IRIDEX CORP
Form 10-Q
November 04, 2008
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 27, 2008

Or

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

Commission file number: 0-27598

IRIDEX CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**77-0210467**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

1212 Terra Bella Avenue Mountain View, California	**94043-1824**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (650) 940-4700

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company þ

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

The number of shares of common stock, $.01 par value, issued and outstanding as of October 31, 2008 was 8,824,301.

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PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements (unaudited)

IRIDEX Corporation

Condensed Consolidated Balance Sheets

(Unaudited, in thousands except share amounts)

	September 27, 2008	December 29, 2007 (1)
Assets		
Current assets:		
Cash and cash equivalents	$ 2,974	$ 5,809
Restricted cash		3,800
Accounts receivable, net	9,215	8,876
Inventories, net	13,527	15,967
Prepaids and other current assets	1,264	1,051
Total current assets	26,980	35,503
Property and equipment, net	1,128	1,621
Goodwill	3,239	3,239
Other intangible assets, net	4,185	5,944
Other long term assets	224	347
Total assets	$ 35,756	$ 46,654
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,593	$ 2,887
Bank line of credit	6,000	4,863
Accrued compensation	1,680	2,024
Accrued expenses	3,235	7,809
Accrued warranty	1,258	1,895
Deferred revenue	2,805	3,350
Bank term loan current portion		5,016
Total current liabilities	17,571	27,844
Commitments and contingencies (Note 7)		
Stockholders equity:		
Convertible preferred stock, $.01 par value:		
Authorized: 2,000,000 shares; Issued and outstanding: 500,000 shares in 2008 and 2007	5	5
Common stock, $.01 par value:		
Authorized: 30,000,000 shares; Issued and outstanding: 8,824,301 shares in 2008 and 2007	89	89
Additional paid-in capital	39,087	38,695
Accumulated other comprehensive loss	(238)	(88)
Treasury stock, at cost	(430)	(430)
Accumulated deficit	(20,328)	(19,461)
Total stockholders equity	18,185	18,810

Total liabilities and stockholders equity	$ 35,756	$ 46,654

(1) Derived from the consolidated audited financial statements included in our report filed on Form 10-K with the SEC for the year ended December 29, 2007.

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

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IRIDEX Corporation

Condensed Consolidated Statements of Operations

(Unaudited, in thousands except per share data)

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Revenues	$ 11,987	$ 13,575	$ 36,383	$ 41,390
Cost of revenues	6,997	7,390	21,257	23,412
Gross profit	4,990	6,185	15,126	17,978
Operating expenses:				
Research and development	972	1,319	2,995	4,636
Selling, general and administrative	4,248	5,920	13,356	21,740
Total operating expenses	5,220	7,239	16,351	26,376
Loss from operations	(230)	(1,054)	(1,225)	(8,398)
Legal settlement			800	2,500
Interest and other expense, net	(54)	(184)	(426)	(603)
Loss before income taxes	(284)	(1,238)	(851)	(6,501)
Benefit (provision) for income taxes	35		(16)	
Net loss	$ (249)	$ (1,238)	$ (867)	$ (6,501)
Net loss per share basic and diluted	$ (0.03)	$ (0.15)	$ (0.10)	$ (0.80)
Shares used in computing net loss per share basic and diluted	8,824	8,218	8,824	8,165

Condensed Consolidated Statements of Comprehensive Loss

(Unaudited, in thousands)

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Net loss	$ (249)	$ (1,238)	$ (867)	$ (6,501)
Foreign currency translation adjustments	(149)	(3)	(150)	(24)
Comprehensive loss	$ (398)	$ (1,241)	$ (1,017)	$ (6,525)

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

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IRIDEX Corporation

Condensed Consolidated Statements of Cash Flows

(Unaudited, in thousands)

	Nine Months Ended	
	September 27, 2008	September 29, 2007
Cash flows from operating activities:		
Net loss	$ (867)	$ (6,501)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,417	3,079
Stock compensation recognized	392	1,033
Provision for doubtful accounts	(2)	1,412
Provision for excess and obsolete inventories	1,582	388
Changes in operating assets and liabilities:		
Accounts receivable	(337)	(3,875)
Inventories	858	(4,140)
Prepaids and other current assets	(213)	(789)
Accounts payable	(294)	1,722
Accrued compensation and expenses	(4,918)	2,066
Accrued warranty	(637)	1,316
Deferred revenue	(545)	2,562
Net cash used in operating activities	(2,564)	(1,727)
Cash flows from investing activities:		
Purchases of property and equipment	(165)	(1,702)
Purchases of intangible assets		(16,618)
Goodwill		(10,509)
Other Assets	123	924
Net cash used in investing activities	(42)	(27,905)
Cash flows from financing activities:		
Proceeds from issuance of common stock		2,889
Proceeds of credit facility, net of issuance costs	1,137	4,890
Repayment of credit facility	(5,016)	10,421
Restricted cash balance offset against credit facility	3,800	(3,800)
Net cash (used in) provided by financing activities	(79)	14,400
Effect of foreign exchange rate changes	(150)	(24)
Net decrease in cash and cash equivalents	(2,835)	(15,256)
Cash and cash equivalents at beginning of period	5,809	21,051
Cash and cash equivalents at end of period	$ 2,974	$ 5,795

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

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IRIDEX Corporation

Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of IRIDEX Corporation (the Company) have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and pursuant to the instructions to Form 10-Q and Article 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the financial statements have been included.

The condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto, together with management s discussion and analysis of financial condition and results of operations, contained in our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on April 10, 2008. The independent accountant s report included a qualification paragraph that stated the Company s losses from operations and failure to meet certain debt covenants raised substantial doubt about the Company s ability to continue as a going concern. The results of operations for the three and nine month periods ended September 27, 2008 are not necessarily indicative of the results for the year ending January 3, 2009 or any future interim period.

Management believes that the Company s current cash and cash equivalents and its credit facility with Wells Fargo Bank provides sufficient liquidity to operate for the next 12 months and that the covenants contained in the Wells Fargo Bank credit facility are reasonable and management expects to be able to meet those covenants based on its operating plan for 2008. However, recent operating results indicate that there is significant risk in achieving the operating plan. If the Company is not able to perform in accordance with its operating plan for 2008 and fails to maintain compliance with its debt covenants, Wells Fargo Bank would be entitled to exercise its remedies under this facility which include declaring all outstanding obligations due and payable, and disposing of the collateral if obligations are not paid.

In August 2008 the Company was not in compliance with certain covenants contained in the credit facility relating to the Company s ability to sufficiently cover its debt service needs; however, the Company has obtained a waiver from Wells Fargo Bank and was in compliance with all of the covenants in the Agreement during September 2008.

These matters raise substantial doubt about the Company s ability to continue as a going concern. The accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty. The Company s financial statements have been prepared on a going concern basis which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business.

Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No 141(R) (revised 2007), Business Combinations (SFAS 141R), which replaces SFAS 141. SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and the goodwill acquired. SFAS 141R also establishes disclosure requirements that will enable users to evaluate the nature and financial effects of the business combination. SFAS 141R is effective as of the beginning of an entity s fiscal year that begins after December 15, 2008 and will be adopted by the Company in the first quarter of fiscal year 2009. While the Company expects that SFAS 141R will have an impact on accounting for business combinations once adopted, the effect is dependent upon acquisitions at that time.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 (SFAS 160). The standard changes the accounting for noncontrolling (minority) interests in consolidated financial statements including the requirements to classify noncontrolling interests as a component of consolidated stockholders equity, and the elimination of minority interest accounting in results of operations with earnings attributable to noncontrolling interests reported as part of consolidated earnings. Additionally, SFAS 160 revises the accounting for both increases and decreases in a parent s controlling ownership interest. SFAS 160 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company believes it is unlikely that the adoption of SFAS 160 will have an impact on the consolidated financial statements because the Company does not hold a noncontrolling (minority) interest in another entity.

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On March 19, 2008, the FASB issued SFAS 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 requires enhanced disclosures about an entity s derivative and hedging activities. These enhanced disclosures will discuss (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Currently, the Company does not engage in derivative and hedging activities.

In April 2008, FASB Staff Position SFAS 142-3, Determination of the Useful Life of Intangible Assets, (FSP 142-3) was issued. FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS 142, Goodwill and Other Intangible Assets, (SFAS 142). FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The guidance for determining the useful life of a recognized intangible asset in paragraphs 7 11 of this FSP shall be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements in paragraphs 13 15 shall be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. FSP 142-3 will be adopted by the Company in the first quarter of fiscal year 2009. The Company does not expect the adoption of FSP 142-3 will have a material impact on its consolidated financial statements.

In May 2008, the FASB issued SFAS 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS 162). SFAS 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with GAAP for nongovernmental entities. SFAS 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The Company does not expect the adoption of SFAS 162 will have a material impact on its consolidated financial statements.

Recently Adopted Accounting Standards

In September 2006, the FASB issued SFAS 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption permitted, except for the impact of FASB Staff Position (FSP) 157-2. FSP 157-2 deferred the adoption of SFAS 157 for non financial assets and liabilities until years ended after November 15, 2008. On December 30, 2007, we adopted SFAS 157 for financial assets and liabilities. Carrying amounts of our financial instruments including cash and cash equivalents, accounts receivables, accounts payables and accrued liabilities approximate fair value due to their short maturities. The fair value of bank line of credit approximates fair value due to its floating rate nature.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 was issued to allow entities to voluntarily choose to measure certain financial assets and liabilities at fair value (fair value option). The fair value option may be elected on an instrument-by-instrument basis and is irrevocable, unless a new election date occurs. If the fair value option is elected for an instrument, SFAS 159 specifies that unrealized gains and losses for that instrument shall be reported in earnings at each subsequent reporting date. SFAS 159 is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. On December 30, 2007 we adopted SFAS 159 and have made no election under SFAS 159.

2. Summary of Significant Accounting Policies

The Company s significant accounting policies are disclosed in our Annual Report on Form 10-K for the year ended December 29, 2007 which was filed with the Securities and Exchange Commission on April 10, 2008.

Valuation of Goodwill and Intangible Assets.

The purchase method of accounting for acquisitions requires estimates and assumptions to allocate the purchase price to the fair value of net tangible and intangible assets acquired. The amounts allocated to, and the useful lives estimated for, intangible assets affect future amortization. There are a number of generally accepted valuation methods used to estimate fair value of intangible assets, and we use primarily a discounted cash flow method, which requires significant management judgment to forecast the future operating results and to estimate the discount factors used in the analysis. Purchased intangible assets were

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initially recorded in the first quarter of 2007 in conjunction with the acquisition of the aesthetics business of Laserscope. We review our intangible assets for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. An asset is considered impaired if its carrying amount exceeds the future net cash flow the asset is expected to generate. If an asset is considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair value. In the fourth quarter of 2007 the Company determined that based on estimated future cash flows the carrying amount of specific intangible assets exceeded their fair value; accordingly an impairment loss was recognized.

Goodwill is not amortized, but is subject to an annual impairment test. To determine any goodwill impairment, a two-step process is performed on an annual basis, or more frequently if necessary, to determine 1) whether the fair value of the relevant reporting unit exceeds carrying value and 2) to measure the amount of an impairment loss, if any. Goodwill was initially recorded in the first quarter of 2007 in conjunction with the acquisition of the aesthetics business of Laserscope. In the fourth quarter of 2007 the Company performed an annual impairment test. We identified the Laserscope Aesthetics reporting unit as the appropriate reporting unit for this analysis. Reporting units are operating segments or components of operating segments for which discrete financial information is available. The conclusion was that the carrying value of the reporting unit exceeded the fair value. As a result, management performed the second step and determined the fair value of the assets and liabilities of the reporting unit to measure the amount of impairment loss. By establishing the fair value of the reporting unit and the fair value of assets and liabilities within the reporting unit, the Company determined the amount of impairment to goodwill.

Future changes in events or circumstances, such as an inability to achieve the cash flows determined above, may indicate that the recorded value of the intangible assets will not be recovered through future cash flows, or if the fair value of the Laserscope Aesthetics business unit is determined to be less than its carrying value, the Company may be required to record an additional impairment charge for the intangible assets or goodwill or further modify the period of expected lives for the intangible assets.

Revenue Recognition.

Our revenues arise from the sale of laser consoles, delivery devices, disposables and service and support activities. Revenue from product sales is recognized upon receipt of a purchase order and product shipment provided that no significant obligations remain and collection of the receivables is reasonably assured. Shipments are generally made with Free-On-Board (FOB) shipping point terms, whereby title passes upon shipment from our dock. Any shipments with FOB receiving point terms are recorded as revenue when the shipment arrives at the receiving point. Cost is recognized as product sales revenue is recognized. Our Company s sales may include post-sales obligations for support activities. When these obligations are fulfilled after product shipment, the Company recognizes revenue in accordance with the multiple element accounting guidance set forth in Emerging Issues Task Force No. 00-21, Revenue Arrangements with Multiple Deliverables. When the Company has objective and reliable evidence of fair value of the undelivered elements, it defers revenue attributable to the post-sale obligations and recognizes such revenue when the obligation is fulfilled. Otherwise, the Company defers all revenue related to the transaction until all elements are delivered. Revenue relating to extended support contracts is recognized on a straight line basis over the period of the applicable support contract. We recognize repair service revenue upon completion of the work.

In international regions outside of the UK and France, we utilize distributors to market and sell our products. We recognize revenue upon shipment for sales to these independent, third party distributors as we have no continuing obligations subsequent to shipment. Generally our distributors are responsible for all marketing, sales, installation, training and support labor coverage for our products. Our standard terms and conditions do not provide price protection or stock retention rights to any of our distributors.

Deferred Revenue

Revenue related to extended service contracts is deferred and recognized on a straight line basis over the period of the applicable service period. Costs associated with these service arrangements are recognized as incurred. The reduction in the deferred revenue balance is attributable to the fact that revenue being recognized from existing contracts exceeds the revenue being deferred from new or renewed contracts due to the decline in the aesthetics business. A reconciliation of the changes in the Company s deferred revenue balance for the nine months ending September 27, 2008 and September 29, 2007 is as follows:

	Nine Months Ended	
(in thousands)	**September 27, 2008**	**September 29, 2007**
Balance, beginning of period	$ 3,350	$ 1,415
Additions to deferral through acquisition		1,938
Additions to deferral	4,901	6,385
Revenue recognized	(5,446)	(5,761)
Balance, end of period	$ 2,805	$ 3,977

Warranty

The Company accrues for estimated warranty cost upon shipment of products. Actual warranty costs incurred have not materially differed from those accrued. The Company s warranty policy is applicable to products which are considered defective in their performance or fail to meet the product specifications. Warranty costs are reflected in the statement of operations as a cost of sales. A reconciliation of the changes in the Company s warranty liability for the nine months ending September 27, 2008 and September 29, 2007 is as follows:

	Nine Months Ended	
(in thousands)	**September 27, 2008**	**September 29, 2007**
Balance, beginning of period	$ 1,895	$ 866
Warranty accrual acquired through acquisition		1,771
Accrual for warranties issued during the period	165	(153)
Settlements made in kind during the period	(802)	(302)
Balance, end of period	$ 1,258	$ 2,182

3. Business Combination

On January 16, 2007, the Company acquired the aesthetics business of American Medical Systems Holdings (AMS) and Laserscope, a wholly owned subsidiary of AMS for $28.6 million including the direct costs of acquisition for cash and 213,435 shares of common stock valued at $9.43 per share. These financial statements include the results of operations for the acquired business from the acquisition date. The Company made the acquisition due to its complementary fit with the existing IRIDEX aesthetics laser business. At the time of the acquisition the Company recorded Goodwill of $10.1 million and intangible assets of $16.4 million. At the end of 2007 the Company conducted an impairment test in accordance with SFAS 142 Goodwill and Other Intangible Assets and determined that based on operating results for 2007 and the outlook for the aesthetics business for 2008 and beyond, there was significant impairment to the intangible assets and goodwill. In addition, the Company revisited the useful lives associated with the remaining intangible assets to ensure they reflected the revised outlook for the aesthetics business. The impact of this review was to write down goodwill by $6.9 million from $10.1 million to $3.2 million and write down the gross carrying value of the intangible assets by $7.8 million from $16.4 million to $8.6 million. The net carrying value of intangible assets after impairment which includes the amortization expense for the year as of December 29, 2007 was $5.9 million and as of September 27, 2008 was $4.2 million. Amortization of intangible assets associated with the acquisition was $4.7 million and $2.1 million for the nine months ended September 27, 2008 and September 29, 2007, respectively.

As part of the acquisition the Company acquired Laserscope s wholly owned subsidiaries in France and the United Kingdom (UK). In June 2008, the Company signed an agreement which transferred the responsibility for sales and service of our aesthetics products in the UK to an independent distributor along with a transfer of associated employees and assets.

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4. Inventories, net

The components of the Company s inventories are as follows:

(in thousands)	September 27, 2008	December 29, 2007
Raw materials	$ 6,297	$ 9,063
Work in progress	1,637	1,832
Finished goods	5,593	5,072
Total inventories	$ 13,527	$ 15,967

During 2007 and the nine months ended September 27, 2008, the Company recorded a lower of cost or market (LCM) reserve associated with the inventory purchased from AMS totaling $1.8 million. As a result of reviewing inventory on hand during the nine months ended September 27, 2008, the Company has reclassified $1.7 million of this reserve to an excess and obsolete reserve and recognized $0.1 million as a favorable purchase price variance. The balance on the LCM reserve was $1.1 million and $0 as of December 29, 2007 and September 27, 2008, respectively.

5. Fair Value Measurement

On December 30, 2007, the Company adopted Statement of Financial Accounting Standards (SFAS) 157, Fair Value Measurements (SFAS 157) which defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. SFAS 157 applies whenever other statements require or permit assets or liabilities to be measured at fair value. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption of SFAS 157 permitted, except for the impact of FASB Staff Position (FSP) 157-2. FSP 157-2 deferred the adoption of SFAS 157 for nonfinancial assets and liabilities until years ended after November 15, 2008.

SFAS 157 includes a fair value hierarchy that is intended to increase the consistency and comparability in fair value measurements and related disclosures. The fair value hierarchy is based on inputs to valuation techniques that are used to measure fair value that are either observable or unobservable. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity s pricing an asset or liability based upon their own market assumptions. The fair value hierarchy consists of the following three levels:

Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets.

Level 2 instrument valuations are obtained from readily-available pricing sources for comparable instruments.

Level 3 instrument valuations are obtained without observable market values and require a high-level of judgment to determine the fair value.

At September 27, 2008, the Company had $3.0 million in cash and cash equivalents. Of this amount, approximately $2.0 million were in money market funds whose fair market value was obtained from real-time quotes for transactions in active markets involving identical assets. At September 27, 2008, the Company had $6.0 million outstanding against the bank line of credit which approximates fair value due to the line of credit s floating rate nature. The Company did not have any Level 2 or Level 3 assets or liabilities.

6. Bank Borrowings

In January 2007, the Company entered into a credit agreement with Mid-Peninsula Bank, part of Greater Bay Bank N.A. (the Prior Lenders) that provided for an asset-based revolving line of credit up to $6 million revolving loan and a $6 million term loan. The Company s obligations under all loans were secured by a lien on substantially all of the Company s assets. These credit facilities contained certain financial and other covenants. In the event of noncompliance by the Company with these covenants, the Prior Lenders would be entitled to exercise their remedies, which included declaring all obligations immediately due and payable and disposing of the collateral if the obligations were not paid. As of December 29, 2007 the Company was out of compliance with its debt covenants on its existing credit facilities with the Prior Lenders.

Subsequent to the year end the Company obtained a waiver for the default.

On March 28, 2008, the Company terminated the Credit Agreement with the Prior Lenders repaying all outstanding balances and entered into (i) a Borrowing Agreement and (ii) an Export-Import Bank Loan and Security Agreement with Wells Fargo Bank (together referred to as the Agreement). The Agreement provides for an asset-based revolving line of credit of up to $8 million (the New Revolving Loans). Of the New Revolving Loans, up to $5 million of the principal amount (the New Exim Sublimit) will be guaranteed by Exim Bank. The Company s obligations under the New Revolving Loans (including the New Exim Sublimit) are secured by a lien on substantially all of the Company s assets. Interest on the New Revolving Loans (including the New Exim Sublimit) is set at the greater of 5% or prime rate as published in the Wall Street Journal, plus 2.00%, subject to

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adjustment under certain circumstances including adjustments to the prime rate, late payment or the occurrence of an event of default. All outstanding amounts under the New Revolving Loans are payable in full on March 27, 2011. If at any time the amount outstanding under the New Revolving Loans exceeds the Borrowing Base as defined in the Agreement, the Company will be required to pay the difference between the outstanding amount and the Borrowing Base. The Company may prepay New Revolving Loans without penalty. These facilities contain certain financial and other covenants, including the requirement for the Company to maintain a certain level of net income (loss) and to be able to sufficiently cover its debt service needs. Other covenants include, but are not limited to, restricting the Company s ability to incur indebtedness, incur liens, enter into mergers or consolidations, dispose of assets, make investments, pay dividends, enter into transactions with affiliates, or prepay certain indebtedness. In the event of noncompliance by the Company with the covenants under this Agreement, Wells Fargo Bank and Export-Import Bank, would be entitled to exercise their remedies, which include declaring all obligations immediately due and payable and disposing of the collateral if obligations are not paid.

In August 2008 the Company was not in compliance with certain covenants contained in the Agreement relating to the Company s ability to sufficiently cover its debt service needs; however, the Company has obtained a waiver from Wells Fargo Bank and was in compliance with all of the covenants in the Agreement during September 2008.

As of September 27, 2008, the total amount outstanding under the New Revolving Loans was $6 million and there was eligible collateral to support an additional $1.3 million in borrowings.

7. AMS Settlement

On August 14, 2007, the Company, AMS and Laserscope (collectively the Parties), entered into a Settlement Agreement (the Settlement Agreement). The Parties entered into the Settlement Agreement to document their full and final agreement as to the amount of the adjustment contemplated by Section 1.5 of the Asset Purchase Agreement, by and among the Parties, dated November 30, 2006 (the Purchase Agreement); to amend the Product Supply Agreement between Laserscope and the Company, dated January 16, 2007 (the Product Supply Agreement); and to set forth the Parties mutual understanding as to certain other matters.

As of December 27, 2007 $4.8 million in obligations to AMS was outstanding and included in accrued liabilities and there were $1.3 million of non-cancelable purchase orders outstanding with AMS for inventory to be delivered and paid for in 2008. As of September 27, 2008 all amounts due to AMS had been paid in full and there were no remaining non-cancelable purchase orders.

During the three months ended September 27, 2008 the Company determined that there was a probable underpayment of withholding tax concerning its overseas subsidiaries relating to periods prior to the Company s acquisition of these subsidiaries. The range of the underpayment including penalties and interest is estimated by management to be $644,000 to $1,877,000. In accordance with SFAS 5, Accounting for Contingencies, with no amount within the range being a better estimate of any other, the amount of $644,000 was recorded in accrued expenses in connection with this potential liability. The acquisition of the overseas subsidiaries is governed by the Purchase Agreement which provides the Company with indemnification by AMS in certain situations, including situations relating to unpaid taxes, and as such the Company has recorded an asset in prepaids and other current assets equal to amount recorded in accrued expenses representing the recoverability of the liability in accordance with FASB Interpretation 39, Offsetting of Amounts Related to Certain Contracts, and as such, no charge to net income has been recorded. The Company is working towards resolution of this issue and currently does not have an estimate of timeframe for resolution.

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8. Stock Based Compensation

For the nine months ended September 27, 2008 the Company had one active stock plan at any given time. The 1998 Stock Plan expired in February 2008. On June 11, 2008, the shareholders approved the adoption of the 2008 Equity Incentive Plan, (the Incentive Plan). There are no material changes in the Incentive Plan from the 1998 Stock Plan. The maximum aggregate number of shares that may be awarded and sold under the Incentive Plan is 300,000 shares plus any shares subject to stock options or similar awards granted under the 1998 Stock Plan that expire or otherwise terminate without having been exercised in full and shares issued pursuant to awards granted under the 1998 Stock Plan that are forfeited to the Company on or after the date the 1998 Stock Plan expires. The terms and awards granted during the nine months ended September 27, 2008 under either plan were consistent with those described in our December 29, 2007 annual consolidated financial statements.

The following table summarizes information regarding activity in our stock option plans during the nine months ended September 27, 2008:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at Dec 29, 2007	1,859,537	$ 6.09		
Granted	480,212	2.94		
Exercised				
Canceled or forfeited	(407,392)	6.63		
Outstanding at Sep 27, 2008	1,932,357	5.20	4.36	$ 201,362
Exercisable at Sep 27, 2008	1,306,497	$ 5.57	3.51	$ 10,246

The aggregate intrinsic value in the table above represents the pre-tax intrinsic value, based on the Company s closing price as of September 27, 2008, that would have been received by option holders had all options holders exercised their stock options as of that date. There were no options exercised during the nine months ended September 27, 2008.

The weighted-average grant fair value of the options granted under the Company s stock plans was $1.73 and $4.56 per share for the nine months ended September 27, 2008 and September 29, 2007, respectively.

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

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Average risk free interest rate	3.03%	4.30%	3.27%	4.48%
Expected life (in years)	4.75 years	4.5 years	4.75 years	4.58 years
Dividend yield	0.0%	0.0%	0.0%	0.0%
Average volatility	69.0%	63.0%	70.0%	60.0%

Option-pricing models require the input of various subjective assumptions, including the option s expected life and the price volatility of the underlying stock. The expected stock price volatility is based on analysis of the Company s stock price history over a period commensurate with the expected term of the options, trading volume of the Company s stock, look-back volatilities and Company specific events that affected volatility in a prior period. The Company has elected to use the simplified method for estimating the expected term as discussed in Staff Accounting Bulletin No. 107 and Staff Accounting Bulletin No. 110. The risk-free interest rate is based on the U.S. Treasury interest rates whose term is consistent with the expected life of the stock options. No dividend yield is included as the Company has not issued any dividends and does not anticipate issuing any dividends in the future.

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The following table shows stock-based compensation expense included in the Consolidated Statements of Operations for the nine months periods ended September 27, 2008 and September 29, 2007 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Cost of revenues	$ 44	$ 36	$ 108	$ 105
Research and development	5	35	70	147
Sales, general and administrative	116	222	214	781
	$ 165	$ 293	$ 392	$ 1,033

9. Stock Option Awards

Exchange Offer

On February 22, 2008, the Company offered (the Exchange Offer) to eligible employees to exchange all of their outstanding restricted common stock for new options to be granted under the 1998 Plan. The Exchange Offer covered 21,000 shares of restricted common stock granted to employees on February 13, 2007. The exchange ratio was 1.5 to one.

The Exchange Offer expired on February 22, 2008, at which time properly tendered restricted common stock for 21,000 shares were cancelled and new options for 31,500 shares were granted at the closing price of our common stock on the grant date. The fair value of modified awards granted approximated the fair value of the original awards cancelled.

All new options have an option expiration term of 7 years. Each new option has a four year vesting period, 1/48th of the shares subject to the option shall vest one month after the grant date and 1/48th of the shares subject to the option will vest each month thereafter.

Incentive Plan

On June 11, 2008, the shareholders approved the adoption of the 2008 Equity Incentive Plan, as described above.

10. Income Taxes

Provision for Income Tax

The Company recorded a benefit for income tax of $35 thousand and $0 for the three months ended September 27, 2008 and September 29, 2007, respectively. The Company s effective tax rate was (12.3)% and 0%, for the three months ended September 27, 2008 and September 29, 2007, respectively. The decrease in our effective tax rate for the three months ended September 27, 2008 was associated primarily with the loss incurred in the U.S. operations.

The Company has recorded a provision for income taxes of $16 thousand and $0 for the nine months ended September 27, 2008, and September 29, 2007, respectively. The Company s effective tax rate for the nine months ended September 27, 2008 was 1.9%.

Deferred Income Taxes

The Company accounts for income taxes in accordance with SFAS 109, Accounting for Income Taxes (SFAS 109)*,* which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax assets will not be realized. A valuation allowance is provided for the majority of the Company s deferred tax assets, as the Company believes that it is more likely than not that those deferred tax assets will not be fully realized.

Uncertain Tax Positions

The balance of gross unrecognized tax benefits as of September 27, 2008 was $550 thousand. If all of our uncertain tax positions were sustained in our favor, the Company would not recognize an aggregate tax benefit due to our valuation allowance against our deferred tax assets.

At September 27, 2008, the Company has accrued $67 thousand for estimated interest and penalties related to uncertain tax positions.

The Company is currently unaware of any uncertain tax positions that could result in significant additional payments, accruals, or other material deviation in this estimate during the fiscal year.

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The Company s tax returns remain open to examination for tax years 2001 through 2007;

11. Computation of Basic and Diluted Net Income (Loss) Per Common Share

Net income (loss) per share is computed in accordance with SFAS 128, Earnings per Share. Basic net income (loss) per share is based upon the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is based upon the weighted average number of common shares outstanding and dilutive common stock equivalents outstanding during the period. Common stock equivalents consist of incremental common shares issuable upon the exercise of stock options and the conversion of Preferred A stock into common stock and are calculated under the treasury stock method. Common equivalent shares from unexercised stock options and the conversion of Preferred A stock are excluded from the computation for periods in which the Company incurs a loss as their effect is anti-dilutive or if the exercise price of such options is greater than the average market price of the stock for the period.

Options to purchase 1,932,357 shares of common stock at a weighted average exercise price of $5.20 were outstanding as of September 27, 2008, for the three and nine months ended, but were not included in the computation of diluted net income (loss) per share because the options would be anti-dilutive under the treasury stock method. In addition, 1,000,000 shares of common shares issuable upon the conversion of 500,000 Preferred A stock which automatically converts into common shares in the event the common stock of the Company trades at or above $5.00 per share for a period of 30 consecutive trading days, also were not included in the computation of diluted net income (loss) per common share because of their effect is anti-dilutive. These shares could dilute earnings per share in future periods.

Options to purchase 2,095,015 shares of common stock at a weighted average exercise price of $5.59 were outstanding as of September 29, 2007, for the three and nine months ended, but were not included in the computation of diluted net loss per share because the options would be anti-dilutive under the treasury stock method.

12. Business Segments

The Company operates in two reportable segments: the ophthalmology segment and the aesthetics segment. In each segment the Company develops, manufactures, and markets medical devices. Our revenues arise from the sale of consoles, delivery devices, disposables and service and support activities.

Information on reportable segments for the three and nine month periods ended September 27, 2008 and September 29, 2007 is as follows:

	Three Months Ended September 27, 2008			Three Months Ended September 29, 2007		
(in thousands)	**Ophthalmology**	**Aesthetics**	**Total**	**Ophthalmology**	**Aesthetics**	**Total**
Revenues	$ 8,181	$ 3,806	$ 11,987	$ 7,865	$ 5,710	$ 13,575
Direct cost of revenues	2,404	1,382	3,786	2,481	2,442	4,923
Direct gross profit	5,777	2,424	8,201	5,384	3,268	8,652
Total unallocated indirect costs			(8,485)			(9,890)
Pre-tax income (loss)			$ (284)			$ (1,238)

	Nine Months Ended September 27, 2008			Nine Months Ended September 29, 2007		
(in thousands)	**Ophthalmology**	**Aesthetics**	**Total**	**Ophthalmology**	**Aesthetics**	**Total**
Revenues	$ 23,889	$ 12,494	$ 36,383	$ 23,443	$ 17,947	$ 41,390
Direct cost of revenues	6,818	5,116	11,934	6,991	9,153	16,144
Direct gross profit	17,071	7,378	24,449	16,452	8,794	25,246
Total unallocated indirect costs			(25,300)			(31,747)

Pre-tax loss	$ (851)	$ (6,501)

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Direct cost of revenues includes standard product cost (direct material, labor and fringe) and any warranty and unit royalty due. Indirect costs of manufacturing, research and development, marketing and selling, and general and administrative costs are not allocated to the segments.

Our revenues by reportable segment by geographic region, based on the location at which each sale originates, is summarized as follows:

	Three Months Ended September 27, 2008			Three Months Ended September 29, 2007		
(in thousands)	Ophthalmology	Aesthetics	Total	Ophthalmology	Aesthetics	Total
Domestic	$ 5,253	$ 2,096	$ 7,349	$ 4,490	$ 2,710	$ 7,200
International	2,928	1,710	4,638	3,374	3,001	6,375
Total revenues	$ 8,181	$ 3,806	$ 11,987	$ 7,864	$ 5,711	$ 13,575

	Nine Months Ended September 27, 2008			Nine Months Ended September 29, 2007		
(in thousands)	Ophthalmology	Aesthetics	Total	Ophthalmology	Aesthetics	Total
Domestic	$ 14,490	$ 5,542	$ 20,032	$ 13,458	$ 8,798	$ 22,256
International	9,399	6,952	16,351	9,984	9,150	19,134
Total revenues	$ 23,889	$ 12,494	$ 36,383	$ 23,442	$ 17,948	$ 41,390

No one customer accounted for more than 10% of total revenue for the three and nine months ended September 27, 2008 and September 29, 2007, respectively.

The Company s assets and liabilities are not evaluated on a segment basis. Accordingly, no disclosure of segment assets and liabilities is provided.

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

This Quarterly Report on Form 10-Q contains trend analysis and other forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, such as statements relating to levels of future sales and operating results; broadening our product line through product innovation; market acceptance of our products; expectations for future sales growth, generally, including expectations of additional sales from our new products and new applications of our existing products; our ability to integrate the acquired aesthetics business into our core business successfully and in a timely manner; the potential for production cost decreases and higher gross margins; our ability to develop and introduce new products through strategic alliances; our ability to reduce spending, including a reduction in headcount; our ability to remediate the material weakness identified in our disclosure controls and procedures; levels of interest income and expense; expectations regarding our effective tax rate; continued receipt of payments from the Synergetics Settlement; general economic conditions; levels of international sales; our current liquidity, ability to obtain additional financing, achieve financial stability, and meet the covenants of our existing financing agreement with Wells Fargo Bank, and the impact of concerns regarding our ability to generate sufficient cash flow to continue as a going concern; and the potential to record an impairment charge to goodwill and intangible assets and effects of recent accounting pronouncements on our financial position; effect of pending or known to be threatened litigation on operating results; and our ability to protect our proprietary information. In some cases, forward-looking statements can be identified by terminology, such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, intends, potential, continue, or the negative of such terms or other comparable terminology. These statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to differ materially from those expressed or implied by such forward-looking statements, including as a result of the factors set forth under Factors That May Affect Future Operating Results and other risks detailed in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 10, 2008 and detailed from time to time in our reports filed with the Securities and Exchange Commission. The reader is cautioned not to place undue reliance on these forward-looking statements, which reflect management s analysis only as of the date of this quarterly report on Form 10-Q. We undertake no obligation to update such forward-looking statements to reflect events or circumstances occurring after the date of this report.

Overview

IRIDEX Corporation is a leading worldwide provider of therapeutic based laser systems and delivery devices used to treat eye diseases in ophthalmology and skin conditions in aesthetics. In January 2007, the Company acquired Laserscope s aesthetics business including its subsidiaries in France and the United Kingdom (UK) from AMS.

Our products are sold in the United States (U.S.) predominantly through a direct sales force and internationally through approximately 100 independent distributors into 107 countries except for our aesthetics products which are sold, marketed and serviced directly in the UK and France. In June 2008, we signed an agreement which transferred the responsibility for sales and service of our aesthetics products in the UK to an independent distributor along with a transfer of associated assets.

We manage and evaluate our business in two segments ophthalmology and aesthetics. We further break down these segments by geography Domestic (U.S.) and International (the rest of the world). In addition, within ophthalmology, we review trends by laser system sales (consoles and delivery devices) and recurring sales (single use disposable laser probes (disposables), service and support).

Our ophthalmology revenues arise primarily from the sale of our IRIS Medical OcuLight and IQ 810 laser systems, disposables and revenues from service and support activities. Our current family of OcuLight systems includes the OcuLight TX, the OcuLight Symphony (Laser Delivery System), OcuLight SL, OcuLight SLx, OcuLight GL and OcuLight GLx laser photocoagulation systems as well as the IRIS Medical IQ 810 laser system. We also produce the Millennium Endolase module which is sold exclusively to Bausch & Lomb and incorporated into their Millennium Microsurgical System.

Our aesthetics revenues arise primarily from the sales of our aesthetics systems including: the Gemini, Venus-*i*, Lyra-*i* and Aura-*i* Laser Systems, the VersaStat 10 mm, VersaStat-*i,* and Dermastat handpieces along with an articulated arm for the Venus-*i* Laser System, as well as our VariLite and DioLite XP laser systems.

Sales to international distributors are made on open credit terms or letters of credit and are currently denominated in United States dollars