IRIDEX CORP
Form 10-Q
December 22, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended July 1, 2006

o **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 No.)

1212 Terra Bella Avenue
Mountain View, California 94043-1824
(Address of principal executive offices, including zip code)
(650) 940-4700
(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 o No þ

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).

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer þ

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

APPLICABLE TO CORPORATE ISSUERS:

The number of shares of common stock, $.01 par value, issued and outstanding as of December 15, 2006 was 7,829,948.

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Part I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

IRIDEX Corporation
Condensed Consolidated Balance Sheets
(in thousands)
(unaudited)

	July 1, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 3,738	$ 12,655
Available-for-sale securities	18,540	8,779
Accounts receivable, net	6,035	6,589
Inventories	8,877	8,594
Prepaids and other current assets	777	885
Current deferred income taxes	1,415	1,415
Total current assets	39,382	38,917
Property and equipment, net	1,048	1,114
Deferred income taxes and other long term assets	1,099	1,073
Total assets	$ 41,529	$ 41,104
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 1,356	$ 1,094
Accrued expenses	3,304	4,421
Deferred revenue	1,224	1,072
Total liabilities	5,884	6,587
Contingencies (Note 6)		
Stockholders equity:		
Common stock	78	76
Additional paid-in capital	28,275	26,334
Accumulated other comprehensive loss	(5)	(27)
Treasury stock	(430)	(430)
Retained earnings	7,727	8,564
Total stockholders equity	35,645	34,517
Total liabilities and stockholders equity	$ 41,529	$ 41,104

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

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IRIDEX Corporation
Condensed Consolidated Statements of Operations
(in thousands, except per share data)
(unaudited)

	Three Months Ended		Six Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Sales	$ 8,804	$ 9,387	$ 17,647	$ 17,532
Cost of sales	4,145	4,842	8,726	9,309
Gross profit	4,659	4,545	8,921	8,223
Operating expenses:				
Research and development	1,328	922	2,449	1,961
Sales, general and administrative	3,864	3,065	7,796	5,862
Total operating expenses	5,192	3,987	10,245	7,823
Income (loss) from operations	(533)	558	(1,324)	400
Interest and other income, net	177	130	356	256
Income (loss) before income taxes	(356)	688	(968)	656
Benefit from (provision for) income taxes	(178)	(258)	131	(246)
Net income (loss)	$ (534)	$ 430	$ (837)	$ 410
Net income (loss) per common share basic	($ 0.07)	$ 0.06	($ 0.11)	$ 0.06
Net income (loss) per common share diluted	($ 0.07)	$ 0.05	($ 0.11)	$ 0.05
Shares used in per common share basic calculations	7,694	7,362	7,641	7,339
Shares used in per common share diluted calculations	7,694	7,955	7,641	7,778

(A) Results for the three and six months ended July 1, 2006 and July 2, 2005 include stock-based compensation expense as follows:

	Three Months Ended		Six Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
	(In thousands)			
Cost of sales	$ 31	$	$ 67	$
Research and development	73		121	

Selling, general and administrative	374	747

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

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IRIDEX Corporation
Condensed Consolidated Statements of Comprehensive Income (Loss)
(in thousands)
(unaudited)

	Three Months Ended		Six Months Ended	
	July 1, 2006	**July 2, 2005**	**July 1, 2006**	**July 2, 2005**
Net income (loss)	$ (534)	$ 430	$ (837)	$ 410
Other comprehensive income (loss):				
Change in unrealized gain (loss) on available-for-sale securities, net of tax	5	12	14	(13)
Comprehensive income (loss)	$ (529)	$ 442	$ (823)	$ 397

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

IRIDEX Corporation
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Six Months Ended	
	July 1, 2006	**July 2, 2005**
Cash flows from operating activities:		
Net income (loss)	$ (837)	$ 410
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	251	223
Stock-based compensation	935	
Provision for (recoveries of) doubtful accounts	68	36
Provision for excess and obsolete inventories	16	134
Changes in operating assets and liabilities:		
Accounts receivable	486	191
Inventories	(299)	(173)
Prepaids and other current assets	108	(160)
Other long term assets	(26)	
Accounts payable	262	(83)
Accrued expenses	(1,115)	(501)
Deferred revenue	152	469
Net cash provided by operating activities	1	546
Cash flows from investing activities:		
Purchases of available-for-sale securities	(18,519)	(3,593)
Proceeds from maturity of available-for-sale securities	8,778	3,016
Acquisition of property and equipment	(185)	(176)
Net cash used in investing activities	(9,926)	(753)
Cash flows from financing activities:		
Issuance of common stock	1,008	308
Net cash provided by financing activities	1,008	308
Net increase (decrease) in cash and cash equivalents	(8,917)	101
Cash and cash equivalents at beginning of period	12,655	10,381
Cash and cash equivalents at end of period	$ 3,738	$ 10,482

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 of America 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 of America for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement 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 3, 2006. The results of operations for the three and six months period ended July 1, 2006 are not necessarily indicative of the results for the year ending December 30, 2006 or any future interim period.

2. Restatement of Financial Results for the Quarter Ended April 1, 2006

As disclosed in the Company s Current Report on Form 8-K dated August 21, 2006, in August 2006, the Audit Committee of the Board of Directors engaged outside counsel and initiated an independent review of the Company s revenue recognition practices. This review was initiated in response to an allegation made by a former employee that the Company had recognized revenues prematurely in its fourth fiscal quarter of 2004. The investigation concluded that the Company had prematurely recognized revenue in 2004, but the error did not arise from any wrongful intent to impact the Company s financial reporting. In the course of this review, other errors unrelated to the allegation were identified from the period beginning in the fourth quarter of 2003 through the first quarter of 2006. As it relates to the errors identified in the first quarter of 2006, the Company determined that it was necessary to restate its financial results for the quarter ended April 1, 2006 to reflect adjustments to the previously reported financial information. While the review identified errors relating to the periods from the fourth quarter of 2003 through December 31, 2005, the Audit Committee of the Board of Directors concluded that these errors were not material to the previously issued financial statements. The six month results of 2006 includes adjustments to reduce revenue, cost of sales and operating expenses by $81,000, $43,000, and $5,000, respectively, related to the correction of immaterial errors related to prior periods.

3. Changes to August 3, 2006 Press Release

On August 3, 2006, the Company issued a press release announcing results for the three and six months ended July 1, 2006 which was furnished in a Current Report on Form 8-K dated August 3, 2006. Those results differ from the results presented in this Form 10-Q as follows:

Increase (decrease) in revenue of $94,000 and ($73,000) for the three and six months ended July 1, 2006, respectively, due to identified errors in revenue recognition in the first quarter of 2006.

Increase (decrease) in cost of sales of $53,000 and ($30,000) and operating expenses of $6,000 and $(4,000) for the three and six months ended July 1, 2006, respectively, due to identified errors in revenue recognition in the first quarter of 2006.

Increase in operating expenses of $169,000 for the three and six months ended July 1, 2006 due to an increase in the estimated provision for bad debt expense based on updated information available subsequent to the issuance of the press release.

Decrease in the income tax benefit of $448,000 and $414,000 for the three and six months ended July 1, 2006, respectively, based on the changes identified above, as well as to a change in the estimated tax rate based on updated forecast results for 2006.

4. 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 31, 2005 which was filed with the Securities and Exchange Commission on April 3, 2006. With the exception of the adoption of Statement of Financial Accounting Standards No. 123(R), (SFAS 123(R)), the Company adopted on January 1, 2006, the Company s significant accounting policies have not materially changed as of July 1, 2006.

Revenue Recognition

Our revenue arise from the sale of consoles, delivery devices 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. Up-front fees received in connection with product sales are deferred

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and recognized over the associated product shipments. Revenue relating to extended warranty contracts is recognized on a straight line basis over the period of the applicable warranty contract. We recognize service repair revenue upon completion of the work. Cost is recognized as product sales revenue is recognized. The Company s sales may include post-sale obligations for training or other deliverables. 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-shipment 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.

Deferred Revenue

Deferred revenue related to warranty contracts is recognized on a straight line basis over the period of the applicable contract. Cost is recognized as incurred. A reconciliation of changes in the Company s deferred revenue balances for the six months ending July 1, 2006 and July 2, 2005 follows (in thousands):

	Six Months Ended	
	July 1, 2006	July 2, 2005
Balance, beginning of period	$ 1,072	$ 910
Additions to deferred revenue	822	1,185
Revenue recognized	(670)	(716)
Balance, end of period	$ 1,224	$ 1,379

Warranty

The Company accrues for an estimated warranty cost upon shipment of products in accordance with Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies. Actual warranty costs incurred have not materially differed from those accrued. The Company s warranty policy is effective for shipped products which are considered defective 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 six months ending July 1, 2006 and July 2, 2005 follows (in thousands):

	Six Months Ended	
	July 1, 2006	July 2, 2005
Balance, beginning of period	$ 1,128	$ 933
Accruals for warranties issued during the period	335	679
Settlements made in kind during the period	(534)	(474)
Balance, end of period	$ 929	$ 1,138

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5. Inventories

Inventories are stated at the lower of cost or market. Cost is determined under a standard cost, which approximates a first in, first out basis. The components of inventories consist of the following (in thousands):

	July 1, 2006	December 31, 2005
Raw materials and work in progress	$ 4,854	$ 5,191
Finished goods	4,023	3,403
Total inventories	$ 8,877	$ 8,594

6. Contingencies

From time to time, the Company may be engaged in certain administrative proceedings, incidental to its normal business activities. Management believes that liabilities resulting from such proceedings, or claims which are pending or known to be threatened, are adequately covered by liability insurance and will not have a material adverse effect on the Company s financial position, results of operations or cash flows.

In October 2005, the Company filed a suit against Synergetics USA, Inc. (Synergetics USA). The suit is entitled *IRIDEX Corporation v. Synergetics USA, Inc.,* Case No. 4:05CV1916CDP in the United States District Court for the Eastern District of Missouri, Eastern Division, St. Louis for infringement of our patent No. 5,085,492. The Company seeks injunctive relief, monetary damages, treble damages, cost and attorneys fees. Synergetics USA answered our complaint in November 2005, denied liability for patent infringement, and filed counterclaims seeking a declaratory judgment that it did not infringe our patent. Synergetics USA also brought three additional counterclaims for false advertising, commercial disparagement, trade libel, injurious falsehood, unfair competition, disparagement of property, slander of goods and defamation, under state and federal law, based upon allegations that we had raised safety issues involving Synergetics product with the Food and Drug Administration and the public. Synergetics seeks monetary damages, costs and attorneys fees. Our response to these counterclaims was a denial of any wrongdoing and a reference to the expiration of the statute of limitations on those claims.

On July 7, 2006, the United States District Court for the Eastern District of Missouri, Eastern Division, St. Louis issued a Claim Construction Ruling, interpreting 14 disputed phrases within the Company s patent No. 5,085,492. The court adopted the Company s position with respect to 13 of the 14 patent terms, and adopted a position between the Company s and Synergetics positions with respect to the 14th term. On November 2, 2006, the Company amended its complaint to add patent infringement claims against Synergetics USA s wholly owned subsidiary, Synergetics Inc. On November 10, 2006, Synergetics Inc. and Synergetics USA answered the amended complaint, denying liability for patent infringement and filing counterclaims seeking a declaratory judgment that they did not infringe the Company s patent. Synergetics Inc. also re-filed the three additional counterclaims relating to disparagement, thereby substituting Synergetics Inc. for Synergetics USA as the plaintiff on those counterclaims. Discovery is scheduled to end on December 22, 2006, and trial is scheduled to begin on April 16, 2007. The Company is confident that its patent claims have merit, and if the parties do not reach a settlement, the Company intends to vigorously pursue its claims to judgment.

The Company is involved in another suit with Synergetics Inc., entitled *Synergetics, Inc. v. Peregrine Surgical, Ltd., Innovatech Surgical, Inc., and IRIDEX Corporation,* Case No. 06-CV-107 in the United States District Court for the Eastern District of Pennsylvania. Synergetics filed suit against the Company on April 25, 2006, by adding the Company as a defendant to a then-existing lawsuit against the other two defendants. Synergetics Inc. alleges that the Company infringes its patent and seeks injunctive relief, monetary damages, treble damages, costs and attorneys fees. On June 29, 2006, the Company filed its response to Synergetics Inc. s pleading, denying Synergetics Inc. s claims and asserting counterclaims seeking a declaratory judgment that it does not infringe Synergetics Inc s patent. Synergetics Inc. responded to the Company s counterclaims on July 24, 2006, denying them. On August 10, 2006, the case was reassigned to District Judge Thomas Golden.

On July 19, 2006, Synergetics Inc. filed suit in the United States District Court for the Eastern District of Missouri against the Company, seeking a declaratory judgment that a laser probe connector system that it announced on July 10, 2006 does not infringe the Company s patent No. 5,085,492, and seeking a declaratory judgment that the Company s patent is invalid and unenforceable. This suit is entitled *Synergetics, Inc. v. IRIDEX Corporation,* Case No. 4:06CV1104CDP. On August 15, 2006, the Company answered the Synergetics Inc. complaint, denying that Synergetics Inc. was entitled to any relief, and filed crossclaims against Synergetics USA Inc. and counterclaims against Synergetics Inc., alleging that they infringe the Company s patent No. 5,085,492 and seeking injunctive relief, monetary damages, treble damages, costs and attorneys fees. On November 20, 2006, the Court ordered that this case (No. 4:06CV1104CDP) be consolidated for all purposes with the case against Synergetics USA pending in the same court (No. 4:05CV1916CDP), that the amended pleadings in the earlier case shall be the operative pleadings, and that this case be administratively closed.

Management believes that liabilities resulting from the proceedings described above (collectively referred to hereafter in this Quarterly Report on Form 10-Q as the Synergetics Litigation Matters), or claims which are pending or known to be threatened, will not have a material adverse effect on the Company s financial position or results of operations and are adequately covered by the Company s liability insurance. However, it is possible that cash flows or results of operations could be materially affected in any particular period by the unfavorable resolution of one or more of these contingencies or because of the diversion of management s attention and the incurrence of significant expenses.

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7. Computations of Net Income (Loss) Per Common Share

Basic and diluted net income (loss) per share are computed by dividing net income (loss) for the period by the weighted average number of shares of common stock outstanding during the period. The calculation of diluted net income (loss) per share includes the dilutive effect of potentially dilutive common stock provided the inclusion of such potential common stock is not antidilutive. Potential common stock consists of incremental common shares issuable upon the exercise of stock options and a warrant to purchase common shares.

During the three months ended July 1, 2006, options to purchase 15,500 shares of common stock at a weighted average exercise price of $12.45 per share as well as warrants to purchase 25,000 shares at a weighted average exercise price of $6.07 were outstanding, but were not included in the computations of diluted net income per common share because the exercise price of the related options exceeded the average market price of the common shares. During the three months ended July 2, 2005, options to purchase 700,667 shares of common stock at a weighted average exercise price of $8.28 per share were outstanding but were not included in the computations of diluted net income per common share because the exercise price of the related options exceeded the average market price of the common shares. During the six months ended July 2, 2005, options to purchase 855,781 shares at a weighted average exercise price of $7.84 were outstanding, but were not included in the computations of diluted net income per share because the exercise price of the related options exceeded the average market price of the common shares. During the six months ended July 1, 2006, options to purchase 2,081,448 shares at a weighted average exercise price of $5.80 as well as a warrant to purchase 25,000 shares at a weighted average exercise price of $6.07 were outstanding, but were not included in the computations of diluted net loss per share because their effect was antidilutive. These options could dilute earnings per share in future periods.

8. Business Segments

We operate in two reportable segments: the ophthalmology medical device segment and the dermatology medical device segment. In both segments, we develop, manufacture and market 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 six months ended July 1, 2006 and July 2, 2005 is as follows (in thousands):

	Three Months Ended July 1, 2006			Three Months Ended July 2, 2005		
	Ophthalmology Medical Devices	Dermatology Medical Devices	Total	Ophthalmology Medical Devices	Dermatology Medical Devices	Total
Sales	$ 7,681	$ 1,123	$ 8,804	$ 7,687	$ 1,700	$ 9,387
Direct cost of goods sold	2,213	475	2,688	2,660	932	3,592
Direct gross margin	5,468	648	6,116	5,027	768	5,795
Total unallocated costs			(6,472)			(5,107)
Pre-tax income (loss)			(356)			688

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	Six Months Ended July 1, 2006			Six Months Ended July 2, 2005		
	Ophthalmology Medical Devices	Dermatology Medical Devices	Total	Ophthalmology Medical Devices	Dermatology Medical Devices	Total
Sales	$ 15,221	$ 2,426	$ 17,647	$ 13,880	$ 3,652	$ 17,532
Direct cost of goods sold	4,742	1,158	5,900	4,759	1,927	6,686
Direct gross margin	10,479	1,268	11,747	9,121	1,725	10,846
Total unallocated costs			(12,715)			(10,190)
Pre-tax income (loss)			(968)			656

Indirect costs of manufacturing, research and development, and selling, general and administrative costs are not allocated to the segments.

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

9. Stock based Compensation

Employee Stock Purchase Plan

The IRIDEX 2005 Stock Purchase Plan (the Purchase Plan) permits eligible employees (including officers) to purchase Common Stock through payroll deductions, which may not exceed 10% of an employee s compensation. No employee may purchase more than $25,000 worth of stock in any calendar year or more than 2,000 shares of Common Stock in any twelve-month period. The price of shares purchased under the Purchase Plan is 85% of the lower of the fair market value of the Common Stock at the beginning of the offering period or the end of the offering period.

Stock Option Plans

***Amended and Restated 1989 Incentive Stock P*lan**

The Amended and Restated 1989 Plan (the 1989 Plan) provided for the grant of options and stock purchase rights to purchase shares of our Common Stock to employees and consultants. The terms of the 1989 Plan, which expired in August 1999, are substantially the same as the 1998 Plan described below.

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1998 Stock Plan

The 1998 Stock Plan (the 1998 Plan), as amended, provides for the granting to employees (including officers and employee directors) of incentive stock options and for the granting to employees (including officers and employee directors) and consultants of nonstatutory stock options, stock purchase rights (SPRs), restricted stock, restricted stock units, performance shares, performance units and stock appreciation rights. The 1998 Plan is administered by the Company s Board of Directors (the Administrator). The exercise price of incentive stock options and stock appreciation rights granted under the 1998 Plan must be at least equal to the fair market value of the shares at the time of grant. With respect to any recipient who owns stock possessing more than 10% of the voting power of our outstanding capital stock, the exercise price of any option or SPR granted must be at least equal to 110% of the fair market value at the time of grant. Options granted under the 1998 Plan are exercisable at such times and under such conditions as determined by the Administrator; generally over a four year period. The maximum term of incentive stock options granted to any recipient must not exceed ten years; provided, however, that the maximum term of an incentive stock option granted to any recipient possessing more than 10% of the voting power of our outstanding capital stock must not exceed five years. In the case of SPRs, unless the Administrator determines otherwise, the Company has a repurchase option exercisable upon the voluntary or involuntary termination of the purchaser s employment with the Company for any reason (including death or disability). Such repurchase option lapses at a rate determined by the Administrator. The purchase price for shares repurchased by the Company is the original price paid by the purchaser. As of July 1, 2006 and July 2, 2005, no shares were subject to repurchase. The form of consideration for exercising an option or stock purchase right, including the method of payment, is determined by the Administrator. The 1998 Plan expires in June 2008.

1995 Director Option Plan

In October 1995, the Company adopted the 1995 Director Option Plan (the Director Plan), under which members of the Board of Directors were granted options to purchase 11,250 shares upon the first to occur of their appointment or the adoption of the Director Plan (First Option) and an option to purchase 3,750 shares (Subsequent Option) on July 1 of each year thereafter provided that he or she has served on the Board of Directors for at least the preceding six months. The options granted had exercise prices equal to the fair market value on the date of grant. The First Option becomes exercisable as to one-twelfth (1/12) of the shares subject to the First Option for each quarter over a three-year period. Each Subsequent Option becomes exercisable as to one-fourth (1/4) of the shares subject to the Subsequent Option for each quarter, commencing one quarter after the First Option and any previously granted Subsequent Options have become fully exercisable. Options granted under the Director Plan have a term of 10 years.

In the event of our merger with or into another corporation, resulting in a change of control, or the sale of substantially all of our assets, each Director Plan options become exercisable in full and shall be exercisable for 30 days after written notice to the holder of the event causing the change in control.

The Director Plan terminated in 2005. Directors are now granted options under the 1998 Plan.

Stand-Alone Options and Warrants

In July 2005, in connection with the employment of Barry G. Caldwell as the Company s Chief Executive Officer, the Company s Board of Directors granted a stand alone option, outside of the Company s existing stock plans, to the Chief Executive Officer. The option entitles Mr. Caldwell to purchase up to 234,104 shares of the Company s common stock at an exercise price of $6.07 per share.

In conjunction with the employment of the Company s Chief Executive Officer in July 2005, in consideration of services performed under a recruiting contract, the Company issued a warrant to purchase 25,000 shares of the Company s common stock at an exercise price of $6.07 per share. The warrant is exercisable at any time and expires on July 5, 2008. The fair value of the warrants of $87,000 was recorded as an expense for the twelve month period ended December 31, 2005. The fair value of the warrant was calculated using the Black-Scholes pricing model with the following assumptions: dividend yield of 0 percent, contractual life of 3 years, risk free rates of 4.04 percent and volatility of 83 percent. At July 1, 2006, the warrant remained outstanding.

In March 2006, in connection with the employment of the Company s Vice President of Product Innovation, the Company s Board of Directors granted a stand alone option, outside of the Company s existing stock plans, to Deborah Tomasco, the Company s Vice President of Product Innovation. The option entitles Ms. Tomasco to purchase up to 50,000 shares of the Company s common stock at an exercise price of $8.26 per share.

Stock-Based Compensation

The Company adopted SFAS 123(R) using the modified prospective method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company s fiscal year. The Company s financial statements as of and for the six months ended July 1, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective method, the Company s financial statements for prior periods have not been restated to reflect, and do not include the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the six months ended July 1, 2006 was $0.9 million, which consisted of stock-based compensation expense related to stock options and employee stock purchases. There was no stock-based compensation expense related to employee stock options and employee stock purchases recognized during the six months ended July 2, 2005.

We estimate the fair value of stock options granted using the Black-Scholes option-pricing formula. In conjunction with the adoption of SFAS 123(R) on January 1, 2006, the Company changed its method of attributing the value of stock-based compensation from the multiple award (graded vesting) method to the straight-line single option method for options granted following the adoption of SFAS 123(R).

The determination of fair value of all options granted by the Company is computed based on the Black-Scholes option-pricing model with the following weighted average assumptions:

	Employee Stock Option Plan Three Months Ended		Employee Stock Purchase Plan Three Months Ended		Employee Stock Option Plan Six Months Ended		Employee Stock Purchase Plan Six Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Average risk free interest rate	5.13%	3.63%	5.11%	3.22%	4.80%	3.50%	5.11%	2.50%
Expected life (in years)	3.8	3	0.5	0.5	3.7	3.0	0.5	0.5
Dividend yield								
Average volatility	50.0%	85.0%	35.0%	85.0%	50.0%	85.0%	47.0%	85.0%

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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. 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 expected term of options granted is based on an analysis of historical exercise and post-vesting employment termination behavior. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. No dividend yield is included as the Company has not issued any dividends and does not anticipate issuing any dividends in the future.

The following table shows stock-based compensation expense included in the condensed consolidated statements of operations for the three and six months ended July 1, 2006 (in thousands):

	Three Months Ended July 1, 2006	Six Months Ended July 1, 2006
Cost of sales	$ 31	$ 67
Research and development	73	121
Sales, general and administrative	374	747
	$ 478	$ 935

Stock-based compensation capitalized as part of inventory for the three and six months ended July 1, 2006 was insignificant.

The modified prospective transition method of SFAS 123(R) requires the presentation of pro-forma information for periods presented prior to the adoption of SFAS 123(R) regarding net income (loss) and net income (loss) per share as if the Company had accounted for the Company s stock options under the fair value method of SFAS 123. If compensation expense had been determined based upon the fair value at grant date for employee compensation arrangements, consistent with the methodology prescribed under SFAS 123, the Company s pro forma net income and net income per common share under SFAS 123 for the six months ended July 2, 2005 would have been as follows (in thousands except per share data).

	Three Months Ended July 2, 2005	Six Months Ended July 2, 2005
Net income, as reported for prior periods	$ 430	$ 410
Stock-based compensation expense related to employee stock options and employee stock purchases	(190)	(315)
Pro forma net income	$ 240	$ 95
Basic net income per share:		
As reported	$ 0.06	$ 0.06

Pro forma	$	0.03	$	0.01
Diluted net income per share:				
As reported	$	0.05	$	0.05
Pro forma	$	0.03	$	0.01

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Pro Forma disclosures for the three and six months ended July 1, 2006 are not presented because stock-based employee compensation was accounted for under SFAS 123(R) s fair value method during this period.

Information with respect to activity under these option plans are set forth below (in thousand except per share and per share data):

	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding at December 31, 2005	2,154,003	$ 5.50	$ 14,518
Options granted	146,800	8.80	145
Options exercised	(194,913)	4.55	(1,021)
Options forfeited/cancelled/expired	(24,442)	7.08	(66)
Outstanding at July 1, 2006	2,081,448	$ 5.80	$ 13,576

The weighted average grant date fair value of options granted during the six months ended July 1, 2006 was $8.80 per share.

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 second 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 July 1, 2006. This amount changes based on the fair market value of the Company s stock. Total intrinsic value of options exercised for the six months ended July 1, 2006 was $1.0 million. Total fair value of options vested and expensed was $0.8 million, net of tax, for the six months ended July 1, 2006.

As a result of adopting the fair value recognition provisions of SFAS 123(R), the impact to the condensed consolidated financial statements for the six months ended July 1, 2006 from stock-based compensation is as follows (in thousands, except per share data):

	Three Months Ended July 1, 2006	Six Months Ended July 1, 2006
Stock-based compensation expense by award type:		
Employee stock options granted	$ 471	$ 918
Employee stock purchase plan	7	17
Total stock-based compensation	478	935
Total effect on stock-based compensation at the Company s marginal tax rate	(88)	(162)
Effect on net income (loss)	$ 390	$ 773

Effect on net income (loss) per share:				
Basic and diluted	$	(0.05)	$	(0.10)

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A summary of the status of the Company s non-vested options as of July 1, 2006 and changes during the period ended July 1, 2006 is presented below (in thousands, except per share data):

	Number of Shares	Weighted Average Grant Dated Fair Value
Non-vested at December 31, 2005	893,119	$ 5.72
Granted	146,800	8.80
Vested	(107,491)	4.35
Cancelled/forfeited	(24,442)	7.08
Non-vested at July 1, 2006	907,986	6.38

As of July 1, 2006, there were $2.2 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements under both of the plans. The cost is expected to be recognized over a weighted average period of 3 years.

The following table summarizes information with respect to stock options outstanding at July 1, 2006:

	Options Outstanding			Options Vested and Exercisable		
Range of Exercise Prices	Number of Shares Outstanding at July 1, 2006	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number of Shares Exercisable at July 1, 2006	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
$2.94 - $3.50	248,680	6.69	$ 3.36	198,105	$ 3.37	6.64
$3.52 - $4.00	315,013	3.43	$ 3.86	299,059	$ 3.87	3.25
$4.01- $5.00	214,177	4.90	$ 4.43	182,469	$ 4.41	4.34
$5.08 - $5.50	221,713	6.52	$ 5.24	91,603	$ 5.27	4.29
$5.56 - $6.00	113,000	8.07	$ 5.61	52,587	$ 5.61	7.21
$6.07 - $6.07	325,000	9.01	$ 6.07	25,000	$ 6.07	9.01
$6.19 - $7.63	212,315	6.76	$ 6.83	107,981	$ 7.00	5.12
$7.98 - $8.88	262,750	5.92	$ 8.40	95,908	$ 8.72	2.04
$9.00 - $12.19	161,300	4.91	$ 9.69	113,250	$ 9.49	4.00

$12.75 - $12.75	7,500	4.01	$ 12.75	7,500	$ 12.75	4.01
$2.94 - $12.75	2,081,448	6.16	$ 5.80	1,173,462	$ 5.39	

As of July 1, 2006, the aggregate intrinsic value of fully vested and exercisable options was $4.0 million.

10. Subsequent Event

On November 30, 2006 the Company signed a definitive agreement with American Medical Systems, Inc. and Laserscope, a wholly owned subsidiary of American Medical Systems, Inc., (AMS) under which we intend to acquire the laser aesthetics business of Laserscope. Under the terms of the definitive agreement, we will acquire certain assets and liabilities of Laserscope, for approximately $26 million in cash and $2 million in unregistered shares of IRIDEX common stock subject to post closing adjustments. AMS will be supplying aesthetics laser products to the Company for a period of up to nine months. At the end of this period, the Company will purchase from AMS any remaining raw material, work in process and finished goods inventory for no more than $9.0 million. The Company plans to use a combination of cash and bank financing to finance the transaction. The Board of Directors for IRIDEX has unanimously approved the terms of the transaction, which is expected to close by early January 2007, subject to certain closing conditions.

11. 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 measurements. 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 operation.

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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, actual order rate and 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; the potential for production cost decreases and higher gross margins; our ability to develop and introduce new products through strategic alliances; favorable Center for Medicare and Medicaid coverage decisions regarding AMD procedures that use our products; results of clinical studies and risks associated with bringing new products to market; general economic conditions; and levels of international sales. 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 3, 2006 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.

Restatement of Financial Results for the Quarter Ended April 1, 2006

As disclosed in the Company s Current Report on Form 8-K dated August 21, 2006, in August 2006, the Audit Committee of the Board of Directors engaged outside counsel and initiated an independent review of the Company s revenue recognition practices. This review was initiated in response to an allegation made by a former employee that the Company had recognized revenues prematurely in its fourth fiscal quarter of 2004. The investigation concluded that the Company had prematurely recognized revenue in 2004, but the error did not arise from any wrongful intent to impact the Company s financial reporting. In the course of this review, other errors unrelated to the allegation were identified from the period beginning in the fourth quarter of 2003 through the first quarter of 2006. As it relates to the errors identified in the first quarter of 2006, the Company determined that it was necessary to restate its financial results for the quarter ended April 1, 2006 to reflect adjustments to the previously reported financial information. While the review identified errors relating to the periods from the fourth quarter of 2003 through December 31, 2005, the Audit Committee of the Board of Directors concluded that these errors were not material to the previously issued financial statements. The six month results of 2006 includes adjustments to reduce revenue, cost of sales and operating expenses by $81,000, $43,000 and $5,000, respectively, related to the correction of immaterial errors related to prior periods.

Changes to August 3, 2006 Press Release

On August 3, 2006, the Company issued a press release announcing results for the three and six months ended July 1, 2006 which was furnished in Current Report on Form 8-K dated August 3, 2006. Those results differ from the results presented in this Form 10-Q as follows:

Increase (decrease) in revenue of $94,000 and ($73,000) for the three and six months ended July 1, 2006, respectively, due to identified errors in revenue recognition in the first quarter of 2006.

Increase (decrease) in cost of goods sold of $53,000 and ($30,000) and operating expenses of $6,000 and $(4,000) for the three and six months ended July 1, 2006, respectively, due to identified errors in revenue recognition in the first quarter of 2006.

Increase in operating expenses of $169,000 for the three and six months ended July 1, 2006 due to an increase in the estimated provision for bad debt expense based on updated information available subsequent to the issuance of the press release.

decrease in the income tax benefit of $448,000 and $414,000 for the three and six months ended July 1, 2006, respectively, based on the changes identified above as well as to a change in the estimated tax rate based on updated forecast results for 2006.

Overview

IRIDEX Corporation is a leading provider of therapeutic based laser systems and delivery devices used to treat eye diseases in ophthalmology and skin conditions in dermatology (aesthetics). Our products are sold in the United States predominantly through a direct sales force and internationally through 73 independent distributors into 107 countries. Our revenues arise primarily from the sale of our OcuLight Systems, IQ810 lasers, VariLite, DioLite 532 systems, delivery devices, disposables and service and support activities. Our business includes a recurring revenue component which includes the sale of our disposable single use laser probes, EndoProbes, combined with the repair, servicing and extended warranty protection for our laser systems. Cost of sales consists primarily of the cost of purchasing components and sub-systems, assembling, packaging, shipping and testing components at our facility, and the direct labor and associated overhead. Research and development expenses consist primarily of personnel costs, materials and research

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support provided to clinicians at medical institutions developing new applications which utilize our products. Research and development costs have been expensed as incurred. Sales, general and administrative expenses consist primarily of costs of personnel, sales commissions, travel expenses, advertising and promotional expenses, facilities, legal and accounting, insurance and other expenses which are not allocated to other departments.

Effective January 1, 2006, we adopted the provisions of SFAS No. 123(R), Share-Based Payment , which requires us to measure all employee stock-based compensation awards using a fair value method and record such expense in our consolidated financial statements. Prior to January 1, 2006, we had accounted for stock-based compensation awards in accordance with Accounting Principles Board (APB) Opinion No. 25. We have chosen to implement SFAS No. 123(R) using the modified prospective method. Under this method, periods prior to January 1, 2006 are not restated to reflect stock-based compensation using the fair value method.

Results of Operations

The following table sets forth certain operating data as a percentage of sales for the periods indicated.

	Three Months Ended		**Six Months Ended**	
	July 1, 2006	**July 2, 2005**	**July 1, 2006**	**July 2, 2005**
Sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	47.1%	51.6%	49.4%	53.1%
Gross profit	52.9%	48.4%	50.6%	46.9%
Operating expenses:				
Research and development	15.1%	9.8%	13.9%	11.2%
Sales, general and administrative	43.9%	32.6%	44.2%	33.4%
Total operating expenses	59.0%	42.4%	58.1%	44.6%
Income (loss) from operations	(6.1)%	6.0%	(7.5)%	2.3%
Interest and other income, net	2.0%	1.3%	2.0%	1.4%
Income(loss) before income taxes	(4.1)%	7.3%	(5.5)%	3.7%
Benefit from (provision for) income taxes	(2.0)%	(2.7)%	0.8%	(1.4%)
Net income (loss)	(6.1)%	4.6%	(4.7)%	2.3%

The following table sets forth for the periods indicated the amount of sales for our operating segments and sales as a percentage of total sales.

	Three Months Ended				Six Months Ended			
	July 1, 2006		July 2, 2005		July 1, 2006		July 2, 2005	
	Amount	Percentage of total sales	Amount	Percentage of total sales	Amount	Percentage of total sales	Amount	Percentage of total sales
Domestic	$ 5,296	60.2%	$ 5,725	61.0%	$ 10,426	59.1%	$ 10,650	60.8%
International	3,508	39.8%	3,662	39.0%	7,221	40.9%	6,882	39.2%
Total	8,804	100.0%	9,387	100.0%	17,647	100.0%	17,532	100.0%
Ophthalmology:								
Domestic	4,544	51.6%	4,333	46.2%	8,637	49.0%	7,746	44.2%
International	3,137	35.6%	3,354	35.7%	6,584	37.3%	6,134	35.0%
Total	7,681	87.2%	7,687	81.9%	15,221	86.3%	13,880	79.2%
Dermatology:								
Domestic	753	8.6%	1,392	14.8%	1,789	10.1%	2,904	16.6%
International	370	4.2%	308	3.3%	637	3.6%	748	4.2%
Total	$ 1,123	12.8%	$ 1,700	18.1%	$ 2,426	13.7%	$ 3,652	20.8%
Total recurring revenue	$ 3,932	44.7%	$ 3,333	35.5%	$ 7,712	43.7%	$ 6,429	36.7%
Total non-recurring revenue	$ 4,872	55.3%	$ 6,054	64.5%	$ 9,935	56.3%	$ 11,103	63.3%

Ophthalmology and Dermatology Sales Overview

We manage and evaluate our business in two segments ophthalmology and dermatology. We then further break down these major segments by geography Domestic (United States) and International (the rest of the world). In addition, within ophthalmology, we review trends by laser system sales (laser boxes and delivery devices) and recurring sales (single use disposable probes, EndoProbes, combined with the repair, servicing and extended warranty protection for our laser systems). Within the dermatology segment we review overall trends surrounding our laser systems, which include our newly introduced DioLite XP and VariLite laser systems and the DioLite laser system.

Total sales decreased by 6.2% to $8.8 million for the three months ended July 1, 2006 from $9.4 million for the three months ended July 2, 2005. Domestic sales which represented 60.2% of total sales, decreased by 7.5% to $5.3 million from $5.7 million. The decrease in domestic sales was a result of a $0.7 million decrease in domestic dermatology sales offset by a $0.2 million increase in domestic ophthalmology revenue. The decrease in domestic dermatology sales was driven primarily by unfilled dermatology sales positions in the second quarter of 2006. International sales, which were 39.8% of total sales, decreased by 4.2% to $3.5 million from $3.7 million. The decrease in international sales was a result of a $0.2 million

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decrease in international ophthalmology revenue offset by a $0.1 million increase in international dermatology revenue. The decrease in international ophthalmology sales was due largely to administrative delays in finalizing sales transactions related to a letter of credit and to shipments into a new country.

For the six months ended July 1, 2006, total sales increased 0.7% to $17.6 million for the six months ended July 1, 2006 from $17.5 million for the six months ended July 2, 2005. Domestic sales, which were 59.1% of total sales, decreased by 2.1% to $10.4 million for the six months ended July 1, 2006 from $10.7 million for the six months ended July 2, 2005. The decrease in domestic sales was a result of a $1.1 million decrease in domestic dermatology sales offset by a $0.9 million increase in domestic ophthalmology revenue. International sales, which represented 40.9% of total sales, increased by 4.9% to $7.2 million for the six months ended July 1, 2006 from $6.9 million for the six months ended July 2, 2005. The increase in international sales was a result of a $0.4 million increase in international ophthalmology sales offset by a $0.1 million decrease in international dermatology revenue.

Ophthalmology Sales

Ophthalmology sales remained constant at $7.7 million for the three months ended July 1, 2006 and July 2, 2005. Domestic ophthalmology sales increased 4.9% to $4.5 million for the three months ended July 1, 2006 from $4.3 million for the three months ended July 2, 2005. The increase in domestic ophthalmology sales was due, in large part, to increased sales of disposable products, including new disposables introduced in the last eighteen months. International ophthalmology sales decreased 6.5% to $3.1 million for the three months ended July 1, 2006 from $3.4 million for the three months ended July 2, 2005. The decrease in international ophthalmology sales was due, in large part, to administrative delays in finalizing sales transactions related to a letter of credit and shipment into a new country, Sudan.

For the six months ended July 1, 2006, ophthalmology sales increased 9.7% to $15.2 million from $13.9 million for the six months ended July 2, 2005. Domestic ophthalmology sales increased 11.5% for the six months ended July 1, 2006 to $8.6 million from $7.7 million for the six months ended July 2, 2005. For the six months ended July 1, 2006, international ophthalmology sales increased 7.3% to $6.6 million from $6.1 million for the six months ended July 2, 2005. The increases in sales for domestic and international ophthalmology for the six month period ended July 1, 2006 was due mainly to increased sales of disposable products.

We anticipate that with the continued focus on our direct ophthalmic business that the disposable business will continue to grow at greater than historical rates. The second half of the year is historically the highest revenue period, with the fourth quarter being the highest.

Dermatology Sales

Dermatology sales decreased 33.9% to $1.1 million for the three months ended July 1, 2006 from $1.7 million for the three months ended July 2, 2005. Domestic dermatology sales decreased 45.9% to $0.8 million for the three month period ended July 1, 2006 from $1.4 million for the comparable period in 2005. The decrease in domestic dermatology sales was driven primarily by unfilled dermatology sales positions. International dermatology sales increased 20.1% to $0.4 million for the three months ended July 1, 2006 from $0.3 million for the three months ended July 2, 2005.

For the six months ended July 1, 2006 dermatology sales decreased 33.6% to $2.4 million from $3.7 million for the six months ended July 2, 2005. Domestic dermatology sales decreased 38.4% to $1.8 million for the six months ended July 1, 2006 from $2.9 million for the six months ended July 2, 2005. The decrease in domestic dermatology sales was driven mainly by unfilled sales positions on the dermatology sales team in the second quarter of 2006. We have since hired an additional dermatology sales representative and have revised our marketing programs. International dermatology sales decreased 14.8% to $0.6 million for the six months ended July 1, 2006 from $0.7 million for the comparable period in 2005.

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The company has increased the domestic sales force and added additional management in order to increase productivity levels. Two new area sales managers have been hired and a third is in process. The company believes that these changes will enhance the level of dermatology revenues the second half of the year.

Gross Margin

	Three Months Ended		Six Months Ended	
	July 1, 2006	**July 2, 2005**	**July 1, 2006**	**July 2, 2005**
Sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	47.1%	51.6%	49.4%	53.1%
Gross profit	52.9%	48.4%	50.6%	46.9%

Our gross profit increased by $0.1 million to $4.7 million for the three month periods ended July 1, 2006 compared to $4.5 million for the three months ended July 2, 2005. Gross profit as a percentage of sales for the three months ended July 1, 2006 increased to 52.9% from 48.4% for the comparable prior year three month period. The total 4.5% increase in gross profit as a percentage of sales during this period included an increase of 4.1% relating to lower product costs including product mix, the change in inventory reserves and warranty charges, and an increase of 1.1% related to lower overhead costs offset by a 0.6% decrease due to reduced average selling prices.

For the six months ended July 1, 2006, gross profit increased by $0.7 million to $8.9 million from $8.2 million for the six months ended July 2, 2005. Gross profit as a percentage of sales for the six months ended July 1, 2006 increased to 50.6% from 46.9%. The total 3.7% increase in gross profit as a percentage of sales during this period included an increase of 4.5% relating to lower product costs including product mix, the change in inventory reserves and warranty charges and an increase of 0.2% related to lower overhead costs offset by a 1.0% decrease due to reduced average selling prices. Although increasing competition has continued to result in a downward trend in average selling prices for some products, we intend to continue o