

IRIDEX CORP
Form 10-Q
November 07, 2016
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended October 1, 2016

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	(I.R.S. Employer
incorporation or organization)	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

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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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes 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

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

The number of shares of common stock, \$0.01 par value, issued and outstanding as of October 24, 2016 was 10,148,110.

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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 and per share data)

	October 1, 2016	January 2, 2016 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	\$9,577	\$9,995
Accounts receivable, net of allowance for doubtful accounts of \$174 as of October 1, 2016 and \$140 as of January 2, 2016	7,926	9,282
Inventories	12,678	11,106
Prepaid expenses and other current assets	1,225	386
Total current assets	31,406	30,769
Property and equipment, net	1,447	1,104
Intangible assets, net	256	268
Goodwill	533	533
Deferred income taxes	8,985	8,985
Other long-term assets	87	164
Total assets	\$42,714	\$41,823
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$2,472	\$2,223
Accrued compensation	1,574	1,572
Accrued expenses	1,622	1,722
Accrued warranty	570	603
Deferred revenue	1,305	1,311
Total current liabilities	7,543	7,431
Long-term liabilities:		
Other long-term liabilities	619	704
Total liabilities	8,162	8,135
Stockholders' equity:		
Common stock, \$0.01 par value:		
Authorized: 30,000,000 shares;		
Issued and outstanding 10,146,235 and 10,009,408 shares		
as of October 1, 2016 and January 2, 2016, respectively	112	111
Additional paid-in capital	39,747	37,986

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Accumulated deficit	(5,307)	(4,409)
Total stockholders' equity	34,552	33,688
Total liabilities and stockholders' equity	\$42,714	\$41,823

(1) Derived from the audited consolidated financial statements included in the Annual Report on Form 10-K filed with the SEC for the year ended January 2, 2016.

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

IRIDEX Corporation

Condensed Consolidated Statements of Operations

(Unaudited, in thousands except per share data)

	Three Months Ended		Nine Months Ended	
	October 1, 2016	October 3, 2015	October 1, 2016	October 3, 2015
Total revenues	\$9,789	\$9,815	\$33,628	\$29,644
Cost of revenues	5,544	4,974	18,352	15,176
Gross profit	4,245	4,841	15,276	14,468
Operating expenses:				
Research and development	1,256	1,237	4,007	4,000
Sales and marketing	2,378	2,234	7,212	6,463
General and administrative	1,858	1,227	5,546	4,206
Total operating expenses	5,492	4,698	16,765	14,669
(Loss) income from operations	(1,247)	143	(1,489)	(201)
Other (expense) income, net	(51)	164	(83)	134
(Loss) income from operations before benefit from income taxes	(1,298)	307	(1,572)	(67)
Benefit from income taxes	(627)	(135)	(674)	(103)
Net (loss) income	\$(671)	\$442	\$(898)	\$36
Net (loss) income per share:				
Basic	\$(0.07)	\$0.04	\$(0.09)	\$0.00
Diluted	\$(0.07)	\$0.04	\$(0.09)	\$0.00
Weighted average shares used in computing net (loss) income per common share:				
Basic	10,129	9,972	10,083	9,956
Diluted	10,129	10,094	10,083	10,142

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

IRIDEX Corporation

Condensed Consolidated Statements of Comprehensive (Loss) Income

(Unaudited, in thousands)

	Three Months Ended October 1, 2016		Nine Months Ended October 1, 2016	
	October 3, 2015	October 3, 2015	October 3, 2015	October 3, 2015
Net (loss) income	\$(671)	\$ 442	\$(898)	\$ 36
Other comprehensive loss, net of tax	—	—	—	—
Comprehensive (loss) income	\$(671)	\$ 442	\$(898)	\$ 36

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

IRIDEX Corporation

Condensed Consolidated Statements of Cash Flows

(Unaudited, in thousands)

	Nine Months Ended	
	October 1, 2016	October 3, 2015
Operating activities:		
Net (loss) income	\$(898)	\$36
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:		
Depreciation and amortization	461	389
Change in fair value of earn-out liability	86	(129)
Stock-based compensation	1,270	725
Provision for doubtful accounts	66	36
Deferred income taxes	—	2
Changes in operating assets and liabilities:		
Accounts receivable	1,290	565
Inventories	(1,572)	(2,065)
Prepaid expenses and other current assets	(839)	(156)
Other long-term assets	77	37
Accounts payable	249	801
Accrued compensation	2	(552)
Accrued expenses	16	(180)
Accrued warranty	(33)	59
Deferred revenue	(6)	32
Other long-term liabilities	26	46
Net cash provided by (used in) operating activities	195	(354)
Investing activities:		
Acquisition of property and equipment	(792)	(731)
Payment on earn-out liability	(313)	(328)
Net cash used in investing activities	(1,105)	(1,059)
Financing activities:		
Proceeds from stock option exercises	650	747
Repurchase of common stock	(59)	(1,543)
Repurchase of vested stock options	—	(275)
Taxes paid related to net share settlements of equity awards	(99)	(606)
Net cash provided by (used in) financing activities	492	(1,677)
Net decrease in cash and cash equivalents	(418)	(3,090)
Cash and cash equivalents, beginning of period	9,995	13,303
Cash and cash equivalents, end of period	\$9,577	\$10,213
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		

Income taxes	\$37	\$33
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The accompanying notes are an integral part of these condensed consolidated financial statements.

IRIDEX Corporation

Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of IRIDEX Corporation (“IRIDEX”, the “Company”, “we”, “our”, or “us”) have been prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) 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 U.S. GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation of the financial statements have been included.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto, together with management’s discussion and analysis of the Company’s financial condition and results of operations, contained in our Annual Report on Form 10-K for the fiscal year ended January 2, 2016, which was filed with the Securities and Exchange Commission (“SEC”) on March 31, 2016. The results of operations for the three and nine months ended October 1, 2016 and October 3, 2015 are not necessarily indicative of the results for the fiscal year ending December 31, 2016 or any future interim period. The three and nine month periods ended October 1, 2016 and October 3, 2015, each had 13 weeks. For purposes of reporting the financial results, the Company’s fiscal years end on the Saturday closest to the end of December. Periodically, the Company includes a 53rd week to a year in order to end that year on the Saturday closest to the end of December.

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 January 2, 2016, which was filed with the SEC on March 31, 2016.

Financial Statement Presentation.

The unaudited condensed consolidated financial statements include the accounts of the Company and our wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates.

The preparation of unaudited condensed consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and the related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.

Actual results may differ from these estimates. In addition, any change in these estimates or their related assumptions could have an adverse effect on our operating results.

Revenue Recognition.

Our revenues arise from the sale of laser consoles, delivery devices, consumables 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 collectibility 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. The Company’s sales may include post-sales obligations for training or other deliverables. For revenue arrangements such as these, we recognize revenue in accordance with Accounting Standards Codification (“ASC”) 605, “Revenue Recognition, Multiple-Element Arrangements”. The Company allocates revenue among deliverables in multiple-element arrangements using the relative selling price method. Revenue allocated to each element is recognized when the basic revenue recognition criteria is met for each element. The Company is required to apply a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (i) vendor-specific objective evidence of selling price (“VSOE”), (ii) third-party evidence of selling price (“TPE”) and (iii) best estimate of the selling price (“ESP”). In general, the Company is unable to establish VSOE or TPE for all of the elements in the arrangement; therefore, revenue is allocated to these elements based on the Company’s ESP, which the Company determines after considering multiple factors such as management approved pricing guidelines, geographic differences, market conditions, competitor pricing strategies, internal costs and gross margin objectives. These factors may vary over time depending upon the unique facts and circumstances related to each deliverable. As a result, the Company’s ESP for products and services could change. Revenues for post-sales obligations are recognized as the obligations are fulfilled.

In international regions, 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 warranty labor coverage for our products. Our standard terms and conditions do not provide price protection or stock retention rights to any of our distributors.

Royalty revenues are typically based on licensees' net sales of products that utilize our technology and are recognized as earned in accordance with the contract terms when royalties from licensees can be reliably measured and collectibility is reasonably assured, such as upon the earlier of the receipt of a royalty statement from the licensee or upon payment by the licensee.

Concentration of Credit Risk.

Our cash and cash equivalents are deposited in demand and money market accounts. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally these deposits may be redeemed upon demand and therefore, bear minimal risk.

We market our products to distributors and end-users throughout the world. Sales to international distributors are generally made on open credit terms and letters of credit. Management performs ongoing credit evaluations of our customers and maintains an allowance for potential credit losses. Historically, we have not experienced any significant losses related to individual customers or a group of customers in any particular geographic area. For the three and nine month periods ended October 1, 2016 and October 3, 2015, no single customer accounted for 10% of total revenues. As of October 1, 2016, no customer accounted for approximately 10% of our accounts receivable and as of January 2, 2016, no customer accounted for more than 10% of our accounts receivable.

Taxes Collected from Customers and Remitted to Governmental Authorities.

Taxes collected from customers and remitted to governmental authorities are recognized on a net basis in the accompanying condensed consolidated statements of operations.

Shipping and Handling Costs.

Our shipping and handling costs billed to customers are included in revenues and the associated expense is recorded in cost of revenues for all periods presented.

Deferred Revenue.

Revenue related to extended service contracts is deferred and recognized on a straight line basis over the period of the applicable service contract. Costs associated with these service arrangements are recognized as incurred.

A reconciliation of the changes in the Company's deferred revenue balance for the nine months ended October 1, 2016 and October 3, 2015 is as follows:

	Nine Months	
	Ended	
	October	October
(in thousands)	1, 2016	3, 2015

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Balance, beginning of period	\$1,311	\$1,179
Additions to deferral	1,025	1,068
Revenue recognized	(1,031)	(1,036)
Balance, end of period	\$1,305	\$1,211

Warranty.

The Company generally provides a one to two year warranty on its products, which is accrued for 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 cost of revenues.

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A reconciliation of the changes in the Company's warranty liability for the nine months ended October 1, 2016 and October 3, 2015 is as follows:

(in thousands)	Nine Months Ended October	
	1, 2016	October 3, 2015
Balance, beginning of period	\$603	\$ 469
Accruals for product warranties	318	267
Cost of warranty claims and adjustments	(351)	(208)
Balance, end of period	\$570	\$ 528

Recently Issued and Adopted Accounting Standards.

In May 2014, as part of its ongoing efforts to assist in the convergence of U.S. GAAP and International Financial Reporting Standards ("IFRS"), the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers." The new guidance sets forth a new five-step revenue recognition model which replaces the prior revenue recognition guidance in its entirety and is intended to eliminate numerous industry-specific pieces of revenue recognition guidance that have historically existed in U.S. GAAP. The underlying principle of the new standard is that a business or other organization will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or services. The standard also requires more detailed disclosures and provides additional guidance for transactions that were not addressed completely in the prior accounting guidance. In August 2015, the FASB issued ASU 2015-14, "Revenue from Contracts with Customers, Deferral of the Effective Date". The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. Early adoption is permitted for annual periods beginning after December 15, 2016. We are currently evaluating the impact that this standard will have on the Company's consolidated financial statements.

In June 2014, the FASB issued ASU 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (a consensus of the FASB Emerging Issues Task Force)". The ASU clarifies that entities should treat performance targets that can be met after the requisite service period of a share-based payment award as performance conditions that affect vesting. Therefore, an entity would not record compensation expense (measured as of the grant date without taking into account the effect of the performance target) related to an award for which transfer to the employee is contingent on the entity's satisfaction of a performance target until it becomes probable that the performance target will be met. The ASU does not contain any new disclosure requirements. The ASU is effective for reporting periods beginning after December 15, 2015. We adopted this standard at the beginning of fiscal 2016 and it did not have a material impact on the Company's consolidated financial statements.

In July 2015, the FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory." Under this ASU, inventory will be measured at the "lower of cost and net realizable value" and options that currently exist for "market value" will be eliminated. The ASU defines net realizable value as the "estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation." No other changes were made to the current guidance on inventory measurement. ASU 2015-11 is effective for interim and annual periods beginning after December 15, 2016. Early application is permitted and should be applied prospectively. Management is evaluating the

provisions of this statement, including which period to adopt, and has not determined what impact the adoption of this standard will have on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases," amending ASC 842. This ASU requires the Company to recognize on the balance sheet the assets and liabilities for the rights and obligations created by leases with terms of more than twelve months. This ASU also requires disclosures enabling the users of financial statements to understand the amount, timing and uncertainty of cash flows arising from leases. This new standard will become effective for the Company for annual periods beginning after December 15, 2018 (including interim reporting periods within those periods). Early adoption is permitted as of the beginning of an interim or annual reporting period. We are currently evaluating the impact of this new standard on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting." This ASU affects entities that issue share-based payment awards to their employees. The ASU is designed to simplify several aspects of accounting for share-based payment award transactions, which include the income tax consequences, classification of awards as either equity or liabilities, classification on the statement of cash flows and forfeiture rate calculations. This ASU will become effective for the Company on December 15, 2016 (including interim reporting periods within those periods). Early adoption is permitted in any interim or annual period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the

beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. We are currently evaluating the impact of this new standard on the Company's consolidated financial statements.

In April 2016, the FASB issued ASU No. 2016-10, "Revenue from Contracts with Customers (Topic 606)", which amended certain aspects of the FASB's new revenue standard, ASU No. 2014-09, Revenue from Contracts with Customers. The standard should be adopted concurrently with adoption of ASU 2014-09 which is effective for annual and interim periods beginning after December 15, 2017. We have not yet selected a transition method nor have we determined the effect of the standard on the Company's ongoing financial reporting.

In May 2016, the FASB issued ASU No. 2016-12 which amended the revenue recognition guidance regarding collectibility, noncash consideration, presentation of sales tax and transition. This ASU is effective during the same period as ASU 2014-09. We are currently evaluating the impact of this guidance on the Company's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15 "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments". The amendment gives guidance and reduces diversity in practice with respect to certain types of cash flows. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. We are currently evaluating the impact of this guidance on the Company's consolidated financial statements.

3. Inventories

The components of the Company's inventories as of October 1, 2016 and January 2, 2016 are as follows:

	October	January
(in thousands)	1, 2016	2, 2016
Raw materials	\$5,499	\$4,578
Work in process	2,715	1,791
Finished goods	4,464	4,737
Total inventories	\$12,678	\$11,106

4. Goodwill and Intangible Assets

Goodwill.

The carrying value of goodwill was \$0.5 million as of October 1, 2016 and January 2, 2016.

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in a business combination. The Company reviews goodwill for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. The Company first assesses qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step quantitative goodwill impairment test. If, after assessing the totality of circumstances, an entity determines that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, then it is required to perform the two-step impairment test. An entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying value. However, an entity also has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. The Company has determined that it has a single reporting unit for purposes of performing its goodwill impairment test. As the Company uses the market approach to assess impairment, its common stock price is an important component of the fair value calculation. If the Company's stock price continues to experience significant price and volume fluctuations, this will impact the fair value of the reporting unit and can lead to potential impairment in future periods. The Company performed its annual impairment test during the second quarter of fiscal 2016 and determined that its goodwill was not impaired. As of October 1, 2016, the Company had not identified any factors that indicated there was an impairment of its goodwill and determined that no additional impairment analysis was then required.

Intangible Assets.

The following table summarizes the components of gross and net intangible asset balances:

	October 1, 2016			Remaining Amortization Life	January 2, 2016		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount		Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
(in thousands)	Amount	Amount	Amount		Amount	Amount	Amount
Patents	\$720	\$ 600	\$ 120	Varies	\$720	\$ 600	\$ 120
Customer relations	240	104	136	8.50 Years	240	92	148
Total	\$960	\$ 704	\$ 256		\$960	\$ 692	\$ 268

For the nine months ended October 1, 2016 and October 3, 2015, amortization expense totaled \$12 thousand for each period.

The amortization of customer relations was charged to sales and marketing expense and the amortization of patents was charged to cost of revenues.

Future estimated amortization expense (in thousands):	
2016 (three months)	\$4
2017	78
2018	74
2019	16
2020	16
Thereafter	68
Total	\$256

5. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

-

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities.

Level 2: Directly or indirectly observable inputs as of the reporting date through correlation with market data, including quoted prices for similar assets and liabilities in active markets and quoted prices in markets that are not active. Level 2 also includes assets and liabilities that are valued using models or other pricing methodologies that do not require significant judgment since the input assumptions used in the models, such as interest rates and volatility factors, are corroborated by readily observable data from actively quoted markets for substantially the full term of the financial instrument.

Level 3: Unobservable inputs that are supported by little or no market activity and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

In determining fair value, the Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible, as well as considers counterparty credit risk in its assessment of fair value.

The carrying amounts of the Company's financial assets and liabilities, including cash and cash equivalents, accounts receivable, accounts payable, and accrued expenses as of October 1, 2016 and January 2, 2016, approximate fair value because of the short maturity of these instruments.

As of October 1, 2016 and January 2, 2016, financial assets and liabilities measured and recognized at fair value on a recurring basis and classified under the appropriate level of the fair value hierarchy as described above were as follows:

(in thousands)	October 1, 2016				January 2, 2016			
	Fair Value Measurements				Fair Value Measurements			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets:								
Money market funds	\$9,577	—	—	\$9,577	\$9,212	—	—	\$9,212
Liabilities:								
Earn-out liability	\$—	—	\$778	\$778	\$—	—	\$1,005	\$1,005

The Company's Level 1 financial assets are money market funds whose fair values are based on quoted market prices. The Company does not have any Level 2 financial assets or liabilities. The fair value of the earn-out liability arising from the acquisitions of RetinaLabs, Inc. and Ocunetics, Inc. is classified within Level 3 of the fair value hierarchy since it is based on significant unobservable inputs. The significant unobservable inputs include projected royalties and discount rates to present value the payments. A significant increase (decrease) in the projected royalty payments in isolation could result in a significantly higher (lower) fair value measurement and a significant increase (decrease) in the discount rate in isolation could result in a significantly lower (higher) fair value measurement. The fair value of the earn-out liability is calculated on a quarterly basis by the Company based on a collaborative effort of the Company's operations, finance and accounting groups as additional information becomes available. Any change in the fair value adjustment is recorded in the statement of operations of that period.

The following table presents quantitative information about the inputs and valuation methodologies used for our fair value measurements classified in Level 3 of the fair value hierarchy as of October 1, 2016.

As of	Fair Value	Valuation	Significant	Weighted
			Unobservable	Average
October 1, 2016	(in thousands)	Technique	Input	(range)
			Projected royalties	\$2,096
Earn-out liability	\$ 778	Discounted cash flow	(in thousands)	(\$134 - \$2,284)
			Discount rate	11.83%
				(10.37% - 27.00%)

A reconciliation of the changes in the Company's earn-out liability (Level 3 liability) for the nine months ended October 1, 2016 and October 3, 2015 is as follows:

(in thousands)	Nine Months Ended October	
	1, 2016	October 3, 2015
Balance as of beginning of the period	\$1,005	\$1,423
Payments against earn-out	(313)	(328)
Change in fair value of earn-out liability	86	(129)
Balance as of the end of the period	\$778	\$966

The earn-out liability is included in accrued expenses and other long-term liabilities in the condensed consolidated balance sheets. Any change in the fair value adjustment is recorded to other expense in the condensed consolidated statements of operations.

6. Stock Based Compensation

The Company accounts for stock-based compensation granted to employees and directors, including employees stock option awards, restricted stock and restricted stock units in accordance with ASC 718, “Compensation – Stock Compensation” (“ASC 718”). Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the employee’s service period. The Company recognizes compensation expense on a ratable basis over the requisite service period of the award.

The Company values options using the Black-Scholes option pricing model. Restricted stock and time-based restricted stock units are valued at the grant date fair value of the underlying common shares. Performance-based restricted stock units with market conditions are valued using the Monte Carlo simulation model. The Black-Scholes option pricing model requires the use of highly subjective and complex assumptions which determine the fair value of stock-based awards, including the option’s expected term and

the price volatility of the underlying stock. The Monte Carlo simulation model incorporates assumptions for the holding period, risk-free interest rate, stock price volatility and dividend yield.

2008 Equity Incentive Plan.

For the nine months ended October 1, 2016, the only active stock-based compensation plan was the 2008 Equity Incentive Plan (the “Incentive Plan”). The terms of awards granted during the nine months ended October 1, 2016 were consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended January 2, 2016.

Summary of Stock Options

The following table summarizes information regarding activity under the Incentive Plan during the nine months ended October 1, 2016:

	Number of Shares	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value (thousands)
Outstanding as of January 2, 2016	551,492	\$ 6.92	
Granted	79,777	\$ 13.30	
Exercised	(117,576)	\$ 5.53	
Canceled or forfeited	(51,307)	\$ 8.56	
Outstanding as of October 1, 2016	462,386	\$ 8.19	\$ 2,980

The weighted average grant date fair value of the options granted under the Incentive Plan as calculated using the Black-Scholes option-pricing model was \$6.37 and \$2.77 per share for the three months ended October 1, 2016 and October 3, 2015, respectively. The weighted average grant date fair value of the options granted under the Incentive Plan as calculated using the Black-Scholes option-pricing model was \$5.23 and \$4.23 per share for the nine months ended October 1, 2016 and October 3, 2015, respectively.

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

	Three Months Ended		Nine Months Ended	
	October	October	1,	October
	1, 2016	3, 2015	2016	3, 2015
Average risk free interest rate	1.03 %	1.30 %	1.10%	1.27 %

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Expected life (in years)	4.55		4.55		4.55		4.55	
	years		years		years		years	
Dividend yield	—%		—%		—%		—%	
Average volatility	46	%	47	%	46	%	50	%

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 employee stock options represents the weighted average period the stock options are expected to remain outstanding and is based on the history of exercises and cancellations on all past option grants made by the Company, the contractual term, the vesting period and the expected remaining term of the outstanding options. 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.

The following table shows stock-based compensation expense included in the condensed consolidated statements of operations for the three and nine months ended October 1, 2016 and October 3, 2015:

	Three Months Ended October 1, 2016		Nine Months Ended October 1, 2015	
	October 3, 2015	October 3, 2015	October 3, 2015	October 3, 2015
Cost of revenues	\$3	\$ 49	\$84	\$ 172
Research and development	39	21	90	153
Sales and marketing	38	42	119	146
General and administrative	390	51	977	254
	\$470	\$ 163	\$1,270	\$ 725

Stock-based compensation expense capitalized to inventory was immaterial for the nine months ended October 1, 2016 and October 3, 2015.

Occasionally, the Company will grant stock-based instruments to non-employees. During the nine months ended October 1, 2016 and October 3, 2015, the amount of stock-based compensation related to non-employee options was not material.

Information regarding stock options outstanding, vested and expected to vest and exercisable as of October 1, 2016 is summarized below:

	Weighted Average			
	Number of Shares	Weighted Average Exercise Price	Remaining Contractual Life (Years)	Aggregate Intrinsic Value (thousands)
Options outstanding	462,386	\$ 8.19	4.54	\$ 2,980
Options vested and expected to vest	428,659	\$ 7.98	4.44	\$ 2,844
Options exercisable	225,703	\$ 6.35	3.52	\$ 1,837

The aggregate intrinsic value in the table above represents the pre-tax intrinsic value, based on the Company's closing price as of September 30, 2016, that would have been received by option holders had all option holders exercised their stock options as of that date. This amount changes based on the fair market value of the Company's stock. The total intrinsic value of options exercised for the three months ended October 1, 2016 and October 3, 2015 was approximately \$187 thousand and \$144 thousand, respectively.

As of October 1, 2016, there was \$3.5 million of total unrecognized compensation cost, net of expected forfeitures, related to non-vested stock-based compensation arrangements under the Incentive Plan. The cost is expected to be recognized over a weighted average period of 2.47 years.

Summary of Restricted Stock Units and Awards

Information regarding the restricted stock units (“RSUs”) activity for the nine months ended October 1, 2016 is summarized below:

	Number of Shares
Outstanding as of January 2, 2016	147,589
Restricted stock units granted	285,005
Restricted stock units released	(30,789)
Restricted stock units cancelled	(66,000)
Outstanding as of October 1, 2016	335,805

During the nine months ended October 1, 2016, the Company awarded 285,005 restricted stock units at a weighted-average grant date fair value of \$11.89 per share. Of this amount, 256,138 stock units represent performance based shares that are subject to service, performance and market vesting conditions with a weighted-average grant date fair value of \$11.40 per share.

RSUs granted with market conditions are valued using the Monte Carlo simulation model and compensation expense is recognized ratably during the service period even if the market condition is not satisfied. To the extent that the market condition is not met, the RSUs will not vest and will be cancelled.

RSUs granted with performance conditions are valued at the grant date fair value of the underlying common shares. The Company makes a determination regarding the probability of the performance criteria being achieved and compensation expense is recognized ratably over the vesting period, if it is expected that the performance criteria will be met.

During the nine months ended October 1, 2016, the Company accelerated the vesting of 6,400 of restricted stock units and 10,000 performance-based restricted stock units in connection with an early termination. In connection with the acceleration, the Company recorded a \$220,000 charge to general and administrative expenses.

Information regarding the restricted stock awards activity for the nine months ended October 1, 2016 is summarized below:

	Number of Shares
Outstanding as of January 2, 2016	2,513
Restricted stock awards granted	1,289
Restricted stock awards released	(2,513)
Outstanding as of October 1, 2016	1,289

During the nine months ended October 1, 2016, the Company awarded 1,289 unvested restricted stock awards at an average grant date fair value of \$15.51 per share.

Stock Repurchase Program.

In February 2013, the Board of Directors approved a one year \$3.0 million stock repurchase program that replaced the prior two year \$4.0 million stock repurchase program. In February 2014, the Board of Directors approved the extension of the plan for an additional year. In July 2014, the Board of Directors approved an extension of the plan for an additional year and authorized an additional \$3.0 million of stock repurchases. In August 2015, the Board of Directors approved a further extension of the plan for another year and authorized an additional \$2.0 million of stock repurchases. During the nine months ended October 1, 2016, the Company repurchased 6,544 shares at an average price of \$9.00 per share. As of October 1, 2016, we have repurchased 843,785 shares for approximately \$6.7 million under this current program. The remaining balance of approximately \$1.0 million approved under the plan was not used when the plan lapsed in August 2016.

7. Income Taxes

Provision for Income Tax.

The Company calculates its interim tax provision in accordance with the provisions of ASC 740-270, Income Taxes; Interim Reporting. For interim periods, the Company estimates its annual effective income tax rate and applies the estimated rate to the year-to-date income or loss before income taxes. The Company also computes the tax provision or benefit related to items reported separately and recognizes the items net of their related tax effect in the interim periods in which they occur. The Company also recognizes the effect of changes in enacted tax laws or rates in the interim periods in which the changes occur. The Company recorded an income tax benefit of \$674 thousand for the nine months ended October 1, 2016 and an income tax benefit of \$103 thousand for the nine months ended October 3, 2015.

Deferred Income Taxes.

The Company accounts for income taxes in accordance with ASC topic 740, Income Taxes (“ASC 740”), 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. ASC 740 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. In the fourth quarter of fiscal year 2014, the Company's management determined, based on the Company's recent history of earnings coupled with its forecasted profitability that it is more likely than not that all of its federal and the majority of its state deferred tax assets will be realized in the foreseeable future. Accordingly, in the fourth quarter of fiscal year 2014, the Company released \$9.2 million of valuation allowance against most of its

deferred tax assets except for the California Research and Development Credits. The Company maintains the same positions as of October 1, 2016 and will reevaluate the position on a quarterly basis.

Uncertain Tax Positions.

The Company accounts for its uncertain tax positions in accordance with ASC 740. As of January 2, 2016, the Company had \$0.9 million of unrecognized tax benefits of which \$0.4 million of unrecognized tax benefits would result in a change in the Company's effective tax rate if recognized in future years.

The Company is not aware of any other uncertain tax positions that could result in significant additional payments, accruals, or other material deviation in this estimate during the fiscal year.

The Company files U.S. federal and state returns. The tax years 2008 to 2015 remain open in several jurisdictions, none of which have individual significance.

8. Computation of Basic and Diluted Net Loss Per Common Share

Basic and diluted net loss per share is based upon the weighted average number of common shares outstanding during the period. Common stock equivalents consist of incremental common shares issuable upon the exercise of stock options, and the release (vesting) of restricted stock units and awards and are calculated under the treasury stock method. Common stock equivalent shares from unexercised stock options, and unvested restricted stock units and awards are excluded from the computation for periods in which we incur a net loss or if the exercise price of such options is greater than the average market price of our common stock for the period as their effect would be anti-dilutive.

For the three and nine months ended October 1, 2016, stock options to purchase 462,386 shares of common stock, 335,805 RSUs and 1,289 restricted stock awards were excluded from the computation of diluted weighted average shares outstanding because the effect of such would be anti-dilutive.

For the three and nine months ended October 3, 2015, stock options to purchase 234,958 shares of common stock, 147,589 RSUs and 2,513 restricted stock awards were excluded from the computation of diluted weighted average shares outstanding because the effect of such would be anti-dilutive.

A reconciliation of the numerator and denominator of basic and diluted net loss per common share is provided as follows:

	Three Months Ended		Nine Months Ended	
	October 1, 2016	October 3, 2015	October 1, 2016	October 3, 2015
Numerator:				
Net (loss) income	\$(671)	\$442	\$(898)	\$36
Denominator:				

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Weighted average shares of common stock (basic)	10,129	9,972	10,083	9,956
Effect of dilutive stock options	—	117	—	174
Effect of dilutive contingent shares	—	5	—	12
Weighted average shares of common stock (diluted)	10,129	10,094	10,083	10,142
Per share data:				
Basic net (loss) income per share	\$(0.07)	\$0.04	\$(0.09)	\$—
Diluted net (loss) income per share	\$(0.07)	\$0.04	\$(0.09)	\$—

9. Business Segments

The Company operates in one segment, ophthalmology. The Company develops, manufactures and markets medical devices. Our revenues arise from the sale of consoles, delivery devices, consumables, service and support activities.

Revenue information shown by geographic region, based on the location at which each sale originates, is as follows:

	Three Months Ended October 1, 2016		Nine Months Ended October 1, 2016	
(in thousands)	October 3, 2015	October 1, 2016	October 3, 2015	October 3, 2015
United States	\$5,871	\$5,791	\$18,642	\$16,763
Europe	2,191	2,083	6,779	5,763
Rest of Americas	476	506	1,858	2,041
Asia/Pacific Rim	1,251	1,435	6,349	5,077
	\$9,789	\$9,815	\$33,628	\$29,644

Revenues are attributed to countries based on location of end customers. No individual country accounted for more than 10% of the Company's revenues, other than the United States, which accounted for 60.0% and 59.0% of revenues for the three month periods ended October 1, 2016 and October 3, 2015, respectively. For the nine month periods ended October 1, 2016 and October 3, 2015, the United States accounted for 55.4% and 56.5% of sales, respectively.

10. Subsequent Events

On November 2, 2016, the Company entered into a Loan and Security Agreement ("Loan Agreement") with Silicon Valley Bank providing for a \$15.0 million secured revolving loan facility ("Revolving Loan Facility"), with availability subject to an accounts receivable borrowing base formula. Borrowings under the Revolving Loan Facility accrue interest at a per annum rate equal to the Wall Street Journal Prime Rate as in effect from time to time, plus 1.5%. The Loan Agreement does not include any financial covenants. The Company may borrow, repay and reborrow funds under the Revolving Loan Facility until November 2, 2019, at which time the Revolving Loan Facility matures and all outstanding amounts must be repaid.

in MicroPulse mode. The majority of our recurring revenues come from the sale of laser probes and our current family of laser probes includes a wide variety of products in 20, 23, 25 and 27 gauge for vitreoretinal surgery along with our recently patented MicroPulse P3 (“MP3”) and G-Probe for glaucoma surgery.

Sales to international distributors are made on open credit terms or letters of credit and are currently denominated in U.S. dollars and accordingly, are not subject to direct risks associated with currency fluctuations. However, increases in the value of the U.S. dollar against any local currencies could cause our products to become relatively more expensive to customers in a particular country or region, leading to reduced revenue or profitability in that country or region.

Cost of revenues consists primarily of the cost of purchasing components and sub-systems, assembling, packaging, shipping and testing components at our facility, direct labor and associated overhead; warranty, royalty and amortization of intangible assets; and depot service costs.

Research and development expenses consist primarily of personnel costs and materials to support new product development, and regulatory expenses. Research and development costs have been expensed as incurred.

Sales and marketing expenses consist primarily of costs of personnel, sales commissions, travel expenses, advertising and promotional expenses.

General and administrative expenses consist primarily of costs of personnel, legal, accounting, public company costs, insurance and other expenses not allocated to other departments.

Results of Operations

The following table sets forth certain operating data as a percentage of revenues:

Three
Months
Ended