CUTERA INC
Form 10-Q
November 08, 2006
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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 September 30, 2006

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period _____ to _____ .

Commission file number: 000-50644

CUTERA, INC.

(Exact name of registrant as specified in its charter)

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

3240 Bayshore Blvd., Brisbane, California 94005

(Address of principal executive offices)

(415) 657-5500

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

The number of shares of Registrant s common stock issued and outstanding as of October 31, 2006 was 12,755,798.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CUTERA, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

(unaudited)

	September 30, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 3,058	$ 5,260
Marketable investments	87,614	86,736
Accounts receivable, net	9,124	6,478
Inventory	5,558	5,245
Deferred tax asset	6,711	3,027
Other current assets	3,998	3,728
Total current assets	116,063	110,474
Property and equipment, net	992	1,015
Intangibles, net	1,515	469
Total assets	$ 118,570	$ 111,958
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 1,396	$ 1,352
Accrued liabilities	12,657	9,131
Deferred revenue	3,126	1,673
Total current liabilities	17,179	12,156
Deferred rent	1,342	1,096
Deferred revenue, net of current portion	2,242	1,469
Deferred tax liability	60	60
Total liabilities	20,823	14,781
Stockholders equity:		
Common stock	13	12
Additional paid-in capital	81,510	77,705
Deferred stock-based compensation	(482)	(2,171)
Retained earnings	16,751	21,743
Accumulated other comprehensive loss	(45)	(112)
Total stockholders equity	97,747	97,177
Total liabilities and stockholders equity	$ 118,570	$ 111,958

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

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CUTERA, INC

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net revenue	$ 25,059	$ 18,950	$ 70,211	$ 51,667
Cost of revenue	7,931	4,746	21,510	13,642
Gross profit	17,128	14,204	48,701	38,025
Operating expenses:				
Sales and marketing	8,174	6,222	25,025	17,854
Research and development	1,679	1,334	4,538	3,932
General and administrative	2,992	1,924	11,615	6,519
Litigation settlement	544		18,935	
Total operating expenses	13,389	9,480	60,113	28,305
Income (loss) from operations	3,739	4,724	(11,412)	9,720
Interest and other income, net	829	549	2,615	1,351
Income (loss) before income taxes	4,568	5,273	(8,797)	11,071
Provision (benefit) for income taxes	1,618	1,472	(3,805)	3,080
Net income (loss)	$ 2,950	$ 3,801	$ (4,992)	$ 7,991
Net income (loss) per share:				
Basic	$ 0.23	$ 0.33	$ (0.40)	$ 0.70
Diluted	$ 0.21	$ 0.27	$ (0.40)	$ 0.58
Weighted-average number of shares used in per share calculations:				
Basic	12,675	11,661	12,460	11,369
Diluted	14,238	13,924	12,460	13,681

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

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CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income (loss)	$ (4,992)	$ 7,991
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	636	503
Change in allowance for doubtful accounts	(63)	(296)
Provision for excess and obsolete inventory	90	434
Change in deferred taxes	(3,684)	612
Stock-based compensation	3,231	1,202
Tax benefit from stock option exercises		3,125
Changes in assets and liabilities:		
Accounts receivable	(2,583)	1,608
Inventory	(403)	(2,430)
Other current assets	(270)	(1,635)
Accounts payable	44	430
Accrued liabilities	3,414	359
Deferred rent	246	336
Deferred revenue	2,226	579
Net cash provided by (used in) operating activities	(2,108)	12,818
Cash flows from investing activities:		
Acquisition of property and equipment	(441)	(414)
Acquisition of intangibles	(1,218)	(165)
Proceeds from sales of marketable investments	12,303	18,294
Proceeds from maturities of marketable investments	76,693	34,373
Purchase of marketable investments	(89,807)	(70,995)
Net cash used in investing activities	(2,470)	(18,907)
Cash flows from financing activities:		
Proceeds from exercise of stock options and employee stock purchase plan	2,376	3,747
Net cash provided by financing activities	2,376	3,747
Net decrease in cash and cash equivalents	(2,202)	(2,342)
Cash and cash equivalents at beginning of period	5,260	7,070
Cash and cash equivalents at end of period	$ 3,058	$ 4,728
Supplemental and non-cash disclosure of cash flow information:		
Change in deferred stock-based compensation, net of terminations	$ (1,261)	$ 1,393

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation

The condensed consolidated financial statements include the accounts of Cutera, Inc. (the Company), a Delaware corporation, and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated.

The financial information furnished 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, 2005 condensed consolidated balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. 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, 2005 filed with the Securities and Exchange Commission (SEC) on March 16, 2006.

Significant Accounting Policies

The Company s significant accounting policies are disclosed in the Company s annual report on Form 10-K for the year ended December 31, 2005 and have not changed significantly as of September 30, 2006, with the exception of the following policies:

Stock-Based Compensation

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)), using the modified prospective transition method and therefore has not restated results for prior periods. Under this transition method, stock-based compensation expense for the first nine months of fiscal 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123). Stock-based compensation expense for all stock-based compensation awards granted after January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, which is generally the vesting term of four years. Prior to the adoption of SFAS 123(R) the Company recognized stock-based compensation expense in accordance with Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 *Share-Based Payment* regarding the SEC s interpretation of SFAS 123(R) and the valuation of stock-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). See Note 2 for a further discussion on stock-based compensation.

Intangible assets

Purchased technology licenses and other intangible assets are presented at cost, net of accumulated amortization. The technology licenses are being amortized on a straight-line basis over their expected useful life of 9-10 years and the other intangibles are being amortized over their expected useful life of two years.

Recent Accounting Pronouncements

In September 2006, the SEC issued SAB No. 108 regarding the process of quantifying financial statement misstatements. SAB No. 108 states that registrants should use both a balance sheet approach and an income statement approach when quantifying and evaluating the materiality of a misstatement. The interpretations in SAB No. 108 contain guidance on correcting errors under the dual approach as well as provide transition guidance for correcting errors. This interpretation does not change the requirements within SFAS No. 154, Accounting Changes and Error Corrections- a replacement of APB No. 20 and Financial Accounting Standards Board (FASB) Statement No. 3, for the correction of an error on financial statements. SAB No. 108 is effective for annual financial statements covering the first fiscal years ending after November 15, 2006. The Company will be required to adopt this interpretation by December 31, 2006. Management is currently evaluating the requirements of SAB No. 108 and the impact this interpretation may have on the consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This standard defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America, and expands disclosure about fair value measurements. This pronouncement applies under other accounting standards that require or permit fair value measurements. Accordingly, this statement does not require any new fair value measurement. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company will be required to adopt SFAS No. 157 in the first quarter of fiscal year 2008. Management is currently evaluating the requirements of SFAS No. 157 and has not yet determined the impact on the consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes effective for fiscal years beginning after December 15, 2006. The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods, disclosure, and transition. The Company will decide on its policy for interest and penalty classification by the end of 2006 and adopt the Interpretation beginning with the fiscal year ending 2007. Upon adoption, it is not expected that the Interpretation will have a material effect on the Company s financial position or results of operations.

Note 2. Accounting for Stock-Based Compensation

Periods Prior to the Adoption of SFAS 123(R)

Prior to January 1, 2006, the Company accounted for stock-based compensation under the recognition and measurement provisions of APB 25. Accordingly, the Company generally recognized compensation expense only when it granted options with a discounted exercise price. Any resulting compensation expense was recognized ratably over the associated service period, which was generally the option vesting term of four years. Effective January 1, 2006, the Company adopted SFAS 123(R), using the modified prospective application transition method, which requires the presentation of pro-forma information for periods prior to the adoption of SFAS 123(R) regarding the net income and net income per share as if the Company had accounted for its stock options under the fair value method of SFAS 123. For the purpose of this pro-forma disclosure, the estimated value of the stock awards is recognized on a straight line basis over the vesting periods of the awards. If compensation had been determined based upon the fair value at the grant date for employee compensation arrangements, consistent with the methodology prescribed in SFAS 123, the Company s pro-forma net income and pro-forma net income per share under SFAS 123 would have been as shown in the table below (in thousands, except per share data):

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	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 3,801	$ 7,991
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	224	716
Less: Total stock-based employee compensation determined under fair-valued based method for all awards, net of related tax effects	(624)	(1,558)
Pro forma net income used in basic and diluted net income per share	$ 3,401	$ 7,149
Basic net income per share:		
As reported	$ 0.33	$ 0.70
Pro forma	$ 0.29	$ 0.63
Diluted net income per share:		
As reported	$ 0.27	$ 0.58
Pro forma	$ 0.25	$ 0.53

Stock Option Plans

As of September 30, 2006, the Company had the below mentioned stock-based employee compensation plans.

2004 Employee Stock Purchase Plan

The Company sponsors the 2004 Employee Stock Purchase Plan (2004 ESPP), pursuant to which eligible employees are permitted to purchase common stock at a discount through payroll deductions. The price of the common stock purchased is equal to 85% of the fair market value of the common stock at the beginning of an offering period or at the end of a purchase period. Shares of common stock eligible for purchase are increased on the first day of each fiscal year by an amount equal to the lesser of (i) 600,000 shares, (ii) 2.0% of the outstanding shares of common stock on such date or (iii) an amount as determined by the Board of Directors. Each offering period includes two six-month purchase periods. The Company added 244,269 reserved shares to the 2004 ESPP on January 1, 2006, bringing the total authorized shares from inception-to-date of 663,413 shares.

As of January 1, 2006 the Company had 569,855 shares available for purchase. During the nine months ended September 30, 2006, the Company issued 24,798 shares and as of September 30, 2006, 545,057 shares remained available for future purchases. Beginning with the offering period that started on November 1, 2006, all future offering periods under the 2004 ESPP will run for approximately six months, each with one purchase period.

2004 Equity Incentive Plan and 1998 Stock Plan

The Company has two stock option plans - the 1998 Stock Plan (the 1998 Plan) and the 2004 Equity Incentive Plan. Shares of common stock approved under the 2004 Equity Incentive Plan will be increased on the first day of each fiscal year, by an amount equal to the lesser of: (i) 5% of the outstanding shares of the first day of such year; (b) 2 million shares; or, (c) an amount determined by the Company s board. On January 1, 2006, the Company added 610,674 shares to the 2004 Equity Incentive Plan, bringing the total authorized shares from inception-to-date under the 2004 Equity Incentive Plan and the 1998 Plan to 7,558,534 shares. As of September 30, 2006, a total of 1,714,734 shares of common stock were available for issuance pursuant to the 2004 Equity Incentive Plan and the 1998 Plan.

Options granted under the 1998 Plan and 2004 Equity Incentive Plan may be incentive stock options or non-statutory stock options. Stock purchase rights, or restricted stock units, may also be granted under the 2004 Equity Incentive Plan. Incentive stock options may only be granted to employees. The Board of Directors determines the period over which options become exercisable, however, except in the case of options granted to officers, directors and consultants, options shall become exercisable at a rate of no less than 20% per year over five years from the date the options are granted. Options are to be granted at an exercise price not less than the fair market value per share on the grant date for

incentive options or 85% of fair market value for nonqualified stock options. The Company has not granted any discounted options since fiscal 2003. Options granted under the Plan generally become exercisable 25% on the first anniversary of the vesting commencement date and an additional 1/48th of the total number of shares subject to the option shares shall become exercisable on the last day of each calendar month thereafter until all of the shares have become exercisable. The terms of the Company s options are either five, seven or ten years from the date of grant.

During the year ended December 31, 2005, under the 2004 Equity Incentive Plan, the Company s Board of Directors approved the grant of performance unit awards (more commonly referred to as restricted stock units) for a total aggregate of 71,500 shares of restricted stock units to selected members of the Company s management. These restricted stock unit awards are independent of option grants and will not vest if employment terminates prior to the release of the restrictions. These restricted stock unit awards vest in four equal, annual installments on the anniversaries of the date of grant. Restricted stock units do not have the voting rights of common stock, and the shares underlying the restricted stock units are not considered issued and outstanding until they vest and are issued. The Company expenses the cost of the restricted stock unit awards, which is determined to be the fair market value of the shares at the date of grant, ratably over the period during which the restrictions lapse - generally four years from the grant date. During the nine months ended September 30, 2006, the Company did not award any additional restricted stock units and issued 17,502 shares with an aggregate fair value of $317,000, or $18.11 per share, upon the vesting of previously awarded restricted stock units.

Option Activity

Activity under the 1998 Plan and 2004 Equity Incentive Plan is summarized as follows:

	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Weighted-Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value (in $ millions)*
Balances, December 31, 2005	1,479,622	3,244,609	$ 6.91		
Additional shares reserved	610,674				
Options granted	(553,943)	553,943	$ 24.10		
Options exercised		(488,406)	$ 3.80		
Options cancelled or forfeited	172,194	(172,194)	$ 17.11		
Restricted stock units forfeited	6,187				
Balances, September 30, 2006	1,714,734	3,137,952	$ 9.87	5.96	$ 52.5
Exercisable as of September 30, 2006		1,952,651	$ 4.31	4.82	$ 43.5

* Based on the closing stock price of the Company s common stock of $26.59 on September 29, 2006.

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The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between the Company s closing stock price on the last trading day of the third quarter of fiscal 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 29, 2006. This amount changes based on the fair market value of the Company s common stock. Total intrinsic value of options exercised in the three and nine months ended September 30, 2006 was $1.9 million and $9.9 million, respectively. Total fair value of vested and expensed stock options, restricted stock units and ESPP shares for the three and nine months ended September 30, 2006 was $858,000 and $2.2 million, net of tax, respectively. The Company issues new shares upon the exercise of options, restricted stock units and ESPP shares.

Impact of Adoption of SFAS 123(R)

As a result of adopting the fair value recognition provisions of SFAS 123(R), the impact to the Condensed Consolidated Financial Statements for the three and nine months ended September 30, 2006 from stock-based compensation is as follows *(in thousands, except per share data)* :

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Stock-based compensation expense by award type:		
Employee stock options granted at their intrinsic value	$ (962)	$ (2,295)
Employee stock options granted below their deemed intrinsic fair value prior to the Company s initial public offering	(143)	(428)
Employee stock purchase plan	(62)	(270)
Restricted stock units	(66)	(238)
Total stock-based compensation	(1,233)	(3,231)
Tax effect on stock-based compensation at the Company s marginal tax rate	375	1,034
Effect on net income	$ (858)	$ (2,197)
Effect on net income per share:		
Basic	$ (0.07)	$ (0.18)
Diluted	$ (0.06)	$ (0.18)
Change in deferred stock-based compensation		
Due to reversal of unamortized deferred stock-based compensation upon adoption	$	$ (1,237)
Due to reversal of unamortized deferred stock-based compensation for terminations of employee stock options granted below their deemed intrinsic fair value prior to the Company s initial public offering (1)	(6)	(24)
	$ (6)	$ (1,261)

(1) This amount would also have been recorded under the provisions of APB 25, prior to the adoption of FAS 123(R).

As of January 1, 2006, the Company had an unrecorded deferred stock-based compensation balance related to stock options of $7.1 million before estimated forfeitures. In the Company s pro forma disclosures prior to the adoption of SFAS 123(R), the Company accounted for forfeitures when they actually occurred. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised if necessary in subsequent periods if actual forfeitures differ from those estimates. Under SFAS 123(R), the Company estimated that $160,000 of the unrecorded deferred stock-based compensation amount as of January 1, 2006 will not be recognized due to forfeitures.

During the nine months ended September 30, 2006, the Company granted stock options for 553,943 shares of common stock with an estimated total grant-date fair value of $7.8 million. Of the grant-date fair value of options granted in the nine months ended September 30, 2006, the

Company estimates that the amount of unrecorded deferred stock-based compensation that is not expected to vest due to forfeiture is $253,000. As of September 30, 2006, the unrecognized compensation cost, net of expected forfeitures, related to non-vested stock options was $9.1 million, which will be recognized using the straight-line attribution method over an estimated weighted-average amortization period of 1.4 years.

As of September 30, 2006, the unrecognized compensation cost related to ESPP shares was $70,000, which will be recognized using the straight-line attribution method over 0.4 years.

As of January 1, 2006, the Company had an unrecorded deferred stock-based compensation balance related to restricted stock unit awards of $1.2 million before estimated forfeitures. Under SFAS 123(R), the Company estimated that $343,000 of the unrecorded deferred stock-based compensation amount as of January 1, 2006 will not be recognized due to forfeitures. As of September 30, 2006, the unrecognized compensation cost related to restricted stock unit awards was $757,000, after estimated forfeitures, which will be recognized over an estimated weighted average amortization period of 2.7 years.

Valuation Assumptions

The Company estimates the fair value of employee stock options and ESPP using a Black-Scholes option-pricing model, consistent with the provisions of SFAS 123(R), SAB 107, and the Company s prior period pro forma disclosures of net income, including stock-based compensation (determined under a fair value method as prescribed by SFAS 123). The fair value of each option grant and each stock issuance under the ESPP was estimated on the date of grant using the Black-Scholes model with the following weighted-average assumptions:

	Three Months Ended, September 30,		Nine Months Ended September 30	
	2006	2005	2006	2005
Employee stock options:				
Risk-free interest rate	4.9%	4.1%	4.9%	3.9%
Expected volatility	62%	67%	64%	67%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Expected life (in years)	5.3	3.8	5.0	3.8
Fair value per option granted	$ 11.99	$ 10.20	$ 14.07	$ 9.22
Employee stock purchase plan:				
Risk-free interest rate	4.6%	3.6%	4.3%	3.1%
Expected volatility	60%	51%	56%	51%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Expected life (in years)	0.8	0.8	0.8	0.7
Fair value per share purchase	$ 9.96	$ 5.19	$ 8.85	$ 4.70

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Option-pricing models require the input of various subjective assumptions, including the option s expected life and the price volatility of the underlying stock.

Expected Volatility: The expected stock price volatility is based on a combination of the Company s historical volatility combined with the weighted average of the volatility of other similar companies in the same industry. With effect from April 2006, the expected stock price volatility was based on a combination of the Company s historical volatility combined with the implied volatility of the Company s quoted stock options. The Company believes these methods of computing volatility are more reflective and a better indicator of the expected future volatility, than using an average of a comparable market index or of a comparable company in the same industry.

Expected Term: The expected term of options granted in the nine months ended September 30, 2006, was based on the Company s historical exercise behavior for ten year term options. For five and seven year term options, that the Company started granting in the second quarter of 2006, the expected term was derived from the short-cut method described in SEC s SAB No. 107.

Risk-Free Interest Rate : The risk-free rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

Expected Dividend: The Company has not paid and does not anticipate paying any dividends in the near future.

Estimated Pre-vesting Forfeitures: When estimating forfeitures, the Company considers voluntary termination behavior based on actual historical information.

Note 3 Net income (loss) per share

Basic net income (loss) per share is calculated based on net income (loss) and the weighted-average number of shares of common stock outstanding during the reported period. Diluted net income (loss) per share is calculated by increasing the weighted-average number of common shares outstanding during the period- if not anti-dilutive- by the number of additional shares of common stock that would have been outstanding if the dilutive potential shares of common stock had been issued. The dilutive effect of potential common stock (including outstanding stock options, ESPP shares, non-employee director stock units and restricted stock units) is reflected in diluted net income per share by application of the treasury stock method, which includes consideration of share-based compensation as required by SFAS 123(R) in the fiscal quarter and nine months ended September 30, 2006.

A reconciliation of weighted-average basic shares outstanding to weighted-average diluted shares outstanding follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Weighted-average number of common shares outstanding used in computing basic net income (loss) per share	12,675	11,661	12,460	11,369
Dilutive potential common shares used in computing diluted net income (loss) per share	1,563	2,263		2,312
Total weighted-average number of shares used in computing diluted net income (loss) per share	14,238	13,924	12,460	13,681

For the quarter and nine months ended September 30, 2006 and 2005, the following stock-based instruments were excluded from the calculation of diluted earnings per share, as their effect was anti-dilutive (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Options to purchase common stock	783		2,691	53

Restricted stock units		61	17
Employee stock purchase plan shares		51	
	783	2,803	70

Note 4. Inventory

Inventory consists of the following (in thousands):

	September 30, 2006	December 31, 2005
Raw materials	$ 3,222	$ 3,071
Finished goods	2,336	2,174
	$ 5,558	5,245

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Note 5. Intangible Assets

Intangible assets are principally comprised of a technology sublicense acquired in 2002; a patent license acquired from Palomar in 2006; and other intangibles. The components of intangible assets were as follows (in thousands):

	As of September 30, 2006		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Patent license	$ 1,218	$ 69	$ 1,149
Technology sublicense	538	234	304
Other intangibles	165	103	62
Total	$ 1,921	$ 406	$ 1,515

	As of December 31, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Technology sublicense	$ 538	$ 193	$ 345
Other intangibles	165	41	124
Total	$ 703	$ 234	$ 469

For the nine months ended September 30, 2006 and 2005, amortization expense for intangible assets was $172,000 and $61,000, respectively.

Based on intangible assets recorded at September 30, 2006, 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:	
2006 remainder	$ 69
2007	233
2008	192
2009	192
2010	192
Thereafter	637
Total	$ 1,515

Note 6. Warranty and Service Contracts

Warranty reserve

The Company has a direct field service organization in the United States, Canada, Switzerland, Germany, Australia and Japan that provides service for its products in these countries. The Company has third party service providers in all other locations. The Company generally provides a warranty with its products, depending on the type of product. After the warranty period, maintenance and support are offered on a service contract basis or on a time and materials basis. The Company currently provides for the estimated cost to repair or replace products under warranty at the time of sale. The warranty reserve activity for the nine months ended September 30, 2006 and 2005 was as follows (in thousands):

	September 30, 2006	September 30, 2005
Balance at December 31, 2005 and 2004	$ 2,043	$ 1,850
Add: Accruals for warranties issued in 2006 and 2005	4,383	1,818
Less: Settlements made during the period	(3,325)	(1,832)
Balance at September 30, 2006 and 2005	$ 3,101	$ 1,836

Deferred service contract revenue

Service contract revenue is recognized on a straight-line basis over the period of the applicable service contract. The deferred service contract revenue activity for the nine months ended September 30, 2006 and 2005 was as follows (in thousands):

	September 30, 2006	September 30, 2005
Balance at December 31, 2005 and 2004	$ 3,117	$ 1,906
Add: Payments received	4,836	2,290
Less: Revenue recognized	(2,740)	(1,641)
Balance at September 30, 2006 and 2005	$ 5,213	$ 2,555

Costs incurred under service contracts during the three months ended September 30, 2006 and 2005, amounted to $419,000 and $304,000, respectively. For the nine months ended September 30, 2006 and 2005, costs incurred under service contracts amounted to $1,261,000 and $795,000, respectively. All service contract costs are recognized as incurred.

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Note 7. Comprehensive Income

Comprehensive income generally represents all changes in stockholders equity except those resulting from investments or contributions by stockholders. The Company s unrealized gains (losses) on marketable investments represent the only component of other comprehensive income (loss) that is excluded from net income (loss). The changes in components of other comprehensive income (loss) for the periods presented are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income (loss)	$ 2,950	$ 3,801	$ (4,992)	$ 7,991
Unrealized gain (loss) on marketable investments	106	(37)	67	(40)
Comprehensive income (loss)	$ 3,056	$ 3,764	$ (4,925)	$ 7,951

Note 8. Provision (Benefit) for Income Tax

The interim effective income tax rate is based on management s best estimate of the annual effective income tax rate. The effective tax rates for the three and nine months ended September 30, 2006, were 35% and 43%, respectively. Applying these effective tax rates to income before income taxes for the quarter and nine month ended September 30, 2006, resulted in a tax provision of $1.6 million and tax benefit of $3.8 million, respectively. For the three and nine months ended September 30, 2005, the effective tax rate was 28%.

Undistributed earnings of the Company s foreign subsidiaries of approximately $901,000 and $383,000 at September 30, 2006 and 2005, respectively, are considered to be indefinitely reinvested and, accordingly, no provision for federal and state income taxes has been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, the Company would be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to various foreign countries.

Note 9. Litigation Settlement

The Company was the defendant in two lawsuits brought against it by a competitor, Palomar Medical Technologies. (Palomar). In the first suit, filed in February 2002 in the United States District Court, District of Massachusetts, Palomar alleged that by making, using, selling or offering for sale the CoolGlide CV, CoolGlide Excel, CoolGlide Vantage and CoolGlide Xeo products, the Company was willfully and deliberately infringing U.S. Patent No. 5,735,844. This patent concerns a method and apparatus for removing hair with light energy. Massachusetts General Hospital (MGH) later joined the lawsuit as an additional plaintiff, since Palomar is the exclusive licensee, and MGH is the owner, of the patent at issue in the lawsuit. In the second lawsuit, filed with the same court in April 2005, the plaintiffs alleged that by making, using, selling or offering for sale products that utilize pulsed-light technology for hair removal, the Company was willfully and deliberately infringing U.S. Patent Nos. 5,735,844 and 5,595,568. In both lawsuits, the plaintiffs were seeking to enjoin the Company from selling products found to infringe these patents, and to obtain compensatory and treble damages, reasonable costs and attorney s fees, and other relief as the court deemed just and proper.

On June 2, 2006, the litigation between the Company and Palomar and MGH was settled - with Palomar granting the Company an irrevocable license to the subject patents. Under the terms of the settlement agreements, the Company agreed to pay Palomar a good-faith estimated payment of $22.0 million, representing the Company s estimate of royalties due on past sales of the infringing systems, plus accrued interest and reimbursement of Palomar s legal costs through March 31, 2006.

During the quarter ended June 30, 2006, the Company completed a calculation of the actual amounts owed to Palomar through March 31, 2006 and estimated the amount due to be $19,561,000. In the quarter ended September 30, 2006, after further discussions with Palomar, the Company revised its estimate of the total settlement amount owed to Palomar through March 31, 2006 to $20,153,000. The actual amounts owed to Palomar are subject to change after a review by an independent public accountant hired by Palomar, however, the amount of such change is not expected to be material. This audit is ongoing and is expected to be completed by December 31, 2006.

Of the $20,153,000 revised settlement amount, $18,935,000 relating to past royalties, interest and legal settlement costs, was recorded as a litigation settlement expense; and $1,218,000, representing the value of the on-going license agreement, was capitalized as an intangible asset.

The intangible asset is being amortized on a straight line basis over the useful economic life of the patents, which expire in February 2015. The remaining balance from the $22 million good-faith estimated payment made, of $1,847,000, has been used to offset royalty amounts due to Palomar for the six months ended September 30, 2006.

The royalty rate for future sales of hair-removal-only systems will be equal to 7.5% of net sales. For multi-application systems containing hair-removal functionality, the royalty rate will either be 3.75% or 5.25%, depending on whether there is one or two hair-removal technologies included in the system, respectively. The Company s revenue from systems that do not include hair-removal capabilities and revenue from service contracts is not subject to royalties. The royalty cost incurred from April 1, 2006 has been recorded as a component of cost of revenue. These royalty obligations will continue for applicable sales made through February 2015 which is the expiration date for the subject patents.

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 financial statements and notes thereto, and with our audited financial statements and notes thereto for the fiscal year ended December 31, 2005 as contained in our annual report on Form 10-K filed with the SEC on March 16, 2006. This quarterly report, including the following sections, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that involve risks and uncertainties. These statements include, but are not limited to, statements relating to our expectations as to the ability to continue to grow our business, revenue and operating expense for the fourth quarter ending on December 31, 2006, capital expenditures and requirements, growth in our operations and the impact of exchange rate volatility. 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 17, identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. The reader is cautioned not to place undue reliance on these forward-looking statements, which reflect management s analysis only as of the date of this report. We undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this Form 10-Q.

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Introduction

Management s discussion and analysis of financial condition and results of operations, or MD&A, is provided as a supplement to the accompanying condensed consolidated financial statements and footnotes contained in Item 1 of this report to provide an understanding of our results of operations, financial condition and changes in financial condition. The 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. In addition, it includes a summary of recent accounting pronouncements that may be applicable to us.

Results of operations. This section provides our analysis and outlook for the significant line items on our consolidated statement 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 that existed as of September 30, 2006.

Executive Summary

Company Description. We are a global medical device company specializing in the design, development, manufacture, marketing and servicing of laser and other light-based aesthetic systems to the professional aesthetic market. Our easy-to-use families of products CoolGlide, Xeo and Solera enable dermatologists, plastic surgeons, gynecologists, primary care physicians and other qualified practitioners to perform safe, effective and non-invasive aesthetic procedures for their patients.

Our corporate headquarters and U.S. operations are located in Brisbane, California, where we conduct our manufacturing, research, regulatory, sales, marketing and administrative activities. Outside the United States, we have a direct sales presence in Australia, Canada, France, Germany, Japan, Spain, Switzerland and the United Kingdom. As of September 30, 2006, we had 74 direct sales employees worldwide, a global network of over 30 distributors, and a distributor relationship in the United States with PSS World Medical Shared Services, Inc. (PSS), a wholly-owned subsidiary of PSS World Medical. PSS operates medical supply distribution service centers with approximately 700 sales representatives serving physician offices in all 50 of the United States.

Products. Our revenue is derived from the sale of products, product upgrades, amortization of pre-paid service contracts, revenue from out-of-warranty services, and Titan handpiece refills. Product revenue represents the sale of a system console that incorporates a universal graphic user interface, a laser and/ or other light-based module, control system software, high voltage electronics, and one or more handpieces. 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 as their practice grows. This enables customers to upgrade their systems whenever they want and provides us with a source of recurring revenue, which we classify as product upgrade revenue. Service revenue relates to amortization of prepaid maintenance and support contract revenue and receipts for services on out-of-warranty products. Titan handpiece refill revenue is associated with our Titan handpiece, which requires a periodic refilling process that includes the replacement of the optical source, after a set number of pulses have been performed.

Significant Business Trends. We believe that our revenue growth has been, and will continue to be, primarily attributable to the following:

Investments made in our global sales and marketing infrastructure, including the expansion of our sales force to increase our market penetration in an expanding aesthetic laser market.

Continuing introduction of new aesthetic products and applications.

Marketing to physicians outside the core dermatologist and plastic surgeon specialties, including the medi-spa market.

During the three months ended September 30, 2006, compared to the same period in 2005, our International net revenue grew by 70%, while our U.S. revenue grew by 20%. The stronger International revenue growth was primarily attributable to significant growth coming from Canada, Japan, and Switzerland. The growth in revenue from Switzerland is primarily attributable to the setting up of our European hub office there in July 2005, from where we also coordinate our European marketing and service activities. For the three months ending December 31, 2006, we expect revenue to be approximately $30.0 million, which will result in the full-year ending December 31, 2006 revenue of over $100 million and an annual growth rate of 33%.

Our gross margin for the nine months ended September 30, 2006 was 69%, compared to 74% for the nine months ended September 30, 2005. This decrease was primarily attributable to $2.0 million, or 3% of net revenue, of royalty expense resulting from the Palomar patent licensing agreement with effect from April 1, 2006- see Note 9 of Notes to Condensed Consolidated Financial Statements Litigation Settlement. Further, the decrease in margins was attributable to $1.1 million, or 2% of net revenue, of higher warranty-related expenses. We expect our margins to remain in the 68%-70% range for the quarter ending December 31, 2006.

We settled our patent litigation with Palomar in June 2006. As a consequence of preparing for and settling this litigation, our general and administrative expenses were significantly higher in the first half of 2006, compared with the same period in 2005. With the litigation matter settled, we expect our general and administrative expenses to be in the range of 10-12% of revenue in the fourth quarter ending December 31, 2006.

Factors that May Impact Future Performance. Our industry is impacted by numerous competitive, regulatory and other significant factors. The growth of our business relies on our ability to continue to develop new products and innovative technologies, obtain regulatory clearances and compliance 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. Our industry is subject to extensive government regulation, including the regulation by the United States Food and Drug Administration. Failure to comply with regulatory requirements could have a material adverse effect on our business. Additionally, our industry is highly competitive and our success depends on our ability to compete successfully. A detailed discussion of these and other factors that could impact our future performance are provided in Part II, Item 1A Risk Factors section.

Critical Accounting Policies and Estimates

The accounting policies that we consider to be critical, subjective, or requiring complex judgments 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, 2005 filed with the SEC on March 16, 2006. Other than the adoption of SFAS 123(R), there have been no significant changes during the nine months ended September 30, 2006 to the items that we disclosed as our critical accounting policies and estimates in our Annual Report on Form 10-K for the year ended December 31, 2005.

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Stock-Based Compensation Expense

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS 123(R), using the modified prospective transition method, and therefore have not restated prior periods results. Under this method we recognize compensation expense for all stock-based payments granted after January 1, 2006, and prior to but not yet vested as of January 1, 2006, in accordance with SFAS 123(R). Under the fair value recognition provisions of SFAS 123(R), we recognize stock-based compensation net of an estimated forfeiture rate and only recognize compensation cost for those shares expected to vest on a straight-line basis over the requisite service period of the award. Prior to SFAS 123(R) adoption, we accounted for stock-based payments under APB 25 and accordingly, recognized compensation expense for options that were granted at an exercise price below their deemed fair market value and for restricted stock units granted to employees.

Determining the appropriate fair value model and calculating the fair value of stock-based payment awards require the input of various highly-subjective assumptions, including the expected life of the stock-based payment awards, our stock price volatility and the expected forfeiture rate of our options. Management determined the expected stock price volatility assumption based on a combination of the Company s historical volatility combined with the weighted average of the volatility of other similar companies in the same industry. With effect from April 2006, the expected stock price volatility was based on a combination of the Company s historical volatility combined with the implied volatility of the Company s quoted stock options. We believe these methods of computing volatility are more reflective and a better indicator of the expected future volatility, than using an average of a comparable market index or of a comparable company in the same industry. The expected term of options granted in the nine months ended September 30, 2006, was based on the Company s historical exercise behavior for ten year term options. For five and seven year term options, that the Company started granting in the second quarter of 2006, the expected term was derived from the short-cut method described in SEC s SAB No. 107. The risk-free rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The assumptions used in calculating the fair value of stock-based payment awards represent management s best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. See Note 1 and 2 to the Condensed Consolidated Financial Statements for a further discussion on stock-based compensation.

Recent Accounting Pronouncements

In September 2006, the SEC issued SAB No. 108 regarding the process of quantifying financial statement misstatements. SAB No. 108 states that registrants should use both a balance sheet approach and an income statement approach when quantifying and evaluating the materiality of a misstatement. The interpretations in SAB No. 108 contain guidance on correcting errors under the dual approach as well as provide transition guidance for correcting errors. This interpretation does not change the requirements within SFAS No. 154, Accounting Changes and Error Corrections- a replacement of APB No. 20 and Financial Accounting Standards Board (FASB) Statement No. 3, for the correction of an error on financial statements. SAB No. 108 is effective for annual financial statements covering the first fiscal years ending after November 15, 2006. We will be required to adopt this interpretation by December 31, 2006. We are currently evaluating the requirements of SAB No. 108 and the impact this interpretation may have on our financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This standard defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America, and expands disclosure about fair value measurements. This pronouncement applies under other accounting standards that require or permit fair value measurements. Accordingly, this statement does not require any new fair value measurement. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We will be required to adopt SFAS No. 157 in the first quarter of fiscal year 2008. We are currently evaluating the requirements of SFAS No. 157 and have not yet determined the impact on the consolidated financial statements.

In July 2006, FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes effective for fiscal years beginning after December 15, 2006. The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting for interim periods, disclosure, and transition. We will decide on a policy for interest and penalty classification by the end of 2006 and adopt the Interpretation beginning with the fiscal year ending 2007. Upon adoption, it is not expected that the Interpretation will have a material effect on our financial position or results of operations.

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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 net revenue:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Consolidated Statement of Operations:				
Revenue Mix By Geography:				
United States customers	69%	76%	69%	70%
International customers	31%	24%	31%	30%
	100%	100%	100%	100%
Revenue Mix By Product:				
Products	83%	85%	84%	84%
Product upgrades	6%	7%	6%	9%
Service	7%	5%	6%	5%
Handpiece refills	4%	3%	4%	2%
	100%	100%	100%	100%
Operating Ratios:				
Net revenue	100%	100%	100%	100%
Cost of revenue	32%	25%	31%	26%
Gross profit	68%	75%	69%	74%
Operating expenses:				
Sales and marketing	32%	33%	36%	34%
Research and development	7%	7%	6%	8%
General and administrative	12%	10%	16%	13%
Litigation settlement	2%	0%	27%	0%
Total operating expenses	53%	50%	85%	55%
Income (loss) from operations	15%	25%	(16)%	19%
Interest and other income, net	3%	3%	4%	2%
Income (loss) before income taxes	18%	28%	(12)%	21%
Provision (benefit) for income taxes	6%	8%	(5)%	6%
Net income (loss)	12%	20%	(7)%	15%

Three and nine months ended September 30, 2006 and September 30, 2005

Net Revenue

Revenue is derived from the sale of products; product upgrades; amortization of prepaid service contracts and revenue from out-of-warranty services; and Titan handpiece refills. For the three months ended September 30, 2006, compared to the same period in 2005, net revenue increased by $6.1 million, or 32%, from $19.0 million to $25.1 million. This was the result of a $4.7 million, or 29%, increase in product revenue and $279,000, or 21%, increase in upgrade revenue, due to increased advertising and promotional activities and the direct sales force expansion that was made in the second half of 2005. Service revenue increased by $549,000, or 52%, due primarily to an increase in the number

of customers purchasing extended service contracts. Revenue from Titan handpiece refills increased by $539,000, or 112%, due to the increased consumer demand for Titan procedures and the fact that the Titan handpiece requires periodic refilling after a set number of pulses have been delivered.

For the nine months ended September 30, 2006, compared to the same period in 2005, net revenue increased by $18.5 million, or 36%, from $51.7 million to $70.2 million. This was the result of a $15.3 million, or 35%, increase in product revenue due to increased advertising and promotional activities and the direct sales force expansion that was made in the second half of 2005. Service revenue for the nine months ended September 30, 2006, compared to the nine months ended September 30, 2005, increased by $1.5 million, or 55%, due primarily to an increase in the number of customers purchasing extended service contracts. For the nine months ended September 30, 2006, compared to the nine months ended September 30, 2005, revenue from Titan handpiece refills increased by $2.0 million, or 199%, due to the increased consumer demand for Titan procedures and the fact that the Titan handpiece requires periodic refilling after a set number of pulses have been delivered. These increases were partially offset by a decline in upgrade revenue, which for the nine months ended September 30, 2006, when compared to the same period in 2005, decreased $277,000 or 6%. This was primarily due to an increase in the number of customers choosing to purchase new systems from our Solera family of products, instead of upgrading their existing systems.

For the three months ended September 30, 2006, compared to the same period in 2005, the geographical source of the $6.1 million increase in net revenue was attributable to $2.9 million in higher U.S. revenue and $3.2 million to higher international revenue. The primary contributors to this revenue growth were the continued expansion of our direct sales force, both domestic and international. For the nine months ended September 30, 2006, compared to the same period in 2005, the geographical source of the $18.5 million increase in net revenue was attributable to $12.5 million in higher U.S. revenue and $6.0 million to higher international revenue. For the three months ending December 31, 2006, we expect revenue to be approximately $30.0 million.

Cost of Revenue

Our cost of revenue consists primarily of material, labor, employee stock-based compensation, royalty expense effective April 1, 2006, warranty, and manufacturing overhead expenses. For the three months ended September 30, 2006, compared to the three months ended September 30, 2005, cost of revenue increased by $3.2 million, or 67%, from $4.7 million to $7.9 million. Cost of revenue as a percentage of revenue, increased from 25% for the three months ended September 30, 2005, to 32% for the three months ended September 30, 2006. This increase in cost of revenue as a percentage of net revenue, was primarily attributable to royalty expense of $1.0 million, or 4% of net revenue, that resulted from the patent licensing agreement entered in June 2006 and discussed in greater detail in Note 9 of Notes to Condensed Consolidated Financial Statements Litigation Settlement; a $477,000, or 2% of net revenue, increase in warranty costs resulting from higher material expenses; and $130,000, or 1% of net revenue, increase in stock-based compensation expense resulting from implementing FAS123(R) with effect from January 1, 2006.

For the nine months ended September 30, 2006, cost of revenue increased by $7.9 million, or 58%, from $13.6 million to $21.5 million. Cost of revenue as a percentage

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of revenue, increased from 26% for the nine months ended September 30, 2005, to 31% for the nine months ended September 30, 2006. This increase was primarily attributable to $2.0 million, or 3% of net revenue, of royalty expense resulting from the patent licensing agreement with effect from April 1, 2006- see Note 9 of Notes to Condensed Consolidated Financial Statements Litigation Settlement; and $1.1 million, or 2% of net revenue, due to an increase in warranty costs resulting from higher material expenses. We expect our margins to remain in the 68%-70% range for the three months ending December 31, 2006.

Sales and Marketing

Sales and marketing expenses consist primarily of personnel cost, including costs associated with employee stock-based compensation, and expenses associated with customer-attended workshops, trade shows and advertising. For the three months ended September 30, 2006, compared to the same period in 2005, sales and marketing expenses increased by $2.0 million, or 31%, from $6.2 million to $8.2 million. This increase was primarily attributable to $824,000 of higher personnel expenses and $274,00 higher travel expenses, associated primarily with the higher headcount; $156,000 in higher advertising and promotion expenses due to increased marketing activity; and $336,000 of higher employee stock-based compensation expenses resulting from the adoption of SFAS 123(R) effective January 1, 2006. As a percentage of net revenue, sales and marketing expenses were 32% and 33% for the three months ended September 30, 2006 and 2005, respectively.

For the nine months ended September 30, 2006, compared to the same period in 2005, sales and marketing expenses increased by $7.2 million, or 40%, from $17.8 million to $25.0 million. This increase was primarily attributable to $3.4 million of higher personnel expenses and $776,000 higher travel expenses, associated primarily with the higher headcount; $1.3 million in higher advertising and promotion expenses due to increased marketing activities; and $925,000 of higher employee stock-based compensation expenses resulting from the adoption of SFAS 123(R). As a percentage of net revenue, sales and marketing expenses increased from 34% in the nine months ended September 30, 2005, to 36% in the nine months ended September 30, 2006. This increase was primarily attributable to an increase in world wide direct sales headcount, increased marketing related activities and higher stock-based compensation expense. For the three months ending December 31, 2006, we estimate that sales and marketing expenses will be in the range of 29-31% of net revenue.

Research and Development

Research and development expenses consist primarily of personnel cost, including costs associated with employee stock-based compensation, clinical, regulatory and material costs. For the three months ended September 30, 2006, compared to the three months ended September 30, 2005, research and development expenses increased by $345,000, or 26%, from $1.3 million to $1.7 million. This increase was primarily attributable to $159,000 of higher personnel expenses associated primarily with higher headcount; $129,000 of higher stock-based compensation expense resulting from the adoption of SFAS 123(R) effective January 1, 2006; offset by a decrease in outside service costs by $67,000. As a percentage of net revenue, research and development expenses were 7% in the three months ended September 30, 2006 and 2005.

For the nine months ended September 30, 2006, compared to the nine months ended September 30, 2005, research and development expenses increased by $606,000, or 15%, from $3.9 million to $4.5 million. This increase was primarily attributable to $460,000 of higher personnel expense, due partly to increased headcount; $308,000 of higher stock-based compensation expense resulting from the adoption of SFAS 123(R); which was offset by a decrease in outside service costs of $247,000. As a percentage of net revenue, research and development expenses decreased from 8% in the nine months ended September 30, 2005, to 6% in the nine months ended September 30, 2006. This was primarily due to the higher net revenue in the nine months ended September 30, 2006 period, compared to the same period in 2005. For the three months ending December 31, 2006, we estimate that research and development expenses will be in the range of 6-7% of net revenue.

General and Administrative

General and administrative expenses consist primarily of personnel costs, including costs associated with employee stock-based compensation, legal and accounting fees and other general and administrative expenses. For the three months ended September 30, 2006, compared to the same period in 2005, general and administrative expenses increased by $1.1 million, or 56%, from $1.9 million to $3.0 million. This increase was primarily attributable to $199,000 increase in outside accounting, tax and audit fees, $158,000 increase in personnel expenses due to higher headcount, and $165,000 of higher stock-based compensation expense resulting from the adoption of SFAS 123(R) effective January 1, 2006. As a percentage of net revenue, general and administrative expenses increased from 10%, for the three months ended September 30, 2005, to 12% for the three months ended September 30, 2006.

For the nine months ended September 30, 2006, compared to the same period in 2005, general and administrative expenses increased by $5.1 million, or 78%, from $6.5 million to $11.6 million. This increase was primarily attributable to $2.7 million of higher legal expenses- due primarily to the patent litigation which was settled in June 2006; $732,000 of higher personnel expenses due to higher headcount; and $386,000 of higher stock-based compensation expense resulting from the adoption of SFAS 123(R) with effect from January 1, 2006. As a percentage of

net revenue, general and administrative expenses increased from 13%, for the nine months ended September 30, 2005, to 16% for the nine months ended September 30, 2006. With the litigation matter settled, we expect our general and administrative expenses to be in the range of 10-12% of revenue in the fourth quarter ending December 31, 2006.

Litigation Settlement

On June 2, 2006, we settled all patent litigation brought against us by Palomar and MGH. Under the terms of the settlement agreement, we agreed to pay Palomar royalties on past sales of infringing systems, plus accrued interest and reimbursement of Palomar s legal costs through March 31, 2006. During the quarter ended June 30, 2006, we completed a calculation of the actual amounts owed to Palomar through March 31, 2006 and estimated the amount due to be $19.6 million. In the quarter ended September 30, 2006, after further discussions with Palomar, we revised our estimate of the total amount owed to Palomar through March 31, 2006 to $20.2 million.

Of the $20.2 million settlement amount, we recorded $18.9 million that related to past royalties, interest and settlement costs, as a litigation settlement expense for the nine months ended September 30, 2006. The remaining $1.2 million was allocated to the value of the license agreement obtained and recorded as an intangible asset. See Note 9 of Notes to Condensed Consolidated Financial Statements for further details and accounting of the settlement agreement.

Interest and Other Income, Net

For the three and nine months ended September 30, 2006, compared to the same period in 2005, interest and other income increased by $280,000 and $1.3 million, respectively. This increase was primarily attributable to higher tax-exempt interest income from higher yields and an increase in the average cash and marketable investments balance.

Provision (Benefit) for Income Taxes

The interim effective income tax rate is based on management s best estimate of the annual effective income tax rate. The effective tax rate for the three and nine months ended September 30, 2006, was 35% and 43%, respectively. Applying these effective tax rates to our income before income taxes for the quarter and nine month ended September 30, 2006, resulted in a tax provision of $1.6 million and tax benefit of $3.8 million, respectively. For both the three and nine months ended September 30, 2005, our effective income tax rate was 28%. The higher effective tax rate for the three and nine months ended September 30, 2006, compared to the same period in 2005, was primarily due to the impact of the litigation settlement expense being included at the marginal tax rate of 39.28%; the expiration of the law relating to the granting of federal research and development credits in 2006; and because we have fully utilized the benefit from disqualifying dispositions of incentive stock options that can reduce our effective tax rate. For the three months ending December 31, 2006, we expect our effective income tax rate to be approximately 33%.

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Liquidity and Capital Resources

As of September 30, 2006, we had cash, cash equivalents and marketable investments of $90.7 million, which we believe are sufficient to meet anticipated cash needs for working capital and capital expenditures for at least the next 12 months. For the nine months ended September 30, 2006 and 2005, our cash flows and contractual obligations are summarized below.

Net Cash Provided by (Used in) Operating Activities

For the nine months ended September 30, 2006, net cash used in operations was $2.1 million. This was primarily attributable to a net loss of $5.0 million; an increase in the deferred tax asset by $3.7 million resulting from the income tax loss carry forward; and cash used to finance an increase in accounts receivable by $2.6 million due to higher revenue. These uses of cash were offset by the adjustment for non-cash stock-based compensation expenses of $3.2 million; cash provided by an increase in accrued liabilities of $3.4 million, due to $1.1 million higher warranty reserve and higher sales and marketing accruals associated with the higher revenue; and cash generated by a $2.2 million increase in deferred revenue associated with a larger number of customers purchasing extended service contracts.

For the nine months ended September 30, 2005, net cash provided by operations was $12.8 million. This was primarily attributable to net income of $8.0 million; cash provided from tax benefits related to employee stock option exercises of $3.1 million; adjustment for non-cash stock-based compensation expenses of $1.2 million; and a reduction of accounts receivable by $1.6 million due to collections of the cyclically high revenue generated in December 2004. This was offset by cash used to increase inventories by $2.4 million for anticipated shipments and a broader product offering; and an increase in other assets of $1.6 million due primarily to prepaid income taxes.

Net Cash Used In Investing Activities

For the nine months ended September 30, 2006, net cash used in investing activities was $2.5 million. Of this amount, $1.2 million was used for the acquisition of the Palomar patent license; $811,000, net, was used to purchase marketable investments with the increase in cash and cash equivalent balance; and $441,000 was used to purchase additional property and equipment primarily for research, development and manufacturing operations.

For the nine months ended September 30, 2005, net cash used in investing activities was $18.9 million. Of this amount, $18.3 million, net, was used to purchase additional marketable investments with the increase in cash and cash equivalent balance, and $579,000 was used to purchase property, equipment and intangibles partly associated with the set up of a new office in Zurich, Switzerland through the acquisition of a distributor.

Net Cash Provided by Financing Activities

For the nine months ended September 30, 2006 and 2005, net cash provided by financing activities was $2.4 million and $3.7 million, respectively. This was attributable to proceeds from the issuance of stock through our stock option and employee stock purchase plans.

Contractual Cash Obligations

The following table discloses aggregate information about our contractual obligations for minimum lease payments related to facility leases and the periods in which these payments are due as of September 30, 2006.

	Payments Due by Period (in thousands)				
		Less Than			More Than
	Total	1 Year	1-3 Years	3-5 Years	5 Years
Operating leases	$ 8,556	$ 1,009	$ 1,872	$ 2,378	$ 3,297

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. As of September 30, 2006, we were not involved in any

unconsolidated transactions.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to interest rate risk relates primarily to our investment portfolio. Fixed rate securities may have their fair market value adversely impacted due to fluctuations in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectation due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates. The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we invest in debt instruments of the U.S. Government and its agencies, municipal bonds and high-quality corporate issuers, and, by policy, restrict our exposure to any single corporate issuer by imposing concentration limits. To minimize the exposure due to adverse shifts in interest rates, we maintain investments at a weighted average maturity (interest reset date for auction-rate securities and variable rate demand notes) of generally less than eighteen months. Assuming a hypothetical increase in interest rates of one percentage point, the fair value of our total investment portfolio as of September 30, 2006 would have potentially declined by $464,000.

We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant partly due to our sales and operating expenses being predominantly denominated in foreign currencies and we do not maintain significant foreign currency cash balances. We cannot assure that there will not be a material impact in the future. Although the majority of our sales and purchases are denominated in U.S. dollars, future fluctuations in the value of the U.S. dollar may affect the price competitiveness of our products. We do not believe, however, that we currently have significant direct foreign currency exchange rate risk and therefore have not hedged exposures denominated in foreign currencies.

We do not utilize derivative financial instruments, derivative commodity instruments or other market risk sensitive instruments, positions or transactions.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. Our management evaluated, with the participation of the Chief Executive Officer and the Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are

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required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and that such information is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosures.

Inherent Limitations on the Effectiveness of Controls. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Changes in Internal Control over Financial Reporting. There was no change in our internal control over financial reporting that occurred during the nine months ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are not a party to any material pending litigation.

ITEM 1A. RISK FACTORS

We compete against companies that have longer operating histories, more established products and greater resources, which may prevent us from achieving significant market penetration or increased operating results.

Our products compete against similar products offered by public companies, such as Candela, Cynosure, Laserscope- now part of American Medical Systems, Lumenis, Palomar, and Syneron as well as private companies such as Reliant Technologies and Thermage. Competition with these companies could result in price-cutting, reduced profit margins and loss of market share, any of which would harm our business, financial condition and results of operations. We also face competition from medical products, such as Botox, an injectable compound used to reduce wrinkles, and collagen injections. Other alternatives to the use of our products include sclerotherapy, a procedure involving the injection of a solution into the vein to collapse it, 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. Our ability to compete effectively depends upon our ability to distinguish our company and our products from our competitors and their products, and includes such factors as:

- intellectual property protection;
- product performance;
- product pricing;
- quality of customer support;
- success and timing of new product development and introductions; and
- development of successful distribution channels, both domestically and internationally.

Some of our competitors have more established products and 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 expensive

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 achieve continued market penetration, we will be unable to compete effectively and our business will be harmed.

In addition, some of our current and potential competitors have significantly greater financial, research and development, manufacturing, and sales and marketing resources than we have. Our competitors could utilize their greater financial resources to acquire other companies to gain enhanced name recognition and market share, as well as new technologies or products that could effectively compete with our existing product lines. For example, ESC Medical purchased Coherent s medical business in 2001 and the surviving company, Lumenis, incorporated competitive product lines and technologies of the predecessor companies into its current products. Given the relatively few competitors currently in the market, any business combination could exacerbate any existing competitive pressures, which could harm our business.

Competition among providers of laser and other light-based devices for the aesthetic market is characterized by rapid innovation, and we must continuously develop new products or our revenues may decline.

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. For example, while our CoolGlide product was the first long-pulse Nd:YAG, or long wavelength, laser system cleared by the FDA for permanent hair reduction on all skin types, competitors have subsequently introduced systems that utilize Nd:YAG lasers, and received FDA clearances to market these products as treating all skin types. We expect that any competitive advantage we may enjoy from other current and future innovations, such as combining multiple handpieces in a single system to perform a variety of applications, 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 will decline as our customers purchase our competitors products.

Our ability to compete depends upon our ability to innovate, to develop and commercialize new products and product enhancements, and to identify new markets for our technology.

We have created products to apply our technology to hair removal, treatment of veins, skin rejuvenation, treatment of pigmented lesions and treatment of wrinkles. Currently, these applications represent the majority of laser and other light-based aesthetic procedures. To be successful in the future, we must develop new and innovative applications of laser and other light-based technology, identify new markets for our existing technology, and develop new technology that is not light-based. To successfully expand our product offerings, we must:

develop or acquire new products that either add to or significantly improve our current products;

convince our target customers that our new products or product upgrades would be an attractive revenue-generating addition to their practices;

sell our products to non-traditional customers;

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.

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Every year since 2000, we have introduced at least one new product and a corresponding upgrade to our existing products. Historically, these introductions have been a significant component of our financial performance. Our business strategy is based, in part, on our expectation that we will continue to make annual product introductions that we can sell to new customers and to existing customers as upgrades. For the quarter ending December 31, 2006, we plan to invest approximately 6-7% of net revenue in our research and development department. Even with a significant investment in research and development, we may be unable, however, to continue to develop new products and technologies annually, or at all, which could adversely affect our projected growth rate.

If PSS World Medical fails to perform to our expectations, we may fail to achieve anticipated operating results.

We have a distribution agreement with PSS World Medical Shared Services, Inc. (PSS), a wholly-owned subsidiary of PSS World Medical, , which operates medical supply distribution service centers with approximately 700 sales representatives serving physician offices in all 50 states of the United States. PSS sales representatives work in coordination with our sales force to locate new potential customers for our products. For the year ended December 31, 2005 and for the nine months ended September 30, 2006, approximately 16% of our revenue came from PSS.

If PSS does not perform adequately under the arrangement, or terminates our relationship, which it can do at any time upon 180 days notice, it may have a material adverse effect on our business, financial condition, results of operations or future cash flows.

If our public guidance or our future operating performance does not meet investor expectations, our stock price could decline.

We provide guidance to the investing community regarding our anticipated future operating performance, both for the coming quarter and fiscal year-end. Our business typically has a short sales cycle, we do not have significant backlog of orders at the start of a quarter, and our ability to sell our products successfully is subject to many uncertainties, as discussed herein. In light of those factors, it is difficult for us to estimate with accuracy our future results. In the past, our actual performance had turned out to be significantly different from our prior guidance. For example, at the beginning of 2005, we indicated that we expected our 2005 revenue to increase by 25% over 2004. Actual 2005 growth was higher, at 44% over 2004. Earlier in the year, we stated publicly that we expected our revenue to grow 25% in 2006, compared to 2005 and we have since revised our guidance for the full year of 2006 to 33%. As we stated at the time, such expectations are subject to numerous risks and uncertainties which could make actual results differ materially, either higher or lower. If our actual results do not meet our public guidance, or our results or guidance as to the future were to be below the expectations of third party financial analysts, our stock price could decline significantly.

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

We recently settled costly patent litigation with Palomar see Note 9 of Notes to Condensed Consolidated Financial Statements Litigation Settlement. As with that case, our competitors or other patent holders may assert that our products and the methods we employ are covered by their patents. In addition, we do not know whether our competitors will apply for and obtain patents that will 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 marketing our products and our business would suffer as a result.

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. We do not know whether necessary licenses would be available to us on satisfactory terms, or whether we could redesign our products or processes to avoid infringement. If we lose this kind of litigation, 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.

Our patent litigation settlement payment to Palomar is subject to audit, which could result in a material adverse effect on our business and our stock price.

On June 2, 2006, we settled our patent litigation with Palomar and MGH - with Palomar granting us an irrevocable license to the subject patents. Under the terms of the settlement agreement, we made a good faith estimated payment to Palomar of $22.0 million, representing our estimate of royalties due on past sales of the infringing systems, plus accrued interest and reimbursement of Palomar s legal costs through March 31, 2006. The actual amounts owed to Palomar through March 31, 2006 are subject to review by an independent public accountant hired by Palomar. This audit is expected to be completed by December 31, 2006.

Subsequent to the date of the settlement, the Company completed a calculation of the actual amounts owed to Palomar through March 31, 2006 and estimated the amount due to be $19.6 million. During the quarter ended September 30, 2006, after further discussions with Palomar, we revised our estimate of the total amount owed to Palomar through March 31, 2006 to $20.2 million. This liability was calculated based on our interpretation of the settlement agreement and our historical records of the underlying transactions that are subject to the royalty. The independent public accountant s interpretation of the applicable royalty rate for our different product and transaction types, and the net revenue for which to calculate the royalty, could be different from ours. In the event that the independent public accountant s assessment of the accuracy of our final settlement amount owed by us to Palomar is materially different from our calculations, we could owe a higher settlement amount to Palomar that would then have to be reported as an additional expense in our financial statements for the year ending on December 31, 2006. This could result in a material adverse effect on our business and stock price.

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, 2006, we had seven issued U.S. patents, some covering our ClearView handpiece design and cooling method. Some of our other 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 could be adversely affected, as could our business.

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If we fail to obtain clearance from the U.S. Food and Drug Administration to market our Titan product for additional indications, our revenue from this product

may be adversely affected.

Our Titan product, introduced in 2004, is a material component of our growth strategy. We currently have FDA clearance to market Titan in the United States for deep dermal heating. The FDA has denied our initial 510(k) application to market Titan for wrinkle reduction on the basis that Titan is not substantially equivalent to predicate devices for the treatment of wrinkles. We are continuing to seek a clearance from the FDA to market Titan for additional indications, but there are no assurances as to when, or whether, we will ever obtain such a clearance. We cannot promote or advertise our Titan product in the United States for any indications other than deep dermal heating until we receive additional FDA clearances. In the event that we do not obtain additional FDA clearances, our ability to market Titan in the United States and revenue derived therefrom, including revenue from both Titan unit sales and handpiece refills, may be adversely affected.

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, or if there are federal or state level regulatory changes, 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 additional FDA clearances, our ability to market future products or applications in the United States and revenue derived therefrom may be adversely affected.

Medical devices may be marketed only for the indications for which they are approved or cleared and if we are found to be marketing our products for off-label, or non-approved, uses we might be subject to FDA enforcement action or have other resulting liability. 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, in flux. 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.

The FDA and state authorities have broad enforcement powers. Our failure to comply with applicable regulatory requirements could result in enforcement action by the FDA or state agencies, which may include any of the following sanctions:

warning letters, fines, injunctions, consent decrees and civil penalties;

repair, replacement, refunds, 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, they 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 have been, and anticipate in the future to be, subject to such inspections. 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 to obtain 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.

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To successfully market and sell our products internationally, we must address many issues with which we have little or no experience.

For the nine months ended September 30, 2006, approximately 31% of our revenue was derived from international customers, which are a material component of our growth strategy. We depend on third-party distributors and a relatively new direct sales operation to sell our products internationally, and if these distributors or direct sales personnel under-perform, we may be unable to increase or maintain our level of international revenue. We will need to attract additional international distributors to grow our business and expand the territories in which we sell our products. Distributors may not accept our business or commit the necessary resources to market and sell our products to the level of our expectations. If current or future distributors do not perform adequately, or we are unable to engage distributors in particular geographic areas, we may not realize projected international revenue growth. Additionally, we expect to expand our direct sales force in Europe and Asia. If we are unable to hire, retain and obtain satisfactory performance from such additional personnel, our revenue from international operations may be adversely affected.

We believe that an increasing amount of our future revenue will come from international sales as we expand our overseas operations and develop opportunities in additional international territories. International sales are subject to a number of risks, including:

- difficulties in staffing and managing our foreign operations;
- difficulties in penetrating markets in which our competitors products are more established;
- reduced protection for intellectual property rights in some countries;
- 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; and
- preference for locally-produced products.

If one or more of these risks were realized, it could require us to dedicate significant resources to remedy the situation, and if we are unsuccessful at finding a solution, our revenue may decline.

The expense and potential unavailability of insurance coverage for our customers and our company could adversely affect our ability to sell our products and 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, industry-wide, potential customers may opt against purchasing laser and other light-based products due to the cost of or inability to procure insurance coverage.

We have been experiencing steep increases in our product liability insurance premiums. If our premiums continue to rise, we may no longer be able to afford adequate insurance coverage. If we are unable to maintain adequate coverage, potential product liability claims would be paid out of cash reserves, harming our financial condition, operating results and profitability.

Because we do not require training for users of our products, and sell our products to non-physicians, there exists an increased potential for misuse of our products, which could harm our reputation and our business.

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 purchasers or operators of our products to attend training sessions. In addition, we sometimes sell our systems to companies that rent our systems to third parties and that provide a technician to perform the procedure. 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 expose us to costly product liability litigation.

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 reduce product sales. Product liability claims in excess of our insurance coverage would be paid out of cash reserves, thereby harming our financial condition and reducing our operating results.

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;

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- 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 commercially 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;
- delay in delivery due to our suppliers prioritizing other customer orders over ours; and
- fluctuation in delivery by our suppliers due to changes in demand from us or their other customers.

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.

Components used in our products are complex in design, and any defects may not be discovered prior to shipment to customers, which could result in warranty obligations, reducing our revenue and increasing our cost.

In manufacturing our products, we depend upon third parties for the supply of various components. Many of these components require a significant degree of technical expertise to produce. If our suppliers fail to produce components to specification, or if the suppliers, or we, use defective materials or workmanship in the manufacturing process, the reliability and performance of our products will be compromised.

If our products contain defects that cannot be repaired easily and inexpensively, we may experience:

- loss of customer orders and delay in order fulfillment;
- damage to our brand reputation;
- increased cost of our warranty program 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 harm our business.

We forecast sales to determine requirements for components and materials used in our products and if our forecasts are incorrect, we may experience either delays in shipments or increased inventory costs.

We keep limited materials and components on hand. To manage our manufacturing operations with our suppliers, we forecast anticipated product orders and material requirements to predict our inventory needs up to nine months in advance and enter into purchase orders on the basis of these requirements. Our limited historical experience may not provide us with enough data to accurately predict future demand. If our business expands, our demand for components and materials would increase and our suppliers may be unable to meet our demand. If we overestimate our component and material requirements, we will have excess inventory, which would increase our expenses. If we underestimate our component and material requirements, we may have inadequate inventory, which could interrupt, delay or prevent delivery of our products to our customers. Any of these occurrences would negatively affect our financial performance and the level of satisfaction our customers have with our business.

If there is not sufficient 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 other light-based aesthetic procedures is a material assumption of our growth 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:

- 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 other light-based technologies and treatments which use pharmaceutical products;
- the success of our sales and marketing efforts; and
- consumer confidence, which may be impacted by economic and political conditions.

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, resulting in unfavorable operating results and lower growth potential.

Lack of demand for our products in the non-core market would harm our anticipated revenue growth.

An increasing portion of our revenue is derived from sales to customers outside of the core dermatologist and plastic surgeon specialties, such as family practitioners, primary care physicians, gynecologists, medi-spas, etc. Continuing to achieve further penetration into this new market is a material assumption of our growth strategy. Demand for our products in the non-core market could be weakened by factors including, poor financial performance of businesses introducing aesthetic procedures to their practice or medi-spas, reduced patient demand for alternative treatments and services being provided by non-core practitioners and an increase in malpractice law suits against non-core practitioners. If we do not achieve anticipated demand for our products in the non-core market, our expected revenue growth may not be achieved.

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We depend on skilled and experienced personnel to operate our business effectively. If we are unable to recruit, hire 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. 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 any 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 will be a critical factor 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 will face particularly significant challenges and risks in hiring, training, managing and retaining engineering and sales and marketing employees. Failure to attract and retain personnel, particularly technical and sales and marketing personnel, would materially harm our ability to compete effectively and grow our business.

Our financial results will be affected by accounting rules governing the recognition of stock-based compensation expense.

As of January 1, 2006, we adopted SFAS 123(R), which requires us to measure and record stock-based compensation expense using the fair value method, which adversely affects our results of operations by increasing our cost by the amount of such stock-based compensation charges. In the quarter ending December 31, 2006, we estimate that the adoption of FAS 123(R) will increase our cost of goods sold and operating expenses by approximately $1.25 million, before income taxes. However, our estimate of future stock-based compensation expense is affected by our stock price, the number of stock-based awards our board of directors may grant or are forfeited in the fourth quarter ending December 31, 2006, as well as a number of valuation assumptions and the related tax effect.

Determining the appropriate fair value model and calculating the fair value of stock-based payment awards require the input of highly subjective assumptions, including the expected life of the stock-based payment awards, our stock price volatility and the expected forfeiture rate of our options; these assumptions represent management s best estimates, and they involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period.

Failure to maintain effective internal control over financial reporting could have a material adverse effect on our business, operating results and stock price.

Beginning with the annual report for our fiscal year ended on December 31, 2005, Section 404 of the Sarbanes-Oxley Act of 2002 required us to include a report by our management on our internal control over financial reporting. Such report contained an assessment by management of the effectiveness of our internal control over financial reporting as of the end of our fiscal year and a statement as to whether or not such internal control is effective. Also included in our Annual Report on Form 10-K was an opinion by our Independent Registered Public Accounting Firm of management s assessment of such internal control.

Our efforts to comply with Section 404 have resulted in, and are likely to continue to result in, significant costs, the commitment of time and operational resources and the diversion of management s attention. Though management did not identify any material weaknesses in our internal control over financial reporting during the year ended December 31, 2005, if we are unable to assert that our internal control over financial reporting is effective as of our fiscal year end in 2006 and future years, our business may be harmed.

Our effective income tax rate may vary significantly.

Unanticipated changes in our tax rates could affect our future results of operations. Our future effective tax rates could be unfavorably affected by changes in tax laws or the interpretation of tax laws, by unanticipated decreases in the amount of revenue or earnings in countries with low statutory tax rates, by changes in the valuation of our deferred tax assets and liabilities, future levels of research & development spending, deductions for employee stock option exercises being different to what we projected, and changes in overall levels of income before taxes.

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

We expect to 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. We do not have any experience with acquiring companies or products. If we decide to expand our product offerings beyond laser and other 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 would be dilutive to our stockholders. While we from time to time evaluate potential collaborative projects and 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 acquisitions or collaborative projects.

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;
- a supermajority stockholder vote requirement for amending certain provisions of our Amended and Restated Certificate of Incorporation and Bylaws;
- 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 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.

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We have not paid dividends in the past and do not expect to pay dividends in the future, and any return on investment may be limited to the value of our stock.

We have never paid cash dividends on our common stock and do not anticipate paying cash dividends on our common stock in the foreseeable future. The payment of dividends on our common stock will depend on our earnings, financial condition and other business and economic factors affecting us at such time as our board of directors may consider relevant. If we do not pay dividends, our stock may be less valuable because a return on investment will only occur if our stock price appreciates.

ITEM 5. OTHER INFORMATION

In accordance with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002 (the Act), we are required to disclose the non-audit services approved by our Audit Committee to be performed by PricewaterhouseCoopers LLP, our Independent Registered Public Accounting Firm. Non-audit services are defined in the Act as services other than those provided in connection with an audit or a review of the financial statements of a company. The Audit Committee has approved the engagement of PricewaterhouseCoopers LLP for the following non-audit services: (1) various tax matter consultations concerning U.S. federal and state taxes and foreign taxes for our expatriates.

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.
10.13*	Distribution Agreement between the Registrant and PSS World Medical Shared Services, Inc., a subsidiary of PSS World Medical dated October 1, 2006.
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.

* Confidential Treatment has been requested for certain portions of this exhibit.

(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.

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SIGNATURE

Pursuant to the requirements 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.

CUTERA, INC.

Date: November 8, 2006

/s/ Ronald J. Santilli
Ronald J. Santilli

Chief Financial Officer

(Principal Financial Officer and

Authorized Signatory)