce their budgets or be unable to fund product or upgrade application purchases, which could cause customers to delay, decrease or cancel purchases of our products and services or cause customers not to pay us or to delay paying us for previously purchased products and services.

In addition, political unrest in regions like the Middle East, terrorist attacks around the globe and the potential for other hostilities in various parts of the world, potential public health crises and natural disasters continue to contribute to a climate of economic and political uncertainty that could adversely affect our results of operations and financial condition, including our revenue growth and profitability. For example, the March 2011 earthquake and tsunami, and other collateral events in Japan adversely affected the demand for our products and services in the Japanese market.

Macroeconomic declines, negative political developments, adverse market conditions and catastrophic events may cause a decline in our revenue, negatively affect our operating results, adversely affect our cash flow and could result in a decline in our stock price

To successfully market and sell our products internationally, we must address many issues that are unique to our international business.

International revenue represented 60% of our total revenue for the nine months ended September 30, 2012, compared to 62% for the same period in 2011. International revenue is a material component of our business strategy. We depend on third-party distributors and a direct sales force to sell our products internationally, and if they underperform, we may be unable to increase or maintain our level of international revenue.

We have experienced significant turnover of our European sales team. While we continue to have a direct sales and service organization in France, and have consolidated our operations with the newly acquired aesthetic business of Iridex there, we have restructured the rest of our European operation. We shut down our direct European hub in Switzerland in December 2011, and in March 2012, we decided to shut down our direct sales offices in Spain and the United Kingdom. We have engaged a distributor in Switzerland and are in the process of identifying new distributor partners in Spain and the United Kingdom. As we restructure parts of our European business towards a more distributor focus, there can be no assurance given that these initiatives will result in improved European-sourced revenue or profitability in the future.

To grow our business, we will need to improve productivity in current sales territories and expand into new territories. However, direct sales productivity may not improve and distributors may not accept our business or commit the necessary resources to market and sell our products to the level of our expectations. If we are not able to increase or maintain international revenue growth, our total revenue, profitability and stock price may be adversely impacted.

We believe, as we continue to manage our international operations and develop opportunities in additional international territories, our international revenue will be subject to a number of risks, including:

Difficulties in staffing and managing our foreign operations;
Export restrictions, trade regulations and foreign tax laws;
Fluctuating foreign currency exchange rates;
Foreign certification and regulatory requirements;
Lengthy payment cycles and difficulty in collecting accounts receivable;

Customs clearance and shipping delays;
Political and economic instability;
Lack of awareness of our brand in international markets;
Preference for locally-produced products; and
Reduced protection for intellectual property rights in some countries.

If one or more of these risks were realized, it could require us to dedicate significant resources to remedy the situation; and if we were unsuccessful at finding a solution, we may not be able to sell our products in a particular market and, as a result, our revenue may decline.

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Our ability to effectively compete and generate additional revenue from new and existing products depend upon our ability to distinguish our company and our products from our competitors and their products, and to develop and effectively market new and existing products. Our success is dependent on many factors, including the following:

- Speed of new and innovative product development;
- Effective strategy and execution of new product launches;
- Identify and develop clinical support for new indications of our existing products;
- Product performance;
- Product pricing;
- Quality of customer support;
- Development of successful distribution channels, both domestically and internationally; and
- Intellectual property protection.

To compete effectively, we have to demonstrate that our new and existing products are attractive alternatives to other devices and treatments, by differentiating our products on the basis of such factors as innovation, performance, brand name, service, and price. This is difficult to do, especially in a crowded aesthetic market. Some of our competitors have newer or different products and more established customer relationships than we do, which could inhibit our market penetration efforts. For example, we have encountered, and expect to continue to encounter, situations where, due to pre-existing relationships, potential customers decided to purchase additional products from our competitors. Potential customers also may need to recoup the cost of products that they have already purchased from our competitors and may decide not to purchase our products, or to delay such purchases.

If we are unable to increase our market penetration or compete effectively, our revenue and profitability will be adversely impacted.

We compete against companies that offer alternative solutions to our products, or have greater resources, a larger installed base of customers and broader product offerings than ours. If we are not able to effectively compete with these companies, it may harm our business.

Our industry is subject to intense competition. Our products compete against similar products offered by public companies, such as Cynosure, Elen (in Italy), Palomar, Solta, and Syneron and as well as private companies such as Alma, Lumenis, Sciton and several other companies. Recently, there has been consolidation in the aesthetic industry leading to companies combining their resources. For example, we acquired the aesthetic business unit of Iridex in February 2012, Solta (previously Thermage) acquired Aesthera in February 2010 and Reliant in December 2008; Syneron acquired Ultrashape in March 2012 and Candela in September 2009; and Cynosure acquired the aesthetic laser business of HOYA ConBio in June 2011. We are likely to compete with new companies in the future. Competition with these companies could result in reduced selling prices, reduced profit margins and loss of market share, any of which would harm our business, financial condition and results of operations.

The energy-based aesthetic market faces competition from non energy-based medical products, such as Botox, an injectable compound used to reduce wrinkles, and collagen injections. Other alternatives to the use of our products include electrolysis, a procedure involving the application of electric current to eliminate hair follicles, and chemical peels. We may also face competition from manufacturers of pharmaceutical and other products that have not yet been developed.

If there is not sufficient consumer demand for the procedures performed with our products, practitioner demand for our products could be inhibited, resulting in unfavorable operating results and reduced growth potential.

Continued expansion of the global market for laser and light-based aesthetic procedures is a material assumption of our business strategy. Most procedures performed using our products are elective procedures not reimbursable through government or private health insurance, with the costs borne by the patient. The decision to utilize our products may therefore be influenced by a number of factors, including:

- Consumer disposable income and access to consumer credit, which as a result of the unstable economy, may have been significantly impacted;
- The cost of procedures performed using our products;
- The cost, safety and effectiveness of alternative treatments, including treatments which are not based upon laser or light-based technologies and treatments which use pharmaceutical products;
- The success of our sales and marketing efforts; and
- The education of our customers and patients on the benefits and uses of our products, compared to competitors' products and technologies.

If, as a result of these factors, there is not sufficient demand for the procedures performed with our products, practitioner demand for our products could be reduced, which could have a material adverse effect on our business, financial condition, revenue and result of operations.

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Any defects in the design, material or workmanship of our products may not be discovered prior to shipment to customers, which could materially increase our expenses, adversely impact profitability and harm our business.

The design of our products is complex. To manufacture them successfully, we must procure quality components and employ individuals with a significant degree of technical expertise. If our designs are defective, or the material components used in our products are subject to wearing out, or if suppliers fail to deliver components to specification, or if our employees fail to properly assemble, test and package our products, the reliability and performance of our products will be adversely impacted. As an example, in 2010, we incurred significant expenses for the voluntary recall of our Titan XL hand pieces.

If our products contain defects that cannot be repaired easily, inexpensively, or on a timely basis, we may experience:

- Damage to our brand reputation;
- Loss of customer orders and delay in order fulfillment;
- Increased costs due to product repair or replacement;
- Inability to attract new customers;
- Diversion of resources from our manufacturing and research and development departments into our service department; and
- Legal action.

The occurrence of any one or more of the foregoing could materially increase expenses, adversely impact profitability and harm our business.

Federal regulatory reforms and changes occurring at the U.S. Food and Drug Administration, or FDA, could adversely affect our ability to sell our products profitably and financial condition.

From time to time, legislation is drafted and introduced in Congress that could significantly change the statutory provisions governing the clearance or approval, manufacture and marketing of a device. It is impossible to predict whether legislative changes will be enacted or FDA regulations, guidance or interpretations changed, and what the impact of such changes, if any, may be.

In addition, FDA regulations and guidance are often revised or reinterpreted by the agency in ways that may significantly affect our business and our products. Changes in FDA regulations may lengthen the regulatory approval process for medical devices and require additional clinical data to support regulatory clearance for the sale and marketing of our new products. In addition, it may require additional safety monitoring, labeling changes, restrictions on product distribution or use, or other measures after the introduction of our products to market. Either of these changes lengthen the duration to market, increase our costs of doing business, adversely affect the future permitted uses of approved products, or otherwise adversely affect the market for our products.

If we fail to obtain or maintain necessary FDA clearances for our products and indications, if clearances for future products and indications are delayed or not issued, if there are federal or state level regulatory changes or if we are found to have violated applicable FDA marketing rules, our commercial operations would be harmed.

Our products are medical devices that are subject to extensive regulation in the United States by the FDA for manufacturing, labeling, sale, promotion, distribution and shipping. Before a new medical device, or a new use of or labeling claim for an existing product, can be marketed in the United States, it must first receive either 510(k) clearance or pre-marketing approval from the FDA, unless an exemption applies. Either process can be expensive and lengthy. In the event that we do not obtain FDA clearances or approvals for our products, our ability to market and sell them in the United States and revenue derived from there may be adversely affected.

Medical devices may be marketed in the United States only for the indications for which they are approved or cleared by the FDA. For example, up until April 2011 our recently introduced GenesisPlus product had a number of general indications for use in the U.S. that allowed us to market the product in the U.S., however we could only market it internationally for the treatment of toenail fungus as it has a CE Mark approval.  In April 2011, we received FDA clearance to market GenesisPlus in the U.S. for the treatment of toenail fungus. Another example is our Pearl Fractional product which is cleared only for skin resurfacing in the U.S. and our Titan product only for deep heating for the temporary relief of muscle aches and pains in the U.S. Therefore, we are prevented from promoting or advertising Titan and Pearl Fractional in the United States for any other indications. If we fail to comply with these regulations, it could result in enforcement action by the FDA which could lead to such consequences as warning letters, adverse publicity, criminal enforcement action and/or third-party civil litigation, each of which could adversely affect us.

We have obtained 510(k) clearance for the indications for which we market our products. However, our clearances can be revoked if safety or effectiveness problems develop. We also are subject to Medical Device Reporting regulations, which require us to report to the FDA if our products cause or contribute to a death or serious injury, or malfunction in a way that would likely cause or contribute to a death or serious injury. Our products are also subject to state regulations, which are, in many instances frequently changing. Changes in state regulations may impede sales. For example, federal regulations allow our products to be sold to, or on the order of, “licensed practitioners,” as determined on a state-by-state basis. As a result, in some states, non-physicians may legally purchase our products. However, a state could change its regulations at any time, thereby disallowing sales to particular types of end users. We cannot predict the impact or effect of future legislation or regulations at the federal or state levels.

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The FDA, state authorities and international regulatory bodies have broad enforcement powers. If we fail to comply with applicable regulatory requirements, it could result in enforcement action by the FDA, state agencies or international regulatory bodies.

The FDA, state authorities and international regulatory bodies have broad enforcement powers. For example, in July 2012, we received a warning letter from the FDA concerning the labeling language for one of our products on our U.S. website. The FDA determined that some of the claims, such as the one related to Skin Rejuvenation, constituted Indications for Use and were subject to 510(k) clearance. We are actively working with the FDA to reach an agreement on the appropriate labeling language for use on our U.S. website. Depending on the final labeling approved by the FDA, any changes made to our marketing material may adversely impact sales of some of our products.

If we fail to comply with any of the applicable regulatory requirements of the FDA, or state, or one of the international regulatory bodies, it could result in enforcement action by the agencies, which may include any of the following sanctions:

Warning letters, fines, injunctions, consent decrees and civil penalties;
Repair, replacement, recall or seizure of our products;
Operating restrictions or partial suspension or total shutdown of production;
Refusing our requests for 510(k) clearance or pre-market approval of new products, new intended uses, or modifications to existing products;
Withdrawing 510(k) clearance or pre-market approvals that have already been granted; and
Criminal prosecution.

If any of these events were to occur, it could harm our business.

If we fail to comply with the FDA's Quality System Regulation and laser performance standards, our manufacturing operations could be halted, and our business would suffer.

We are currently required to demonstrate and maintain compliance with the FDA's Quality System Regulation, or QSR. The QSR is a complex regulatory scheme that covers the methods and documentation of the design, testing, control, manufacturing, labeling, quality assurance, packaging, storage and shipping of our products. Because our products involve the use of lasers, our products also are covered by a performance standard for lasers set forth in FDA regulations. The laser performance standard imposes specific record-keeping, reporting, product testing and product labeling requirements. These requirements include affixing warning labels to laser products, as well as incorporating certain safety features in the design of laser products. The FDA enforces the QSR and laser performance standards through periodic unannounced inspections. We had a full quality system audit in 2008 and an FDA audit of compliance with laser performance standards in 2010 and a full quality system audit plus laser performance standard audit in August 2011. There were no significant findings as a result of these audits and our responses have been accepted by the FDA. Our failure to take satisfactory corrective action in response to an adverse QSR inspection or our failure to comply with applicable laser performance standards could result in enforcement actions, including a public warning letter, a shutdown of our manufacturing operations, a recall of our products, civil or criminal penalties, or other sanctions, such as those described in the preceding paragraph, which would cause our sales and business to suffer.

If we modify one of our FDA-approved devices, we may need to seek re-approval, which, if not granted, would prevent us from selling our modified products or cause us to redesign our products.

Any modifications to an FDA-cleared device that would significantly affect its safety or effectiveness or that would constitute a major change in its intended use would require a new 510(k) clearance or possibly a pre-market approval. We may not be able to obtain additional 510(k) clearance or pre-market approvals for new products or for modifications to, or additional indications for, our existing products in a timely fashion, or at all. Delays in obtaining future clearance would adversely affect our ability to introduce new or enhanced products in a timely manner, which in turn would harm our revenue and future profitability.

We have made modifications to our devices in the past and may make additional modifications in the future that we believe do not or will not require additional clearance or approvals. If the FDA disagrees, and requires new clearances or approvals for the modifications, we may be required to recall and to stop marketing the modified devices, which could harm our operating results and require us to redesign our products.

We may be unable to obtain or maintain international regulatory qualifications or approvals for our current or future products and indications, which could harm our business.

Sales of our products outside the United States are subject to foreign regulatory requirements that vary widely from country to country. In addition, exports of medical devices from the United States are regulated by the FDA. Complying with international regulatory requirements can be an expensive and time-consuming process and approval is not certain. The time required for obtaining clearance or approvals, if required by other countries, may be longer than that required for FDA clearance or approvals, and requirements for such clearances or approvals may significantly differ from FDA requirements. We may be unable to obtain or maintain regulatory qualifications, clearances or approvals in other countries. We may also incur significant costs in attempting to obtain and in maintaining foreign regulatory approvals or qualifications. If we experience delays in receiving necessary qualifications, clearances or approvals to market our products outside the United States, or if we fail to receive those qualifications, clearances or approvals, we may be unable to market our products or enhancements in international markets effectively, or at all, which could have a material adverse effect on our business and growth strategy.

Product liability suits could be brought against us due to a defective design, material or workmanship or misuse of our products and could result in expensive and time-consuming litigation, payment of substantial damages and an increase in our insurance rates.

If our products are defectively designed, manufactured or labeled, contain defective components or are misused, we may become subject to substantial and costly litigation by our customers or their patients. Misusing our products or failing to adhere to operating guidelines could cause significant eye and skin damage, and underlying tissue damage. In addition, if our operating guidelines are found to be inadequate, we may be subject to liability. We have been involved, and may in the future be involved, in litigation related to the use of our products. Product liability claims could divert management’s attention from our core business, be expensive to defend and result in sizable damage awards against us. We may not have sufficient insurance coverage for all future claims. We may not be able to obtain insurance in amounts or scope sufficient to provide us with adequate coverage against all potential liabilities. Any product liability claims brought against us, with or without merit, could increase our product liability insurance rates or prevent us from securing continuing coverage, could harm our reputation in the industry and could reduce product sales. In addition, we historically experienced steep increases in our product liability insurance premiums as a percentage of revenue. If our premiums continue to rise, we may no longer be able to afford adequate insurance coverage.

If customers are not trained and / or our products are used by non-physicians, it could result in product misuse and adverse treatment outcomes, which could harm our reputation, result in product liability litigation, distract management, result in additional costs, all of which could harm our business.

Because we do not require training for users of our products, and sell our products at times to non-physicians, there exists an increased potential for misuse of our products, which could harm our reputation and our business. U.S. federal regulations allow us to sell our products to or on the order of “licensed practitioners.” The definition of “licensed practitioners” varies from state to state. As a result, our products may be purchased or operated by physicians with varying levels of training, and in many states, by non-physicians, including nurse practitioners, chiropractors and technicians. Outside the United States, many jurisdictions do not require specific qualifications or training for purchasers or operators of our products. We do not supervise the procedures performed with our products, nor do we require that direct medical supervision occur. We and our distributors generally offer but do not require product training to the purchasers or operators of our products. In addition, we sometimes sell our systems to companies that rent our systems to third parties and that provide a technician to perform the procedures. The lack of training and the purchase and use of our products by non-physicians may result in product misuse and adverse treatment outcomes, which could harm our reputation and our business, and, in the event these result in product liability litigation, distract management and subject us to liability, including legal expenses.

In 2010 and 2011 we entered into strategic alliances to distribute third party products internationally. To successfully market and sell these products, we must address many issues that are unique to these businesses and could reduce our available cash reserves and negatively impact our profitability.

In 2010 and 2011, we entered into distribution arrangements pursuant to which we utilize our sales force and distributors to sell products manufactured by other companies. Commencing in the fourth quarter of 2011, we began to distribute in Japan a Q-switched laser product manufactured by a third party OEM. In the first quarter of 2010, we entered into an agreement with Obagi to distribute certain of their proprietary cosmeceuticals, or skin care products, in Japan. This agreement requires us to purchase an annual minimum dollar amount of their product. The minimum purchase requirement for 2012 is $2.0 million. If we do not make these minimum purchases, we could lose exclusivity for distributing Obagi products to physicians in Japan. Finally, we also have an agreement with Merz Aesthetics to distribute their Radiesse® dermal filler product in Japan.

Each of these distribution agreements presents its own unique risks and challenges. For example, to sell products in partnership with Obagi we need to invest in creating a sales structure that is experienced in the sale of cosmeceuticals and not in capital equipment. We need to commit resources to training this sales force, obtaining regulatory licenses in Japan and developing new marketing materials to promote the sale of Obagi products. For each of these distribution arrangements, until we can develop our own experienced sales force, we may need to pay third party distributors to sell the products which will result in higher fees and lower margins than if we sell direct to customers. In addition, the minimum commitments and other costs of distributing products manufactured by these companies may exceed the incremental revenue that we derive from the sale of their products thereby reducing our available cash reserves and negatively impacting our profitability.

Adverse conditions in the global banking industry and credit markets may adversely impact the value of our marketable investments or impair our liquidity.

We invest our excess cash primarily in money market funds and in highly liquid debt instruments of the U.S. government and its agencies and U.S. municipalities, in commercial paper and high grade corporate debt. As of September 30, 2012, our balance in marketable investments was $55.8 million. The longer the duration of a security, the more susceptible it is to changes in market interest rates and bond yields. As yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. For example, assuming a hypothetical increase in interest rates of one percentage point, the fair value of our total investment portfolio as of September 30, 2012 would have potentially decreased by approximately $584,000, resulting in an unrealized loss that would subsequently adversely impact our earnings. As a result, changes in the market interest rates will affect our future net income (loss).

We depend on skilled and experienced personnel to operate our business effectively. If we are unable to recruit, hire, train and retain these employees, our ability to manage and expand our business will be harmed, which would impair our future revenue and profitability.

Our success largely depends on the skills, experience and efforts of our officers and other key employees. Except for Change of Control and Severance Agreements for our executive officers, we do not have employment contracts with any of our officers or other key employees. Any of our officers and other key employees may terminate their employment at any time. We do not have a succession plan in place for each of our officers and key employees. In addition, we do not maintain “key person” life insurance policies covering any of our employees. The loss of any of our senior management team members could weaken our management expertise and harm our business.

Our ability to retain our skilled labor force and our success in attracting and hiring new skilled employees are critical factors in determining whether we will be successful in the future. We may not be able to meet our future hiring needs or retain existing personnel. We may face particularly significant challenges and risks in hiring, training, managing and retaining engineering and sales and marketing employees. Failure to attract, train and retain personnel, particularly technical and sales and marketing personnel, would materially harm our ability to compete effectively and grow our business.

The price of our common stock may fluctuate substantially due to several factors, some of which are discussed below. Further, we have a limited number of shares of common stock outstanding, a large portion of which is held by a small number of investors, which could result in the increase in volatility of our stock price.

As of June 30, 2012, approximately 42% of our outstanding shares of common stock were held by 10 institutional investors. As a result of our relatively small public float, our common stock may be less liquid than the stock of companies with broader public ownership. Among other things, trading of a relatively small volume of our common stock may have a greater impact on the trading price for our shares than would be the case if our public float were larger. The public market price of our common stock has in the past fluctuated substantially and, due to the current concentration of stockholders, it may continue to do so in the future. The market price for our common stock could also be affected by a number of other factors, including:

- Litigation surrounding executive compensation has increased with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. If we are involved in a lawsuit related to compensation matters or any other matters not covered by our D&O insurance, there could be material expenses involved, fines, or remedial actions which could negatively affect our stock price;
- The general market conditions unrelated to our operating performance;
- Sales of large blocks of our common stock, including sales by our executive officers, directors and our large institutional investors;
- Quarterly variations in our, or our competitors', results of operations;
- Changes in analysts' estimates, investors' perceptions, recommendations by securities analysts or our failure to achieve analysts' estimates;
- The announcement of new products or service enhancements by us or our competitors;
- The announcement of the departure of a key employee or executive officer by us or our competitor;
- Regulatory developments or delays concerning our, or our competitors' products; and
- The initiation of litigation by us or against us.

Actual or perceived instability in our stock price could reduce demand from potential buyers of our stock, thereby causing our stock price to either remain depressed or to decline further.

We may be involved in future costly intellectual property litigation, which could impact our future business and financial performance.

Our competitors or other patent holders may assert that our present or future products and the methods we employ are covered by their patents. In addition, we do not know whether our competitors own or will obtain patents that they may claim prevent, limit or interfere with our ability to make, use, sell or import our products. Although we may seek to resolve any potential future claims or actions, we may not be able to do so on reasonable terms, or at all. If, following a successful third-party action for infringement, we cannot obtain a license or redesign our products, we may have to stop manufacturing and selling the applicable products and our business would suffer as a result. In addition, a court could require us to pay substantial damages, and prohibit us from using technologies essential to our products, any of which would have a material adverse effect on our business, results of operations and financial condition.
We may become involved in litigation not only as a result of alleged infringement of a third party's intellectual property rights but also to protect our own intellectual property. For example, we have been, and may hereafter become, involved in litigation to protect the trademark rights associated with our company name or the names of our products. Infringement and other intellectual property claims, with or without merit, can be expensive and time-consuming to litigate, and could divert management's attention from our core business.

Any acquisitions that we make could disrupt our business and harm our financial condition.

From time to time we evaluate potential strategic acquisitions of complementary businesses, products or technologies. We may also consider joint ventures and other collaborative projects. We may not be able to identify appropriate acquisition candidates or strategic partners, or successfully negotiate, finance or integrate any businesses, products or technologies that we acquire. Furthermore, the integration of any acquisition and management of any collaborative project may divert management's time and resources from our core business and disrupt our operations and we may incur significant legal, accounting and banking fees in connection with such a transaction. In addition, if we purchase a company that is not profitable, our cash balances may be reduced or depleted. We do not have any experience as a team with acquiring companies or products. If we decide to expand our product offerings beyond laser and light-based products, we may spend time and money on projects that do not increase our revenue. Any cash acquisition we pursue would diminish our available cash balances to us for other uses, and any stock acquisition could be dilutive to our stockholders.
While we from time to time evaluate potential acquisitions of businesses, products and technologies, and anticipate continuing to make these evaluations, we have no present understandings, commitments or agreements with respect to any material acquisitions or collaborative projects.

Our manufacturing operations are dependent upon third-party suppliers, making us vulnerable to supply shortages and price fluctuations, which could harm our business.

Many of the components and materials that comprise our products are currently manufactured by a limited number of suppliers. A supply interruption or an increase in demand beyond our current suppliers' capabilities could harm our ability to manufacture our products until a new source of supply is identified and qualified. Our reliance on these suppliers subjects us to a number of risks that could harm our business, including:

Interruption of supply resulting from modifications to or discontinuation of a supplier's operations;
Delays in product shipments resulting from uncorrected defects, reliability issues or a supplier's variation in a component;

A lack of long-term supply arrangements for key components with our suppliers;

Inability to obtain adequate supply in a timely manner, or on reasonable terms;

Inability to redesign one or more components in our systems in the event that a supplier discontinues manufacturing such components and we are unable to source it from other suppliers on reasonable terms;

Difficulty locating and qualifying alternative suppliers for our components in a timely manner;

Production delays related to the evaluation and testing of products from alternative suppliers and corresponding regulatory qualifications; and

Delay in supplier deliveries

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Any interruption in the supply of components or materials, or our inability to obtain substitute components or materials from alternate sources at acceptable prices in a timely manner, could impair our ability to meet the demand of our customers, which would have an adverse effect on our business.

Intellectual property rights may not provide adequate protection for some or all of our products, which may permit third parties to compete against us more effectively.

We rely on patent, copyright, trade secret and trademark laws and confidentiality agreements to protect our technology and products. At September 30, 2012, we had 21 issued U.S. patents. Some of our components, such as our laser module, electronic control system and high-voltage electronics, are not, and in the future may not be, protected by patents. Additionally, our patent applications may not issue as patents or, if issued, may not issue in a form that will be advantageous to us. Any patents we obtain may be challenged, invalidated or legally circumvented by third parties. Consequently, competitors could market products and use manufacturing processes that are substantially similar to, or superior to, ours. We may not be able to prevent the unauthorized disclosure or use of our technical knowledge or other trade secrets by consultants, vendors, former employees or current employees, despite the existence generally of confidentiality agreements and other contractual restrictions. Monitoring unauthorized uses and disclosures of our intellectual property is difficult, and we do not know whether the steps we have taken to protect our intellectual property will be effective. Moreover, the laws of many foreign countries will not protect our intellectual property rights to the same extent as the laws of the United States.

The absence of complete intellectual property protection exposes us to a greater risk of direct competition. Competitors could purchase one of our products and attempt to replicate some or all of the competitive advantages we derive from our development efforts, design around our protected technology, or develop their own competitive technologies that fall outside of our intellectual property rights. If our intellectual property is not adequately protected against competitors' products and methods, our competitive position and our business could be adversely affected.

We offer credit terms to some qualified customers and also to leasing companies to finance the purchase of our products. In the event that any of these customers default on the amounts payable to us, our earnings may be adversely affected.

While we qualify customers to whom we offer credit terms (generally net 30 to 90 days), we cannot provide any assurance that the financial position of these customers will not change adversely before we receive payment. Our general and administrative expenses and earnings are negatively impacted by customer defaults and cause an increase in the allowance for doubtful accounts. In the event that there is a default by any customers to whom we have provided credit terms in the future, we may recognize a bad debt charge in our general and administrative expenses and this could negatively affect our earnings and results of operations.

We are subject to fluctuations in the exchange rate of the U.S. dollar and foreign currencies.

As a result of recent fluctuations in currency markets and the strong dollar relative to many other major currencies, our products priced in U.S. dollars may be cheaper or more expensive relative to products of our foreign competitors, which could result in volatility in our revenue. 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, Canadian Dollar and British Pound Sterling. As a result, changes in the exchange rates of these currencies to the U.S. Dollar will affect our results from operations.

The expense and potential unavailability of insurance coverage for our customers could adversely affect our ability to sell our products, and therefore our financial condition.

Some of our customers and prospective customers have had difficulty in procuring or maintaining liability insurance to cover their operation and use of our products. Medical malpractice carriers are withdrawing coverage in certain states or substantially increasing premiums. If this trend continues or worsens, our customers may discontinue using our products and potential customers may opt against purchasing laser and light based products due to the cost or inability to procure insurance coverage. The unavailability of insurance coverage for our customers and prospects could adversely affect our ability to sell our products, and that could harm our financial condition.

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Anti-takeover provisions in our Amended and Restated Certificate of Incorporation and Bylaws, and Delaware law, contain provisions that could discourage a takeover.

Our Amended and Restated Certificate of Incorporation and Bylaws, and Delaware law, contain provisions that might enable our management to resist a takeover, and might make it more difficult for an investor to acquire a substantial block of our common stock. These provisions include:

- A classified board of directors;
- Advance notice requirements to stockholders for matters to be brought at stockholder meetings;
- Limitations on stockholder actions by written consent; and
- The right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer.

These provisions, as well as Change of Control and Severance Agreements entered into with each of our executive officers, might discourage, delay or prevent a change in control of our company or a change in our management. The existence of these provisions could adversely affect the voting power of holders of common stock and limit the price that investors might be willing to pay in the future for shares of our common stock.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

We did not sell any equity securities during the period covered by this report.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 4. MINE SAFETY DISCLOSURES

None.

## ITEM 5. OTHER INFORMATION

In October 2012, our board of directors approved a stock repurchase plan to repurchase up to $10 million of our common stock. The common stock will be acquired from time to time in open market transactions, block purchases and other transactions complying with the Securities and Exchange Commission’s Rule 10b-18. The Company intends to adopt a 10b5-1 trading plan to implement the repurchase program. The amount and exact timing of any repurchases will depend upon market conditions and other factors. There can be no assurances that we will repurchase any shares during the period, and we may suspend or discontinue the stock repurchase plan at any time subject to the 10b5-1 trading plan.

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ITEM 6. EXHIBITS

| Exhibit No. | Description |
|---|---|
| 3.2(1) | Amended and Restated Certificate of Incorporation of the Registrant (Delaware). |
| 3.4(1) | Bylaws of the Registrant. |
| 4.1(2) | Specimen Common Stock certificate of the Registrant. |
| 10.14(3) | Cutera, Inc. 2004 Equity Incentive Plan, as amended by its Board of Directors on April 25, 2008. |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.ins | Instance Document |
| 101.sch | XBRL Taxonomy Extension Schema Document |
| 101.cal | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.def | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.lab | XBRL Taxonomy Extension Label Linkbase Document |
| 101.pre | XBRL Taxonomy Extension Presentation Linkbase Document |

(1) Incorporated by reference from our Registration Statement on Form S-1 (Registration No. 333-111928) which was declared effective on March 30, 2004.
(2) Incorporated by reference from our Annual Report on Form 10-K filed with the SEC on March 25, 2005.
(3) Incorporated by reference from our Definitive Proxy Statement on Form 14A filed with the SEC on April 28, 2008.

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## SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of The Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of Brisbane, State of California, on the 5th day of November, 2012.

CUTERA, INC.

/S/ RONALD J. SANTILLI
Ronald J. Santilli
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)