IRIDEX CORP
Form 10-Q
November 04, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 28, 2013

Or

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

For the transition period from _____ to _____

Commission file number: 0-27598

IRIDEX CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	77-0210467

(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
1212 Terra Bella Avenue	
Mountain View, California	94043-1824
(Address of principal executive offices)	(Zip Code)

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

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

Indicate by check mark whether the registrant 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 þ No ¨

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

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

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

The number of shares of common stock, $0.01 par value, issued and outstanding as of October 18, 2013 was 9,804,582.

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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)

	September 28, 2013	December 29, 2012 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,089	$ 11,901
Accounts receivable, net of allowance for doubtful accounts of $206 at September 28, 2013 and $146 at December 29, 2012	5,743	5,480
Inventories	9,998	8,035
Prepaid expenses and other current assets	534	1,129
Current assets of discontinued operations	0	510
Total current assets	30,364	27,055
Property and equipment, net	526	483
Intangible assets, net	382	554
Goodwill	533	533
Other long-term assets	233	287
Total assets	$ 32,038	$ 28,912
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,077	$ 2,105
Accrued compensation	1,538	1,563
Accrued expenses	1,370	1,242
Accrued warranty	472	453
Deferred revenue	1,062	1,004
Total current liabilities	6,519	6,367
Long-term liabilities:		
Other long-term liabilities	441	640
Total liabilities	6,960	7,007
Stockholders equity:		
Convertible preferred stock, $0.01 par value:		
Authorized: 2,000,000 shares;		
Issued and outstanding: 0 and 500,000 shares at September 28, 2013 and at December 29, 2012, respectively	0	5
Common stock, $0.01 par value:		
Authorized: 30,000,000 shares;		

Issued and outstanding 9,818,012 and 8,452,971 shares at September 28, 2013 and at December 29, 2012, respectively		103		94
Additional paid-in capital		40,308		38,958
Accumulated deficit		(15,333)		(17,152)
Total stockholders equity		25,078		21,905
Total liabilities and stockholders equity	$	32,038	$	28,912

(1) Derived from the audited consolidated financial statements included in the annual report filed on Form 10-K with the SEC for the year ended December 29, 2012.

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	
	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Total revenues	$ 9,526	$ 7,881	$ 27,675	$ 24,631
Cost of revenues	4,802	3,970	14,238	12,623
Gross profit	4,724	3,911	13,437	12,008
Operating expenses:				
Research and development	923	1,006	2,803	3,294
Sales and marketing	1,869	1,875	5,340	5,861
General and administrative	1,267	1,609	3,690	4,018
Proceeds from demutualization of insurance carrier	0	0	(473)	0
Total operating expenses	4,059	4,490	11,360	13,173
Income (loss) from continuing operations	665	(579)	2,077	(1,165)
Legal settlement	0	0	0	800
Interest and other expense, net	(85)	(117)	(200)	(192)
Income (loss) from continuing operations before provision for (benefit from) income taxes	580	(696)	1,877	(557)
Provision for (benefit from) income taxes	50	(141)	58	(134)
Income (loss) from continuing operations	530	(555)	1,819	(423)
Loss from discontinued operations, net of tax	0	(190)	0	(413)
Gain on sale of discontinued operations, net of tax	0	0	0	2,032
(Loss) income from discontinued operations, net of tax	0	(190)	0	1,619
Net income (loss)	$ 530	$ (745)	$ 1,819	$ 1,196
Net income (loss) per share:				
Basic				
Continuing operations	$ 0.05	$ (0.06)	$ 0.20	$ (0.05)
Discontinued operations	0.00	(0.02)	0.00	0.18
Net income (loss)	$ 0.05	$ (0.08)	$ 0.20	$ 0.13
Diluted				
Continuing operations	$ 0.05	$ (0.06)	$ 0.18	$ (0.05)
Discontinued operations	0.00	(0.02)	0.00	0.18
Net income(loss)	$ 0.05	$ (0.08)	$ 0.18	$ 0.13
Weighted average shares used in computing net income (loss) per common share				
Basic	9,796	9,005	9,044	8,974
Diluted	10,177	9,005	9,995	8,974

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

IRIDEX Corporation

Condensed Consolidated Statements of Comprehensive Income (Loss)

(Unaudited, in thousands)

	Three Months Ended		Nine Months Ended	
	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Net income (loss)	$ 530	$ (745)	$ 1,819	$ 1,196
Recognition of accumulated foreign currency translation loss related to sale of foreign operations	0	0	0	35
Comprehensive income (loss)	$ 530	$ (745)	$ 1,819	$ 1,231

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	
	September 28, 2013	September 29, 2012
Operating activities:		
Net income	$ 1,819	$ 1,196
Less income from discontinued operations	0	1,619
Income (loss) from continuing operations	1,819	(423)
Adjustments to reconcile net income (loss) from continuing operations to net cash provided by (used in) operating activities:		
Depreciation and amortization	364	310
Change in fair value of earn-out liability	181	195
Stock compensation expense	511	277
Provision for doubtful accounts	60	(24)
Changes in operating assets and liabilities, net of assets and liabilities acquired:		
Accounts receivable	(323)	79
Inventories	(1,963)	(883)
Prepaid expenses and other current assets	595	(653)
Other long-term assets	54	(20)
Accounts payable	(28)	(51)
Accrued compensation	(25)	807
Accrued expenses	35	(999)
Accrued warranty	19	(28)
Deferred revenue	58	(153)
Other long-term liabilities	0	21
Net cash provided by (used in) operating activities	1,357	(1,545)
Investing activities:		
Acquisition of property and equipment	(235)	(310)
Payment on earn-out liability	(287)	(241)
Net cash used in investing activities	(522)	(551)
Financing activities:		
Proceeds from stock option exercises	1,077	405
Repurchase of common stock	(194)	(578)
Payment of legal costs in connection with tender offer	(40)	0
Net cash provided by (used in) financing activities	843	(173)
Net cash provided by operating activities from discontinued operations	0	547
Net cash provided by investing activities from discontinued operations	510	4,632
Effect of foreign exchange rate changes from discontinued operations	0	35

Net cash provided by discontinued operations		510		5,214
Net increase in cash and cash equivalents		2,188		2,945
Cash and cash equivalents, beginning of period		11,901		10,789
Cash and cash equivalents, end of period	$	14,089	$	13,734
Supplemental disclosure of cash flow information:				
Cash paid during the period for:				
Income taxes	$	12	$	29
Non-cash financing transaction:				
Preferred stock conversion into common stock	$	5	$	0

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 generally accepted accounting principles in the United States (US 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 US 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 December 29, 2012, which was filed with the Securities and Exchange Commission (SEC) on March 28, 2013. The results of operations for the three and nine months ended September 28, 2013 are not necessarily indicative of the results for the year ending December 28, 2013 or any future interim period.

2. Summary of Significant Accounting Policies

The Company s significant accounting policies are disclosed in our Annual Report on Form 10-K for the year ended December 29, 2012, which was filed with the SEC on March 28, 2013.

Financial Statement Presentation.

The 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 consolidated financial statements in conformity with US 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.

Discontinued Operations.

Discontinued operations are presented and accounted for in accordance with Accounting Standards Codification (ASC) 360, Impairment or Disposal of Long-Lived Assets , (ASC 360). When a qualifying component of the Company is disposed of or has been classified as held for sale, the operating results of that component are removed from continuing operations for all periods presented and displayed as discontinued operations if: (a) elimination of the component s operations and cash flows from the Company s ongoing operations has occurred (or will occur) and

(b) significant continuing involvement by the Company in the component s operations does not exist after the disposal transaction.

On December 30, 2011, we entered into an agreement to sell our aesthetics business to Cutera, Inc. The sale of the aesthetics business was completed on February 2, 2012.

The operating results of our aesthetics business were therefore classified as discontinued operations, and the associated assets and liabilities were classified as discontinued operations for all periods presented under the requirements of ASC 360.

	Three Months Ended		Nine Months Ended	
(in thousands)	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Total revenues	$ 0	$ 399	$ 0	$ 1,627
Loss from discontinued operations	$ 0	(56)	$ 0	(279)
Gain on sales of aesthetics business, net	$ 0	0	$ 0	1,149
(Loss) income before provision for (benefit from) income taxes	$ 0	(56)	$ 0	870
Income tax (expense) benefit	$ 0	(134)	$ 0	749
(Loss) income from discontinued operations, net of tax	$ 0	(190)	$ 0	1,619

Current assets of discontinued operations as of December 29, 2012 comprised of restricted cash in the amount of $510 thousand. In accordance with the terms of the sale of the aesthetics segment to Cutera, Inc., 10% of the total purchase price was deposited and held in an escrow account for a period of twelve months from the date of closing and was available to resolve certain claims by Cutera, Inc., if any, which the Company had indemnified. There had been no claims made by Cutera, Inc. and in May 2013, the cash held in the escrow account was released to the Company.

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 collection of the receivables is reasonably assured. Shipments are generally made with Free-On-Board (FOB) shipping point terms, whereby title passes upon shipment from our dock. Any shipments with FOB receiving point terms are recorded as revenue when the shipment arrives at the receiving point. Cost is recognized as product sales revenue is recognized. 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 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.

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 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 September 28, 2013 and September 29, 2012 is as follows:

	Nine Months Ended	
	September 28,	September 29,
(in thousands)	2013	2012
Balance, beginning of period	$ 1,004	$ 1,014
Additions to deferral	985	680
Revenue recognized	(927)	(833)
Balance, end of period	$ 1,062	$ 861

Warranty.

The Company generally provides a one to two years 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.

A reconciliation of the changes in the Company s warranty liability for the nine months ended September 28, 2013 and September 29, 2012 is as follows:

	Nine Months Ended	
	September 28,	September 29,
(in thousands)	2013	2012
Balance, beginning of period	$ 453	$ 556
Accruals for product warranties	162	123
Cost of warranty claims and adjustments	(143)	(151)
Balance, end of period	$ 472	$ 528

Recently Issued and Adopted Accounting Standards.

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income (AOCI), which aims to improve the reporting of reclassifications out of AOCI. This update requires an entity to report the effect of significant reclassifications out of AOCI on the respective line items in net income if the amount being reclassified is required under US GAAP to be reclassified in its entirety to net income. For other amounts that are not required under US GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under US GAAP that provide additional detail about those amounts. The amendments do not change the current requirements for reporting net income or other comprehensive income in financial statements. For public entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2012. The Company adopted this standard in the first quarter of fiscal year 2013. The adoption of this standard did not have a material effect on our consolidated financial position, results of operations, or cash flows.

In July 2013, the FASB issued Accounting Standards Update (ASU) No. 2013-11, Presentation of an Unrecognized Tax Benefit when a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. This standard requires an entity to present unrecognized tax benefits as a reduction to deferred tax assets when a net operating loss carryforward, similar tax loss or a tax credit carryforward exists, with limited exceptions. This standard is effective for fiscal years beginning on or after December 15, 2013, and for interim periods within those fiscal years. Since ASU 2013-11 only impacts financial statement disclosure requirements for unrealized tax benefits, the Company does not expect its adoption to have an impact on the Company s financial position or results of operations.

3. Inventories

The components of the Company s inventories as of September 28, 2013 and December 29, 2012 are as follows:

(in thousands)	September 28, 2013	December 29, 2012
Raw materials and work in process	$ 6,318	$ 5,357
Finished goods	3,680	2,678
Total inventories	$ 9,998	$ 8,035

4. Goodwill and Intangible Assets

Goodwill.

The carrying amount of goodwill and the changes in those balances are as follows:

(in thousands)	
Balance, December 29, 2012	$ 533
Additions as a result of acquisitions	0
Balance, September 28, 2013	$ 533

Intangible Assets.

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

	September 28, 2013			December 29, 2012			
(in thousands)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Amortization Life
Patents	$ 720	$ 522	$ 198	$ 720	$ 362	$ 358	Varies
Customer relations	240	$ 56	184	240	44	196	11.5 years
	$ 960	$ 578	$ 382	$ 960	$ 406	$ 554	

Amortization expense totaled $172 thousand and $143 thousand for the nine months ended September 28, 2013 and September 29, 2012, respectively.

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):	
2013 (three months)	$ 82
2014	30
2015	52
2016	86
2017	16
Thereafter	116
Total	$ 382

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:

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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 at September 28, 2013 and December 29, 2012, approximate fair value because of the short maturity of these instruments.

As of September 28, 2013 and December 29, 2012, 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 was as follows:

	September 28, 2013 Fair Value Measurements				December 29, 2012 Fair Value Measurements			
(in thousands)	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets:								
Money market funds	$ 12,741			$ 12,741	$ 10,839	0	0	$ 10,839
Liabilities:								
Earn-out liability			$ 546	$ 546	$ 0	0	$ 652	$ 652

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 based on additional information as it 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 September 28, 2013.

As of September 28, 2013	Fair Value (in thousands)	Valuation Technique	Significant Unobservable Input	Weighted Average (range)
Earn-out liability	$546	Discounted cash flow	Projected royalties (in thousands)	$1,408 ($414 - $1,644)
			Discount rate	21.67% (20.40% - 27.00%)

A reconciliation of the changes in the Company s earn-out liability (Level 3 liability) for the nine months ended September 28, 2013 and September 29, 2012 is as follows:

Nine Months Ended

(in thousands)	September 28 2013,	September 29, 2012
Balance at the beginning of the period	$ 652	$ 765
Payments against earn-out	(287)	(241)
Change in fair value of earn-out liability	181	195
Balance at the end of the period	$ 546	$ 719

The earn-out liability is included in accrued expenses and other long-term liabilities in the condensed consolidated balance sheets.

6. Stock Based Compensation

2008 Equity Incentive Plan

For the nine months ended September 28, 2013, the only active share-based compensation plan was the 2008 Equity Incentive Plan (the Incentive Plan). The terms of awards granted during the nine months ended September 28, 2013 were consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 29, 2012.

Summary of Stock Options

The following table summarizes information regarding activity in our stock option plan during the nine months ended September 28, 2013:

	Number of Shares	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value (thousands)
Outstanding at December 29, 2012	1,570,543	$ 3.64	
Granted	145,800	$ 5.59	
Exercised	(373,663)	$ 2.88	
Canceled or forfeited	(117,879)	$ 5.54	
Outstanding at September 28, 2013	1,224,801	$ 3.92	$ 2,706

The weighted-average grant date fair value of the options granted under the Company s stock plans as calculated using the Black-Scholes option-pricing model was $3.19 and $2.37 per share for the three months ended September 28, 2013 and September 29, 2012, respectively. The weighted-average grant date fair value of the options granted under the Company s stock plans as calculated using the Black-Scholes option-pricing model was $3.12 and $2.70 per share for the nine months ended September 28, 2013 and September 29, 2012, 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	
	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Average risk free interest rate	1.26%	0.59%	1.11%	0.68%
Expected life (in years)	4.50 years	4.55 years	4.50 years	4.55 years
Dividend yield	0.0%	0.0%	0.0%	0.0%
Average volatility	66%	90%	72%	91%

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 months and nine months ended September 28, 2013 and September 29, 2012:

	Three Months Ended		Nine Months Ended	
	September 28,	September 29,	September 28,	September 29,
(in thousands)	2013	2012	2013	2012
Cost of revenues	$ 27	$ 17	$ 78	$ 51
Research and development	17	19	53	58
Sales and marketing	30	29	80	84
General and administrative	103	(85)	300	84
	$ 177	$ (20)	$ 511	$ 277

Approximately $17 thousand and $11 thousand of the stock-based compensation recognized was capitalized into inventory as a component of overhead for the quarters ended September 28, 2013 and September 29, 2012, respectively.

Information regarding stock options outstanding, vested and expected to vest and exercisable at September 28, 2013 is summarized below:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (thousands)
Options outstanding	1,224,801	$ 3.92	3.73	$ 2,706
Options vested and expected to vest	1,155,031	$ 3.89	3.56	$ 2,596
Options exercisable	789,589	$ 3.67	2.42	$ 1,967

The aggregate intrinsic value in the table above represents the pre-tax intrinsic value, based on the Company s closing price as of September 27, 2013, 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 nine months ended September 28, 2013 and September 29, 2012 were approximately $231 thousand and $225 thousand, respectively.

As of September 28, 2013, there was $1.0 million of total unrecognized compensation cost, net of expected forfeitures, related to non-vested share-based compensation arrangements under the Incentive Plan. The cost is expected to be recognized over a weighted average period of 3.09 years.

Summary of Restricted Stock Units and Awards

Information regarding the restricted stock units activity for the nine months ended September 28, 2013 is summarized below:

	Number of Shares
Outstanding at December 29, 2012	55,999
Restricted stock units granted	230,509
Restricted stock units released	(17,249)
Restricted stock units forfeited	0
Outstanding at September 28, 2013	269,259

The grant date fair value for restricted stock units awarded during the period was $318 thousand. The weighted average stock price on the date of grant was $4.51 per share.

On March 25, 2013, the Company granted a restricted stock unit award for up to 220,000 shares of the Company s common stock (the Market Performance Award) under the terms of the Company s 2008 Equity Incentive Plan, as amended, to the Company s President and Chief Executive Officer. The number of shares issuable pursuant to the Market Performance Award will be based upon the Company s average stock price performance during the two months prior to and two months following the date the service condition is met, or the fair market value of the Company s common stock in the event vesting is triggered by a change of control of the Company. The Market Performance

Award is expected to vest on December 31, 2014, given that no other vesting triggers occur prior to that date. To the extent that the market condition is not met, the Market Performance Award will not vest and will be cancelled. Since the market conditions will affect the vesting of the Market Performance Award, the Company cannot use the Black-Scholes option-pricing model to value the award; instead, a binomial model must be used. The Company utilized the Monte Carlo simulation technique, which incorporated assumptions for the expected holding period, risk-free interest rate, stock price volatility and dividend yield. Compensation expense is recognized ratably until such time as the market condition is satisfied.

There were 3,503 restricted stock awards granted, vested and forfeited for the nine months ended September 28, 2013.

Stock Repurchase Program

In May 2011, the Company approved a stock repurchase program authorizing the Company to purchase in open market or privately negotiated transactions, up to $2.0 million worth of our common stock, from time to time during the next 12 months. In February 2012, the Company approved an extension of its stock repurchase program authorizing the Company to purchase up to $4.0 million worth of our common stock, from time to time prior to March 2013. In February 2013, the Board of Directors approved a new one year $3.0 million stock repurchase program that replaced the prior two year $4.0 million stock repurchase program. For the nine months ended September 28, 2013, the Company has purchased 36,537 shares at an average price of $5.31 per share. As of September 28, 2013, the Company still has the authorization to purchase up to $2.8 million in common shares under the stock repurchase program. See Item 2, Unregistered Sales of Equity Securities and Use of Proceeds in Part II, Other Information, for additional information.

Preferred Stock Conversion

On June 11, 2013, all outstanding shares of the Company s Series A Preferred Stock automatically converted into 1,000,000 shares of common stock. The Series A Preferred shares were issued to BlueLine Capital Partners LP and affiliated entities as part of a private placement in 2007. The Certificate of Designation authorizing the Series A Preferred shares provided for their automatic conversion into common stock in the event that IRIDEX common stock traded above $5.00 per share for 30 consecutive trading days.

7. Income Taxes

Provision for Income Tax

The Company calculates its interim tax provision in accordance with the provisions of ASC topic -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 a provision for income tax of $58 thousand for the nine months ended September 28, 2013 and a benefit from income taxes of $134 thousand for the nine months ended September 29, 2012.

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. As of December 29, 2012, the Company had a deferred tax asset of approximately $10.1 million which is fully offset by a valuation allowance. If realized, the asset will be reflected on the Company s balance sheet and the reversal of the corresponding valuation allowance will result in a tax benefit being recorded in the statement of operations in the respective period.

The American Taxpayer Relief Act of 2012 was enacted on January 2, 2012. The Act reinstated the research and development credit retroactively to January 1, 2012 and extended it through 2013.

Uncertain Tax Positions

The Company accounts for its uncertain tax positions in accordance with ASC 740. As of December 29, 2012, the Company had $1.0 million of unrecognized tax benefits which would impact the income statement if recognized.

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, as well as foreign returns in France. The tax years 2007 to 2012 remain open in several jurisdictions, none of which have individual significance.

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

Basic net income per share is computed by dividing net income for the period by the weighted average number of shares outstanding during the period.

Diluted net income per share is computed as follows:

In periods of net income from continuing operations, diluted net income per share is computed by dividing net income for the period by the weighted average number of shares, plus the weighted average common stock equivalents outstanding during the period, which included 1,000,000 shares of common stock issuable upon conversion of 500,000 shares of convertible Series A Preferred Stock. In June 2013, the Series A Preferred Stock was converted into 1,000,000 shares of common stock. The Company excludes options from the computation of diluted weighted average shares outstanding if the exercise price of the options is greater than the average market price of the shares because the inclusion of these options would be anti-dilutive to earnings per share. Accordingly, for the three months ended September 28, 2013 and September 29, 2012, respectively, stock options to purchase 147,111 and 881,893 shares were excluded from the computation of diluted weighted average shares outstanding. For the nine months ended September 28, 2013 and September 29, 2012, respectively, stock options to purchase 543,142 and 899,809 shares were excluded from the computation of diluted weighted average shares outstanding.

In periods of net loss from continuing operations, the basic and diluted weighted average shares of common stock and common stock equivalents are the same because inclusion of common stock equivalents would be anti-dilutive.

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

	Three Months Ended		Nine Months Ended	
(in thousands, except per share amounts)	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Numerator:				
Income (loss) from continuing operations	$ 530	$ (555)	$ 1,819	$ (423)
Income (loss) from discontinued operations	0	(190)	0	1,619
Net income (loss)	$ 530	$ (745)	$ 1,819	$ 1,196
Denominator:				
Weighted average shares of common stock (basic)	9,796	9,005	9,044	8,974
Effect of dilutive preferred shares	0	0	597	0
Effect of dilutive stock options	276	0	270	0
Effect of dilutive contingent shares	105	0	84	0
Weighted average shares of common stock (diluted)	10,177	9,005	9,995	8,974
Per share data:				
Basic income (loss) per share:				
Income (loss) before discontinued operations	$ 0.05	$ (0.06)	$ 0.20	$ (0.05)
Discontinued operations	0.00	(0.02)	0.00	0.18
Net income (loss)	$ 0.05	$ (0.08)	$ 0.20	$ 0.13
Diluted income (loss) per share:				
Income (loss) before discontinued operations	0.05	(0.06)	0.18	(0.05)
Discontinued operations	0.00	(0.02)	0.00	0.18
Net income (loss)	$ 0.05	$ (0.08)	$ 0.18	$ 0.13

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		Nine Months Ended	
	September 28,	September 29,	September 28,	September 29,
(in thousands)	2013	2012	2013	2012

United States	$ 5,572	$ 4,516	$ 14,743	$ 13,180
Europe	1,942	1,686	5,543	5,463
Rest of Americas	578	394	2,369	1,722
Asia/Pacific Rim	1,434	1,285	5,020	4,266
	$ 9,526	$ 7,881	$ 27,675	$ 24,631

Revenues are attributed to countries based on location of end customers. No individual country accounted for more than 10% of the Company s revenues for the three and nine month periods, except for the United States, which accounted for 58.5% and 57.3% of revenues for the three month periods ended September 28, 2013 and September 29, 2012, respectively. For the nine month periods ended September 28, 2013 and September 29, 2012, it accounted for 53.3% and 53.5% of revenues, respectively.

No one customer accounted for more than 10% of total revenues for the three and nine month periods ended September 28, 2013 and September 29, 2012, respectively.

10. Subsequent Events

The Company has evaluated subsequent events and has concluded that no additional subsequent events that require disclosure in the financial statements have occurred since the quarter ended September 28, 2013.

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 our anticipated levels of future sales; our operating results and long term growth; market acceptance and adoption of our products and our outlook for system sales; our gross margin goals and performance; the success of our efforts to reduce costs and manage cash flows; general economic conditions and levels of international sales; corporate strategy; effects of seasonality; FDA inspections; our current and future liquidity and capital requirements; levels of future investment in research and development and sales and marketing efforts; and our product distribution strategies with Alcon, Inc. and Peregrine Surgical Ltd. In some cases, forward-looking statements can be identified by terminology, such as may, will, should, expects, plans, anticip 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 March 28, 2013 and detailed from time to time in our reports filed with the Securities and Exchange Commission. The reader is cautioned not to place undue reliance on these forward-looking statements, which reflect management s analysis only as of the date of this quarterly report on Form 10-Q. We undertake no obligation to update such forward-looking statements to reflect events or circumstances occurring after the date of this report.

Overview

IRIDEX Corporation is a leading worldwide provider of therapeutic based laser systems, delivery devices and consumable instrumentation used to treat sight-threatening eye diseases in ophthalmology. Our ophthalmology products are sold in the United States predominantly through direct and independent sales forces and internationally through approximately 70 independent distributors into over 100 countries.

We manage and evaluate our business in one segment ophthalmology. We break down this segment by geography Domestic (U.S.) and International (the rest of the world). In addition, we review trends by laser system sales (consoles and durable delivery devices) and recurring sales (single use consumable laser probes and other associated instrumentation (consumables), service and support).

Our ophthalmology revenues arise primarily from the sale of our IQ and OcuLight laser systems, consumables and service and support activities. Our current family of IQ products includes IQ 532, IQ 577 and IQ 810 laser photocoagulation systems and our OcuLight products include OcuLight TX, OcuLight Symphony (Laser Delivery System), OcuLight SL, OcuLight SLx, OcuLight GL and OcuLight GLx laser photocoagulation systems. Certain of our laser systems are capable of performing our patented Fovea-Friendly MicroPulse laser photocoagulation in addition to conventional continuous wavelength photocoagulation offered by each of our laser systems. Towards the end of 2012, we introduced the TxCell Scanning Laser Delivery System which saves significant time in a variety of laser photocoagulation procedures by allowing physicians to deliver the laser in a multi-spot scanning mode, a more efficient method for these procedures than the traditional single spot 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 and 25 gauge for vitreoretinal surgery and glaucoma surgery.

In March 2013, the Company entered into a global distribution and supply agreement with Peregrine Surgical Ltd. (Peregrine) which commenced on April 1, 2013. Under the agreement, IRIDEX became a worldwide distributor for Peregrine labeled products and Peregrine became part of the IRIDEX supply chain. In addition, IRIDEX assumed responsibility for the independent sales force consisting of 10 representatives who sell the Peregrine products domestically. The Peregrine products consist of laser probes and other associated instrumentation and are a logical fit within our existing product portfolio. The ultimate objective is to have all of our channels both domestically and

internationally sell both IRIDEX and Peregrine labeled consumable products.

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 risks associated with currency fluctuations.

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, materials to support new product development and research support provided to clinicians at medical institutions developing new applications which utilize our products; 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 and other 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		Nine Months Ended	
	September 28, 2013	September 29, 2012	September 28, 2013	September 29, 2012
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	50.4%	50.4%	51.4%	51.2%
Gross margin	49.6%	49.6%	48.6%	48.8%
Operating expenses:				
Research and development	9.7%	12.8%	10.1%	13.4%
Sales and marketing	19.6%	23.8%	19.3%	23.8%
General and administrative	13.3%	20.4%	13.4%	16.3%
Proceeds from demutualization of insurance carrier	0.0%	0.0%	(1.7)%	0.0%
Total operating expenses	42.6%	57.0%	41.1%	53.5%
Income (loss) from continuing operations	7.0%	(7.4)%	7.5%	(4.7)%
Legal settlement	0.0%	0.0%	0.0%	3.2%
Other expense, net	(0.9)%	(1.5)%	(0.7)%	(0.8)%
Income (loss) from continuing operations before income taxes	6.1%	(8.9)%	6.8%	(2.3)%
Provision for income taxes	0.5%	1.8%	0.2%	(0.6)%
Income (loss) from continuing operations, net of tax	5.6%	(7.1)%	6.6%	(1.7)%
Income (loss) from discontinued operations, net of tax	0.0%	(2.4)%	0.0%	6.6%
Net income (loss)	5.6%	(9.5)%	6.6%	4.9%

The following comparisons are between the three month periods ended September 28, 2013 and September 29, 2012:

Revenues.

(in thousands)	Three Months Ended September 28, 2013	Three Months Ended September 29, 2012	Change in $	Change in %
Systems domestic	$ 2,252	$ 1,694	$ 558	32.9%
Systems international	2,407	1,959	448	22.9%
Recurring revenues	4,783	4,123	660	16.0%

OEM	84	105	(21)	(20.0)%
Total revenues	$ 9,526	$ 7,881	$ 1,645	20.9%

Our total revenues increased $1.6 million or 20.9% from $7.9 million to $9.5 million, as a result of increases in both system sales and in our recurring revenues. The increase in system sales was due to an increase in sales of our IQ lasers that features MicroPulse. The increase in recurring revenues was attributable to the inclusion of sales generated by the independent sales force resulting from the Peregrine agreement, as well as an increase in sales of our licensed GreenTip product by our distribution partner, Alcon, Inc. (Alcon), and we anticipate benefiting from these sales for the foreseeable future. OEM sales are expected to cease shortly as our OEM partner, Bausch & Lomb, Incorporated (B&L), has discontinued selling this product.

Gross Profit and Gross Margin.

Gross profit was $4.7 million compared with $3.9 million, an increase of $0.8 million or 20.8%. Gross margin remained constant at 49.6% for both periods which is in line with our short term goal for gross margin of 50%.

Gross margins as a percentage of revenues will continue to fluctuate due to changes in the relative proportions of domestic and international sales, the product mix of sales, manufacturing variances, total unit volume changes that lead to greater or lesser production efficiencies and a variety of other factors. See Item 1A. Risk Factors Factors That May Affect Future Results Our Operating Results May Fluctuate from Quarter to Quarter and Year to Year.

Research and Development.

Research and development (R&D) expenses decreased $0.1 million or 8.3% from $1.0 million to $0.9 million. The decrease in spending was primarily attributable to a decrease in headcount and associated costs. We anticipate a slight increase on the spending level in R&D in support of new products and certain product cost reduction programs we are initiating going forward.

Sales and Marketing.

Sales and marketing expenses remained constant at $1.9 million. We anticipate an increase in our sales and marketing spending due to the inclusion of the independent sales forces amongst other items with the objective of driving increased sales.

General and Administrative.

General and administrative expenses decreased $0.3 million or 21.3% from $1.6 million to $1.3 million. The decrease was primarily attributable to the fact that we recorded $0.7 million in severance and related costs in Q3 2012, this reduction in expenditures was partially offset by increased expenses associated with the Medical Device Tax, and an increase in compensation charges.

Legal Settlement and Interest and Other Expense, Net.

For the three months ended September 28, 2013 and for the same period a year earlier, interest and other expense, net consisted primarily of expense recorded for the fair value remeasurement of the contingent earn-out liabilities incurred as a result of the Company s recent acquisitions and was $0.1 million for both periods.

Income Taxes.

The Company recorded an income tax provision of $50 thousand for the quarter ended September 28, 2013, compared to a benefit from income taxes of $141 thousand for the comparable quarter of the prior year, for continuing operations.

The following comparisons are between the nine months ended September 28, 2013 and September 29, 2012:

Revenues.

(in thousands)	Nine Months Ended September 28, 2013	Nine Months Ended September 29, 2012	Change in $	Change in %
Systems domestic	$ 5,223	$ 4,485	$ 738	16.5%
Systems international	8,087	7,008	1,079	15.4%
Recurring revenues	14,124	12,893	1,231	9.5%
OEM	241	245	(4)	1.6%
Total revenues	$ 27,675	$ 24,631	$ 3,044	12.4%

Our total revenues increased $3.0 million or 12.4% from $24.6 million to $27.7 million, as a result of increases in both system sales and in our recurring revenues. The increase in system sales was due to an increase in sales of our IQ lasers that features MicroPulse, and during the second quarter of the current year, we received two large international orders. We believe the outlook for system sales continues to look positive. The increase in recurring revenues was attributable to the inclusion of sales generated by the independent sales force resulting from the Peregrine agreement, as well as an increase in sales of our licensed GreenTip product by our distribution partner, Alcon, and we anticipate benefiting from these sales for the foreseeable future. OEM sales are expected to cease shortly as our OEM partner, B&L, has discontinued selling this product.

Gross Profit and Gross Margin.

Gross profit was $13.4 million compared with $12.0 million an increase of $1.4 million or 11.9%. Gross margin remained fairly constant at 48.6% compared to 48.8%.

Gross margins as a percentage of revenues will continue to fluctuate due to changes in the relative proportions of domestic and international sales, the product mix of sales, manufacturing variances, total unit volume changes that lead to greater or lesser production efficiencies and a variety of other factors. See Item 1A. Risk Factors Factors That May Affect Future Results Our Operating Results May Fluctuate from Quarter to Quarter and Year to Year.

Research and Development.

R&D expenses decreased $0.5 million or 14.9% from $3.3 million to $2.8 million. The decrease in spending was primarily attributable to a decrease in headcount and associated costs. We anticipate a slight increase on the spending level in R&D in support of new products and certain product cost reduction programs we are initiating.

Sales and Marketing.

Sales and marketing expenses decreased $0.5 million or 8.9% from $5.9 million to $5.3 million. The decrease in spending was primarily attributable to a decrease in headcount and related cost and to a decrease in general spending, partly offset by commissions and other costs associated with the expansion of our independent sales force resulting from the Peregrine transaction.

General and Administrative.

General and administrative expenses decreased $0.3 million or 8.2% from $4.0 million to $3.7 million. The decrease was primarily attributable to the fact that we recorded $0.7 million in severance and related costs in Q3 2012, this reduction in expenditures was partially offset by increased expenses associated with the Medical Device Tax, and an increase in compensation charges.

Proceeds from Demutualization of Insurance Carrier.

In January 2013, we received $0.5 million as a result of the demutualization of our product and liability insurance carrier.

Legal Settlement and Interest and Other Expense, Net.

The legal settlement relates to payments received from Synergetics, Inc. associated with a 2007 settlement of legal claims for patent infringement. The $0.8 million received during the nine months ended September 29, 2012 represented the final payment.

For the nine months ended September 28, 2013 and for the same period a year earlier, interest and other expense, net consisted primarily of expense recorded for the fair value re-measurement of the contingent earn-out liabilities incurred as a result of the Company s recent acquisitions and was $0.2 million for both periods.

Income Taxes.

For the nine months ended September 28, 2013, the Company recorded an income tax provision of $58 thousand compared to an income tax benefit of $134 thousand for the comparable period of the prior year, for continuing operations.

Discontinued Operations.

In February 2012, we sold our aesthetics business to Cutera, Inc. The operating results and the associated assets and liabilities of our aesthetics business have been classified as discontinued operations for all periods presented.

Liquidity and Capital Resources.

Liquidity is our ability to generate sufficient cash flows from operating activities to meet our obligations and commitments. In addition, liquidity includes the ability to obtain appropriate financing or to raise capital.

As of September 28, 2013, we had cash and cash equivalents of $14.1 million, working capital of $23.8 million compared to cash and cash equivalents of $11.9 million and working capital of $20.7 million as of December 29, 2012. The increase in cash and cash equivalents for the nine months ended September 28, 2013 was generated primarily by income from continuing operations, after the add back of non-cash items, of $2.9 million, partially offset by changes in operating assets by $1.6 million. We used $0.2 million on capital expenditures and $0.3 million on paying the contingent earn-out liability. Exercises of stock options generated $1.1 million and we spent $0.2 million to purchase stock under our stock repurchase program, and we received $0.5million in cash from the release of funds held in escrow. See Item 2, Unregistered Sales of Equity Securities and Use of Proceeds in Part II, Other Information, for additional information.

Management is of the opinion that the Company s current cash and cash equivalents together with our ability to generate cash flows from operations provide sufficient liquidity to operate for the next 12 months.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Other Information

IRIDEX Corporation was incorporated in California in February 1989 as IRIS Medical Instruments, Inc. In November 1995, we changed our name to IRIDEX Corporation and reincorporated in Delaware. Our executive offices are located at 1212 Terra Bella Avenue, Mountain View, California 94043-1824, and our telephone number is (650) 940-4700. We can also be reached at our website at www.IRIDEX.com. Investors and others should note that we announce material financial information to our investors using SEC filings, press releases, our investor relations website, public conference calls and webcasts. We use these channels as well as social media to communicate with investors, customers and the public about our company, our products and other issues. It is possible that the information we post on social media channels could be deemed to be material information. We encourage investors, our customers, and others interested in our company to review the information we post on our Facebook page (www.facebook.com/IRIDEX) and Twitter feed (https://twitter.com/IRIDEX). Any information on, or that can be accessed through, our website and social media channels is not part of this report.

Item 3. Quantitative and Qualitative Disclosure about Market Risk

Market risk represents the risk of loss that may impact the financial position, results of operations or cash flows due to adverse changes in financial and commodity market prices and rates. We transact the majority of our business in US dollars and therefore changes in foreign currency rates will not have a significant impact on our income statement or cash flows. However, increases in the value of the US 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. As we continue to expand our international sales, our non-US dollar denominated revenue and our exposure to gains and losses on international currency transactions may increase. We currently do not engage in transactions to hedge against the risk of the currency fluctuation, but we may do so in the future.

Interest Rate Risk

Our exposure to interest rate risk at September 28, 2013 is related to our cash equivalent holdings. Since we have no fixed or variable interest rate debt outstanding, our interest expense is relatively fixed and not affected by changes in interest rates. In the event we issue any new debt in the future, increases in interest rates will increase the interest expense associated with the debt.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures, as such term is defined in Rules 13a-15(e) or 15d-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or

submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

As required by SEC Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of September 28, 2013. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the period covered by this Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we may be involved in legal proceedings arising in the ordinary course of business. We believe there is no litigation currently pending that could have, individually or in the aggregate, a material adverse effect on our operations or financial condition.

Item 1A. Risk Factors

Factors That May Affect Future Results

In addition to the other information contained in this Quarterly Report Form 10-Q, we have identified the following risks and uncertainties that may have a material adverse effect on our business, common stock price, financial condition or results of operation. You should carefully consider the risks described below before making an investment decision.

We have marked with an asterisk (*) those risk factors below that reflect substantive changes from the risk factors included in our Annual Report on Form 10-K filed with the SEC on March 28, 2013.

Our Operating Results May Fluctuate from Quarter to Quarter and Year to Year.

Our sales and operating results may vary significantly from quarter to quarter and from year to year in the future. Our operating results are affected by a number of factors, many of which are beyond our control. Factors contributing to these fluctuations include the following:

- general economic uncertainties and political concerns;
- the timing of the introduction and market acceptance of new products, product enhancements and new applications;
- changes in demand for our existing line of ophthalmology products;
- the cost and availability of components and subassemblies, including the willingness and ability of our sole or limited source suppliers to timely deliver components at the times and prices that we have planned;
- our ability to maintain sales volumes at a level sufficient to cover fixed manufacturing and operating costs;
- fluctuations in our product mix within ophthalmology products and foreign and domestic sales;

- the effect of regulatory approvals and changes in domestic and foreign regulatory requirements;

- introduction of new products, product enhancements and new applications by our competitors, entry of new competitors into our markets, pricing pressures and other competitive factors;

- our long and highly variable sales cycle;

- changes in the prices at which we can sell our products;

- changes in customers or potential customers budgets as a result of, among other things, reimbursement policies of government programs and private insurers for treatments that use our products; and

- increased product innovation costs.

In addition to these factors, our quarterly results have been, and are expected to continue to be, affected by seasonal factors. For example, our European sales during the third quarter are generally lower due to many businesses being closed for the summer vacation season.

Our expense levels are based, in part, on expected future sales. If sales levels in a particular quarter do not meet expectations, we may be unable to adjust operating expenses quickly enough to compensate for the shortfall of sales, and our results of operations may be adversely affected. In addition, we have historically made a significant portion of each quarter s product shipments near the end of the quarter. If that pattern continues, any delays in shipment of products could have a material adverse effect on results of operations for such quarter. Due to these and other factors, we believe that quarter to quarter and year to year comparisons of our past operating results may not be meaningful. You should not rely on our results for any quarter or year as an indication of our future performance. Our operating results in future quarters and years may be below expectations, which would likely cause the price of our common stock to fall.

* Our Stock Price Has Been and May Continue to be Volatile and an Investment in Our Common Stock Could Suffer a Decline in Value.

The trading price of our common stock has been subject to wide fluctuations in response to a variety of factors, some of which are beyond our control, including quarterly variations in our operating results, announcements by us or our competitors of new products or of significant clinical achievements, changes in market valuations of other similar companies in our industry and general market conditions. For the first nine months of fiscal 2013, the closing price of our common stock fluctuated from a low of $3.76 per share to a high of $6.50 per share. There can be no assurance that our common stock trading price will not suffer declines. Our common stock may experience an imbalance between supply and demand resulting from low trading volumes and therefore broad market fluctuations could have a significant impact on the market price of our common stock regardless of our performance.

We Rely on Continued Market Acceptance of Our Existing Products and Any Decline in Sales of Our Existing Products Would Adversely Affect Our Business and Results of Operations.

We currently market visible and infrared medical laser systems and delivery devices to the ophthalmology market. We believe that continued and increased sales, if any, of these medical laser systems is dependent upon a number of factors including the following:

- acceptance of product performance, features, ease of use, scalability and durability, including our MicroPulse laser photocoagulation systems ;

- recommendations and opinions by ophthalmologists, other clinicians, and their associated opinion leaders;

- clinical study outcomes;

- price of our products and prices of competing products and technologies particularly in light of the current macro-economic environment where healthcare systems and healthcare operators are becoming increasingly price sensitive;

- availability of competing products, technologies and alternative treatments; and

- level of reimbursement for treatments administered with our products.

In addition, we derive a meaningful portion of our sales in the form of recurring revenues from selling consumable instrumentation including our EndoProbe devices and service. Our ability to increase recurring revenues from the sale of consumable products will depend primarily upon the features of our current products and product innovation, the quality of our products, ease of use and prices of our products, including the relationship to prices of competing products. The level of our service revenues will depend on the quality of service we provide and the responsiveness and the willingness of our customers to request our services rather than purchase competing products or services. Any significant decline in market acceptance of our products or our revenues derived from the sales of laser consoles, delivery devices, consumables or services may have a material adverse effect on our business, results of operations and financial condition.

We Face Strong Competition in Our Markets and Expect the Level of Competition to Grow in the Foreseeable Future.

Competition in the market for devices used for ophthalmic treatment procedures is intense and is expected to increase. Our competitive position depends on a number of factors including product performance, characteristics and functionality, ease of use, scalability, durability and cost. Our principal competitors in ophthalmology are Alcon Inc., Carl Zeiss Meditec AG, Nidek Co. Ltd., Synergetics, Topcon Corporation, Ellex Medical Lasers, Ltd., Quantel Medical SA, and Lumenis Ltd. Most of these companies currently offer a competitive, semiconductor-based laser system for ophthalmology. Also within ophthalmology, pharmaceutical alternative treatments for AMD and DME such as Lucentis/Avastin (Genentech), Eylea (Regeneron), and to a lesser extent Visudyne (Novartis), Macugen (OSI Pharmaceuticals) and Ozurdex (Allergan) compete rigorously with traditional laser procedures. A number of these competitors have substantially greater financial, engineering, product development, manufacturing, marketing and technical resources than we do, including greater name recognition, and benefit from long-standing customer relationships. Some medical companies, academic and research institutions, or others, may develop new technologies or therapies that are more effective in treating conditions targeted by us or are less expensive than our current or future products. Any such developments could have a material adverse effect on our business, financial condition and results of operations.

Our Operating Results May be Adversely Affected by Uncertainty Regarding Healthcare Reform Measures and Changes in Third Party Coverage and Reimbursement Policies.

The recent decision to uphold the Patient Protection and Affordable Care Act means that we will be required to pay a 2.3% tax on our products sold in the US. If we are not able to pass this tax onto our customers, our profits will be significantly reduced or losses significantly enlarged.