

VISX INC  
Form 10-Q  
May 06, 2004

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D. C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2004**

**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 1-10694**

**VISX, INCORPORATED**

*(Exact name of registrant as specified in its charter)*

**Delaware**

**06-1161793**

*(State or other Jurisdiction of  
Incorporation or  
Organization)*

*(IRS Employer  
Identification No.)*

**3400 Central Expressway, Santa Clara, California 95051-0703**

*(Address of principal executive offices) (Zip Code)*  
*(Registrant s telephone number, including area code): (408) 733-2020*

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes (X) No ( )

Total number of shares of common stock outstanding as of April 22, 2004: 48,714,091.

---

**VISX, INCORPORATED**  
**TABLE OF CONTENTS**

	<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Unaudited Condensed Consolidated Interim Financial Statements</u></b>	
<u>Condensed Consolidated Interim Balance Sheets as of March 31, 2004 and December 31, 2003</u>	3
<u>Condensed Consolidated Interim Statements of Operations for the Three Months Ended March 31, 2004 and 2003</u>	4
<u>Condensed Consolidated Interim Statements of Cash Flows for the Three Months Ended March 31, 2004 and 2003</u>	5
<u>Notes to Condensed Consolidated Interim Financial Statements</u>	6
<b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	
<u>Overview</u>	11
<u>Results of Operations</u>	13
<u>Liquidity and Capital Resources</u>	16
<u>Critical Accounting Policies, Estimates and Judgments</u>	18
<b><u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u></b>	25
<b><u>Item 4. Controls and Procedures</u></b>	25
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>Item 1. Legal Proceedings</u></b>	26
<b><u>Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities</u></b>	26
<b><u>Item 5. Other Information</u></b>	26
<b><u>Item 6. Exhibits and Reports on Form 8-K</u></b>	27
<b><u>SIGNATURES</u></b>	28
<u>EXHIBIT 31.1</u>	
<u>EXHIBIT 31.2</u>	
<u>EXHIBIT 32.1</u>	

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Interim Financial Statements****VISX, INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED INTERIM BALANCE SHEETS**  
**(In thousands, except share and per share amounts)**

	<b>March 31, 2004</b>	<b>December 31, 2003</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 24,111	\$ 24,895
Short-term investments	76,628	61,181
Accounts receivable, net of allowance for doubtful accounts of \$4,102 and \$4,195 respectively	27,641	27,432
Inventories	11,336	11,219
Deferred tax assets and prepaid expenses	15,881	20,450
	<hr/>	<hr/>
Total current assets	155,597	145,177
<b>Property and Equipment, net</b>	3,883	3,850
<b>Long-Term Deferred Tax and Other Assets</b>	13,772	14,936
	<hr/>	<hr/>
Total assets	\$ 173,252	\$ 163,963
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities:</b>		
Accounts payable	\$ 3,604	\$ 3,442
Accrued liabilities and other current liabilities	37,666	34,722
	<hr/>	<hr/>
Total current liabilities	41,270	38,164
	<hr/>	<hr/>
<b>Stockholders Equity:</b>		
Common stock: \$.01 par value, 180,000,000 shares authorized; 64,990,089 shares issued at March 31, 2004 and December 31, 2003, respectively	650	650
Additional paid-in capital	199,339	201,108
Treasury stock, at cost 16,447,903 and 16,295,297 shares, at	(262,091)	(258,218)

Edgar Filing: VISX INC - Form 10-Q

March 31, 2004 and December 31, 2003 respectively

Accumulated other comprehensive income	410	341
Retained earnings	<u>193,674</u>	<u>181,918</u>
Total stockholders' equity	<u>131,982</u>	<u>125,799</u>
Total liabilities and stockholders' equity	<u>\$ 173,252</u>	<u>\$ 163,963</u>

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

Page 3 of 29

---

Table of Contents**VISX, INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED INTERIM STATEMENTS OF OPERATIONS**  
**(In thousands, except per share amounts)**

	<b>Three months ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(unaudited)</b>	
<b>Revenues:</b>		
License and other revenues	\$32,487	\$19,677
System revenues	6,076	9,926
Service and parts revenues	5,242	4,830
	<hr/>	<hr/>
Total revenues	43,805	34,433
	<hr/>	<hr/>
<b>Costs and Expenses:</b>		
Cost of license and other revenues	980	832
Cost of system revenues	5,291	8,379
Cost of service and parts revenues	3,598	3,613
Selling, general and administrative	9,757	9,454
Research, development and regulatory	5,044	4,046
	<hr/>	<hr/>
Total costs and expenses	24,670	26,324
	<hr/>	<hr/>
<b>Income From Operations</b>	19,135	8,109
Interest and other income	328	943
	<hr/>	<hr/>
<b>Income Before Provision For Income Taxes</b>	19,463	9,052
Provision for income taxes	7,707	3,576
	<hr/>	<hr/>
<b>Net Income</b>	<b>\$11,756</b>	<b>\$ 5,476</b>
	<hr/>	<hr/>
<b>Earnings Per Share:</b>		
Basic	\$ 0.24	\$ 0.11
	<hr/>	<hr/>

Diluted	\$ 0.23	\$ 0.11
	<u>          </u>	<u>          </u>
<b>Shares Used For Earnings Per Share:</b>		
Basic	48,672	51,342
	<u>          </u>	<u>          </u>
Diluted	50,433	51,805
	<u>          </u>	<u>          </u>

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

**Table of Contents****VISX, INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CASH FLOWS****(In thousands)**

	<b>Three months ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(unaudited)</b>	
<b>Cash flows from operating activities:</b>		
Net income	\$ 11,756	\$ 5,476
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,185	1,274
Provision for doubtful accounts receivable	85	209
Increase (decrease) in cash flows from changes in operating assets and liabilities:		
Accounts receivable	(297)	(1,577)
Inventories	(1,326)	(3,219)
Deferred tax assets and prepaid expenses	4,260	3,360
Long-term deferred tax and other assets	996	872
Accounts payable	162	1,276
Accrued liabilities and other current liabilities	2,939	(440)
	<hr/>	<hr/>
Net cash provided by operating activities	20,760	7,231
	<hr/>	<hr/>
<b>Cash flows from investing activities:</b>		
Capital expenditures	(540)	(251)
Purchases of available for sale securities	(18,054)	(14,882)
Proceeds from maturities of available for sale securities	2,684	6,971
	<hr/>	<hr/>
Net cash (used in) investing activities	(15,910)	(8,162)
	<hr/>	<hr/>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock	2,476	72
Repurchases of common stock	(8,118)	<hr/>
	<hr/>	<hr/>
Net cash provided by (used in) financing activities	(5,642)	72
	<hr/>	<hr/>
Effect of exchange rate changes on cash and cash equivalents	8	



	_____	_____
Net (decrease) in cash and cash equivalents	(784)	(859)
Cash and cash equivalents, beginning of period	24,895	37,687
	_____	_____
Cash and cash equivalents, end of period	\$ 24,111	\$ 36,828
	_____	_____
<b>Supplemental Cash Flow Information:</b>		
Cash paid (refunded) for income taxes	\$ 959	\$ (10)
	_____	_____
Non-cash investing activities:		
Inventory transferred to deferred costs under operating leases	\$ 1,203	\$ 1,726
	_____	_____

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

Table of Contents**VISX, INCORPORATED AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS****March 31, 2004****(Unaudited)****1. Significant Accounting Policies**

*Basis of Presentation.* We prepared our Condensed Consolidated Interim Financial Statements in conformity with Securities and Exchange Commission rules and regulations. Accordingly, we condensed or omitted certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States. Please read our 2003 Annual Report on Form 10-K to gain a more complete understanding of these interim financial statements.

We included in these interim financial statements all adjustments (consisting primarily only of normal recurring adjustments) that in our opinion are necessary to present fairly our results for the interim period. Our interim financial statements have not been audited.

*Earnings Per Share.* Basic earnings per share ( EPS ) equals net income divided by the weighted average number of common shares outstanding. Diluted EPS equals net income divided by the weighted average number of common shares outstanding plus dilutive potential common shares calculated in accordance with the treasury stock method. All amounts in the following table are in thousands, except per share data, and are unaudited.

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Net income	\$11,756	\$ 5,476
Basic earnings per share		
Income available to common shareholders	\$11,756	\$ 5,476
Weighted average common shares outstanding	48,672	51,342
Basic Earnings Per Share	\$ 0.24	\$ 0.11
Diluted earnings per share		
Income available to common shareholders	\$11,756	\$ 5,476
Weighted average common shares outstanding	48,672	51,342
Dilutive potential common shares from stock options	1,761	463

Weighted average common shares and dilutive potential common shares	<u>50,433</u>	<u>51,805</u>
Diluted Earnings Per Share	<u>\$ 0.23</u>	<u>\$ 0.11</u>

Options to purchase 2,172,000 and 6,597,000 shares with a weighted average exercise price of \$33.80 and \$21.51, during the three-month periods ended March 31, 2004 and 2003, respectively, were excluded from the computation of diluted EPS because the options' exercise prices were greater than the average market price of our common stock during these periods and would have been anti-dilutive.

**Table of Contents**

*Stock-Based Employee Compensation.* We account for stock-based employee compensation arrangements using the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ) and Financial Accounting Standards Board ( FASB ) Interpretation No. 44 ( FIN 44 ), Accounting for Certain Transactions Involving Stock Compensation an Interpretation of APB No. 25 and comply with the disclosure provisions of Statement of Financial Accounting Standards No. 148, Accounting For Stock-Based Compensation Transition and Disclosure ( SFAS 148 ). In accordance with APB 25 and FIN 44, we record no stock-based employee compensation cost in our net income because (1) all options granted under our stock option plans have an exercise price equal to the market value of the underlying common stock on the date of grant and (2) stock purchased through our Employee Stock Purchase Plan is priced at 85% of the fair market value of the stock on the first day of a two-year offering period or as of the end of each six month purchase segment of a two year offering period, whichever is lower. The following table illustrates the effect on net income and earnings per share if we had applied the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ), to stock-based employee compensation (unaudited, in thousands, except per share data).

		<b>Three Months Ended March 31,</b>	
		<b>2004</b>	<b>2003</b>
	As Reported	\$ 11,756	\$ 5,476
Net Income			
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		<u>(1,947)</u>	<u>(1,817)</u>
	Pro Forma	<u>\$ 9,809</u>	<u>\$ 3,659</u>
Net Income			
	As Reported	\$ 0.24	\$ 0.11
Basic Earnings Per Share			
	Pro Forma	0.20	0.07
	As Reported	\$ 0.23	\$ 0.11
Diluted Earnings Per Share.			
	Pro Forma	0.20	0.07

For purposes of computing pro forma net income, we estimate the fair value of each option grant and employee stock purchase plan purchase right on the date of grant using the Black-Scholes option pricing model. The assumptions used to value the option grants and purchase rights are stated as follows:

**Three months ended  
March 31,**

	<b>2004</b>	<b>2003</b>
Expected life of options (in years)	5.36	4.36
Expected life of ESPP rights (in years)	1.25	1.25
Volatility for options	72%	76%
Volatility for ESPP rights	59%	60%
Risk free interest rate for options	2.86%	2.55%
Risk free interest rate for ESPP rights	1.71%	1.63%
Dividend yield	0.0%	0.0%

The weighted average fair value of options granted under our stock option plans during the three month periods ended March 31, 2004 and 2003 was \$12.34 and \$4.82, respectively. The weighted average fair value per share of options granted under the ESPP during the three month periods ended March 31, 2004 and 2003 was \$4.30 and \$3.64, respectively.

**Table of Contents**

These pro forma amounts may not be representative of the effects for future years as options vest over several years and additional awards are generally made each year.

**2. Segment Reporting**

*Segments.* Statement of Financial Accounting Standards No. 131, Disclosures About Segments of an Enterprise and Related Information, ( SFAS No. 131 ) established standards for reporting information about operating segments in financial statements. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or chief operating decision making group, in deciding how to allocate resources and in assessing performance. Our CEO is our chief operating decision maker. Our business is focused on one operating segment, products and procedures to improve people's vision with laser vision correction. All of our revenues and profits are generated through the sale, licensing, and service of products for this one segment.

*Export Revenues.* Export revenues accounted for 14% and 21% of total revenues for the three month periods ended March 31, 2004 and 2003 respectively. We did not generate export revenues to any country that equaled or exceeded 10% of our total revenues for either of the three month periods ended March 31, 2004 and 2003. In the following table we have presented our export revenues by geographic region (in thousands):

	<b>Three months ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(Unaudited)</b>	
Europe	\$1,980	\$1,956
Americas (excluding the United States)	895	945
Asia and Other	3,140	4,479
	<u>        </u>	<u>        </u>
	<b>\$6,015</b>	<b>\$7,380</b>
	<u>        </u>	<u>        </u>

Substantially all of our long-term assets are located in the United States.

*Major Customers.* A significant portion of our revenues is derived from sales to TLC Vision Corporation ( TLC ). Sales to TLC accounted for 29% and 13% of total revenues in the first quarter of 2004 and 2003, respectively. Additionally, TLC accounted for 24% and 22% of our total receivables at March 31, 2004 and December 31, 2003, respectively.

**3. Inventories**

Components of inventories are as follows (in thousands):

**March 31,**                      **December 31,**

	<u>2004</u>	<u>2003</u>
	<b>(Unaudited)</b>	
Raw materials and subassemblies	\$ 6,678	\$ 7,786
Work-in-process	1,722	1,321
Finished goods	<u>2,936</u>	<u>2,112</u>
	<u>\$11,336</u>	<u>\$11,219</u>

**Table of Contents****4. Comprehensive Income**

We report components of comprehensive income in our annual consolidated statements of stockholders' equity. Components of comprehensive income (unaudited, in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Net income	\$11,756	\$5,476
Other comprehensive income (net of tax effects)		
Increase (decrease) in accumulated unrealized holding gains on available-for-sale securities	77	(122)
Change in accumulated foreign currency translation adjustment	(8)	
	<u>          </u>	<u>          </u>
Comprehensive income	<u>\$11,825</u>	<u>\$5,354</u>

**5. Warranty Obligations**

Changes in product warranty obligations for the periods ended March 31, 2004 and 2003 are as follows (unaudited, in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Balance as of the beginning of the period	\$1,779	\$1,963
Expense accrued (recoveries recognized)	(14)	768
Cost of services provided	(419)	(751)
	<u>          </u>	<u>          </u>
Balance as of the end of the period	<u>\$1,346</u>	<u>\$1,980</u>

**6. Stockholders' Equity**

On April 4, 2001, our Board of Directors authorized a new Stock Repurchase Program under which up to 10 million shares of VISX common stock may be repurchased. In accordance with this authorization and applicable securities laws, we have repurchased 7.5 million shares cumulatively on the open market through March 31, 2004 at a total cost of \$98.6 million. Accordingly, 2.5 million shares remain available as of March 31, 2004 for repurchase under the



Board of Directors April 2001 authorization. On May 28, 2003, the Board of Directors authorized the repurchase of an additional 3.5 million shares of VISX stock at a total cost of \$63.0 million, all of which were purchased during the quarter ended June 30, 2003.

## **7. New Accounting Pronouncements**

In December 2003, the FASB revised Interpretation No. 46 ( FIN 46 ), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 which it had originally issued in January 2003. As revised, FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. As revised, application of FIN 46 is required for

**Table of Contents**

interests in special-purpose entities for periods ending after December 15, 2003. Application for all other types of entities covered by FIN 46 is required in financial statements for periods ending after March 15, 2004. The adoption of FIN 46 as revised, did not have a material impact on our financial position or results of operations.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150 ( SFAS 150 ), Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity . SFAS 150 requires that certain financial instruments, which under previous guidance were accounted for as equity, must now be accounted for as liabilities. The financial instruments affected include mandatory redeemable stock, certain financial instruments that require or may require the issuer to buy back some of its shares in exchange for cash or other assets and certain obligations that can be settled with shares of stock. SFAS 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, although certain aspects have been delayed pending further clarifications. The Company currently does not have any financial instruments that are within the scope of this statement.

**8. Reclassifications**

Certain reclassifications were made to prior year financial data to conform with current year presentation.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This Report contains forward-looking statements, including but not limited to: our belief that our CustomVue procedure represents a new standard in laser vision correction; our belief that ongoing technical advances (including our CustomVue procedure) have the potential to improve a person's vision beyond that which can be obtained with contact lenses or glasses and may reduce concerns perceived by some consumers; our belief that acceleration of the market's acceptance of, and conversion to, our CustomVue procedure, or our ability to maintain or gain market share, or an increase in our penetration of the laser vision correction market in general, could cause an increase in our licensing revenue; our plan to continue to generate cash from our ongoing business in 2004; our intention to continue to repurchase shares of our common stock in 2004; our near-term level of expenditures; our belief that ongoing technical advances will enhance patients' vision, which may increase customer acceptance of laser vision correction surgery; our belief that our revenue and profit in 2004 will improve compared to 2003; our belief that operating expenses will increase 5% to 9% compared to 2003; our target of increasing operating margins to in excess of 35% of revenues; our expectation that we will continue to generate cash from operations; our belief that customers will increase adoption of CustomVue; our belief that license and other revenues will increase in 2004 compared to 2003; our belief that there will be no significant growth in revenues from laser system revenues in 2004 and that the sale of WaveScan Systems will be less than in 2003; our expectation that service revenues will be lower in the remaining quarters of 2004; our anticipation that gross profit margin will decrease through the remainder of 2004 as revenues from per-procedure based service plans generate lower revenues; our current operations plan for the remainder of 2004; our belief that operations will generate cash in 2004 at a level equal to or greater than in 2003; and our belief that cash from operations will exceed cash required to fund our working capital and capital equipment needs during the coming twelve months. These forward-looking statements are estimates reflecting the best judgment of our senior management, and they involve a number of risks and uncertainties that could cause actual results to differ materially from those suggested by the forward-looking statements. The risks and uncertainties include the potential reduction in demand for our equipment and upgrades, and the potential decline in demand for procedures caused by the weakness in the economy, consumer confidence and stock markets in the United States in recent years. In addition, please see the disclosure under the caption "Risk Factors" at the end of Item 2. Moreover, we caution you not to place undue reliance on these forward-looking statements, which speak only as of the date they were made. We do not undertake any obligation to publicly release any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events.

**Overview**

VISX, Incorporated ( "VISX" ), a Delaware corporation organized in 1988, is a worldwide leader in the design and development of proprietary technologies and systems for laser vision correction. Our primary operations are in Santa Clara, CA.

Our products require FDA approval in the United States and comparable regulatory agency approvals in other countries. Our approvals in the United States and key markets worldwide for laser vision correction cover most types of refractive vision disorders including:

Nearsightedness;

Farsightedness; and

Astigmatism.

Our CustomVue procedure is also available for all of these refractive vision disorders in certain key international markets. In May 2003, we obtained FDA approval for our new CustomVue procedure for nearsightedness and

astigmatism.

We sell products worldwide and generate the majority of our revenues and cash through licensing fees charged for the performance of laser vision correction procedures using the VISX STAR Excimer Laser System ( VISX STAR System ). The license fee charged for a particular procedure depends on whether the procedure is performed in the United States or internationally, and the type of procedure

**Table of Contents**

involved. In the United States, we have always charged a license fee for our standard procedure and charge a license fee for our CustomVue procedure that is more than twice the amount charged for our standard procedure. Additionally, we charge a standard price of \$10 per procedure for treatment cards. Internationally, for standard procedures we charge a small price per procedure for the treatment card. For CustomVue procedures we charge a significantly larger price per procedure.

We believe our CustomVue procedure, which requires use of a WaveScan System, represents a new standard in laser vision correction. It enables doctors to identify, measure, and correct imperfections in a patient's eye much more precisely than ever before, thus creating the potential for patients to experience better vision than is possible with glasses or contact lenses.

We believe we have the largest installed base of laser vision correction systems, with over 1300 VISX Star Systems in place worldwide. We also believe we maintained at least 60% market share for procedures performed in the United States in 2003. According to MarketScope, we have held at least 60% market share since 1997.

Licensing revenues comprise the majority of our revenues and generated in excess of 90% of our gross profit dollars. They are predominantly derived from license fees from our United States customers. Licensing revenues grew 65% in the three month period ended March 31, 2004 compared with the corresponding period in 2003 and generated approximately 97% gross profit margin on the sale of procedures. We evaluate this aspect of our business by tracking the following:

The number of procedures sold;

Trends in procedures sales, including conversion rates from standard to CustomVue procedures; and

Market share for VISX and its competitors.

Any increase in license fee revenue that results from either an increase in the amount charged for a particular procedure or from an increase in overall procedure volume directly impacts our net income. As a result, our management team is focused on activities that will (i) accelerate the market's acceptance of, and conversion to, our CustomVue procedure; (ii) enable VISX to maintain or gain market share; and (iii) increase the laser vision correction market in general. Progress on any one of these fronts offers the potential for growth in our licensing revenue.

We manage our expenses closely and plan to continue to generate cash from our ongoing business operations in 2004. Historically, our primary non-operating use of cash has been to repurchase shares of our common stock. We bought 0.4 million shares of stock in the first quarter of 2004 and intend to continue to repurchase additional shares through the remainder of 2004. We will also continue to investigate areas where we can expand our presence in the refractive surgery market. This could result in using cash for the acquisition of technology or a business. Our capital expenditures have been in the range of \$2.3 million to \$4 million per year in the past five years. We do not expect a near-term change in this level of expenditures. We have no long term debt.

Looking to the remainder of 2004, our business is highly leveraged on procedure volume, and increasingly, the conversion to CustomVue procedures. A number of factors, the most material of which are set forth below, could impact our success in 2004 and beyond:

Market acceptance of laser vision correction. Increased acceptance of laser vision correction by both doctors and patients in the United States and key international markets is essential for our

**Table of Contents**

continued growth. Laser vision correction has penetrated less than 6% of the eligible United States population, and our profitability and continued growth will be largely dependent on increasing levels of market acceptance and procedure growth, especially with regard to our higher-priced CustomVue procedure. We expect that ongoing technical advances, such as the CustomVue procedure, will enhance the quality of patients' vision which may also increase consumer acceptance of laser vision correction surgery.

Our ability to obtain additional FDA approvals. We continue to expand the list of FDA approved indications that can be treated by our systems. As we receive approvals for additional types and ranges of refractive disorders from the FDA, the pool of eligible laser vision correction candidates increases, raising the potential for growth in procedures, CustomVue adoption and licensing revenue.

Our competition. Competition in the laser vision correction market is intense. Many of our competitors have greater resources and a stronger international market presence. As a result, we compete aggressively to obtain procedure market share.

The United States economy. Because we have always charged a license fee for procedures sold in the United States, the United States remains, by far, our most significant market for licensing revenue. Economic conditions in the United States therefore impact our licensing revenue more than global economic conditions. Industry analysts have tracked procedure volume in the United States against economic indicators such as consumer confidence. They have noted a correlation between consumer confidence and the number of laser vision correction procedures performed per quarter. We believe that the rebound in the United States economy and increases in consumer confidence have provided renewed support for the laser vision correction market in the United States. A decline in economic conditions in the United States could result in a decline in the number of laser vision correction procedures performed.

We believe that our revenue and profit in 2004 will improve compared to 2003 as a result of various factors including continued conversion to the CustomVue procedure, maintenance, at least, of our United States market share, and improvements in the United States economy. For 2004, we anticipate that operating expenses will increase 5% to 9% compared to 2003 with a target of increasing our operating margins to in excess of 35% of revenues. We expect to continue to generate cash from operations.

**Results of Operations**

	<b>Three Months Ended March 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>Change</b>
License and other revenues	\$32,487	\$19,677	65%
<i>Percent of total revenues</i>	<i>74.2%</i>	<i>57.2%</i>	
System revenues	6,076	9,926	(39)%
<i>Percent of total revenues</i>	<i>13.9%</i>	<i>28.8%</i>	
Service and parts revenues	5,242	4,830	9%
<i>Percent of total revenues</i>	<i>11.9%</i>	<i>14.0%</i>	
Total revenues	\$43,805	\$34,433	27%

*License and Other Revenues*

**Table of Contents**

License and other revenues grew 65%, or \$12.8 million, in the first quarter of 2004 compared with 2003, reflecting primarily increased adoption of our new CustomVue procedure and 20% procedure growth in the United States. We introduced the CustomVue procedure in June 2003 in the United States and sell the product for more than double the price of our standard procedure. In the United States, CustomVue procedures represented 34.3% of the procedure orders in the first quarter of 2004.

Based on economists' projections for further improvements in the United States economy in 2004 and our belief that customers will increase adoption of our CustomVue product, we continue to believe that license and other revenues will increase in 2004 compared to 2003. The decision to have laser vision correction surgery is influenced by many factors. The procedure is elective and generally not covered by medical insurance; therefore it competes with many types of purchases for consumers' discretionary spending. Perceptions about safety and effectiveness of the procedure are additional considerations. The lack of long-term follow-up studies of the procedure combined with media coverage of selected unfavorable outcomes may contribute to uncertainty and delay by some potential consumers. Economic uncertainties may also impact the interest in laser vision correction. As such, we cannot accurately predict when, or to what extent, these anticipated changes in the economy and technology will impact our license and other revenues.

*System Revenues*

System revenues comprise sales and leases of the following equipment:

VISX STAR Systems;

Upgrades to the VISX STAR System; and

WaveScan Systems.

System revenues were negatively impacted by:

Fewer VISX STAR System sales due primarily to softness of laser markets and competitive pricing pressures.

Fewer WaveScan System sales as at least 80% of our United States customers now have one or more WaveScan Systems.

The market for laser systems remains competitive. We experienced lower per unit pricing on laser sales in the first quarter of 2004 compared with the comparable period of 2003. MarketScope estimates that VISX is the leader in the worldwide market with approximately 30% of worldwide laser placements.

In the remainder of 2004, we believe there will be no significant growth in revenues from laser system revenues and that the sale of WaveScan Systems will be less than in 2003, since most of our customers have already purchased a WaveScan System.

*Service and parts revenues*

Service and parts revenues in the first quarter of 2004 were \$0.4 million higher than the comparable period of 2003 due primarily to higher revenues derived from customers that purchased service on a per procedure basis. Historically, procedure volume has been highest in the first quarter, therefore we expect service revenues to be lower in the remaining quarters of 2004.

**Table of Contents**

	<b>Three Months Ended March 31,</b>		
	<b>2004</b>	<b>2003</b>	<b>Change</b>
Cost of license and other revenues	980	832	18%
<i>Percent of related revenues</i>	<i>3.0%</i>	<i>4.2%</i>	
Cost of system revenues	5,291	\$8,379	(37)%
<i>Percent of related revenues</i>	<i>87.1%</i>	<i>84.4%</i>	
Cost of service and parts revenues	3,598	3,613	%
<i>Percent of related revenues</i>	<i>68.6%</i>	<i>74.8%</i>	
Selling, general and administrative	9,757	9,454	3%
<i>Percent of total revenues</i>	<i>22.3%</i>	<i>27.5%</i>	
Research, develop. and regulatory	5,044	4,046	25%
<i>Percent of total revenues</i>	<i>11.5%</i>	<i>11.8%</i>	
<i>Cost of license and other revenues</i>			

Cost of license and other revenues increased in the first quarter of 2004 from the comparable period of the prior year due to the increased number of procedures. The gross profit margin increased slightly as the fixed cost components were spread over a larger revenue base.

*Cost of system revenues*

Cost of system revenues decreased 37%, or \$3.1 million, in the first quarter of 2004 from the comparable period of the prior year. Sales of lasers, upgrades and WaveScan Systems decreased and the overall gross profit margin decreased as the competitive pricing pressure for excimer lasers reduced the average system selling price with no corresponding reduction in average system cost. Warranty expense decreased in the first quarter of 2004 from the comparable period of the prior year due to the reduced incidence of service calls for systems under warranty.

*Cost of service and parts revenues*

Cost of service and parts revenues was largely unchanged in the first quarter of 2004 compared to the comparable quarter of 2003. The overall gross profit margin increased to 31.4% in the first quarter of 2004 compared to 25.2% in the corresponding quarter of 2003 as labor service costs are relatively fixed and parts usage does not increase with procedure volume. We anticipate that our gross profit margin percentage for the balance of 2004 will be lower than the first quarter of 2004 as revenues from per-procedure based service plans generate lower revenues.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses increased by approximately \$0.3 million to \$9.8 million in the first quarter of 2004 compared with the corresponding period of 2003. The change reflects primarily the following items:

Selling expenses increased \$0.8 million primarily reflecting increased headcount and additional commission costs due to the increase in procedure revenues; and

Marketing costs decreased \$0.4 million primarily due to a reduction in professional media costs due to the launch of CustomVue in 2003.

For the remainder of 2004, our current plan for operations includes:



Continued modest increases in marketing and sales expenses as we continue to promote our CustomVue procedure;

A modest increase in administrative spending to reflect the growth in our operations and the cost of compliance with the provisions of the Sarbanes Oxley Act; and

**Table of Contents**

An net increase in legal expenses in 2004, due to the significant insurance reimbursements received in 2003.  
*Research and Development and Regulatory Expenses*

Our research and development and regulatory expenses increased by approximately \$1.0 million in the first quarter of 2004 compared to the corresponding period of 2003. The increase relates primarily to our ongoing focus on next generation technologies and developments for laser vision correction, including:

Laser system advancements;

New methods for correcting vision disorders including further indications (such as hyperopia and high myopia) for our CustomVue treatment; and

Continued research and clinical trials for treatment of presbyopia;

We believe these factors will result in an increase of 5% to 9% in the combined total of our selling, general and administrative, and research and development and regulatory expenses.

*Interest and Other Income*

Interest income declined in the first quarter of 2004 from the comparable period of 2003 as a result of:

Lower average cash balances due to use of cash for the repurchase of our stock; and

Lower average yields on our portfolio of cash and investments compared to the first quarter of 2003 due to market declines in interest rates.

*Income Tax Provision*

Our effective tax rate of 39.6% remained approximately constant in the first quarter of 2004 compared to the comparable period of 2003.

**Liquidity and Capital Resources**

Cash, cash equivalents and short-term investments ( cash ) and working capital were as follows (in thousands):

	<b>March 31, 2004</b>	<b>December 31, 2003</b>
	<b>(Unaudited)</b>	
Cash, cash equivalents and short-term investments	\$ 100,739	\$ 86,076
Working capital	114,327	107,013
Stockholders' equity	131,982	125,799

Our cash, cash equivalents and short-term investments consist principally of money market funds and bonds issued by the United States government, government sponsored enterprises and corporations. All of our short-term investments are classified as available-for-sale under the provisions of Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. The securities are carried at fair market value with the unrealized gains and losses, net of tax, included in accumulated other comprehensive income, which is reflected as

a separate component of stockholders equity. Gains and losses are recognized when realized on the consolidated statements of operations.

**Table of Contents**

Cash, cash equivalents and short-term investments were \$100.7 million at March 31, 2004, an increase of \$14.7 million compared with December 31, 2003. It was impacted principally by:

Stock repurchases of \$8.1 million;

Positive cash flow from operating activities of \$20.8 million; and

Proceeds from issuance of common stock related to employee participation in employee stock programs generating \$2.5 million.

Operating activities generated \$20.8 million in cash in the first quarter of 2004 compared with \$7.2 million provided in the corresponding period of 2003. In the first quarter of 2004 we:

Generated \$14.0 million of cash from net income plus non-cash related expenses (\$2.3 million);

Increased accrued liabilities balances due primarily to a \$3.1 million increase in income taxes payable;

Decreased deferred tax assets and prepaid expenses due primarily to the utilization of prepaid tax assets of \$4.3 million.

Net cash used by investing activities was \$15.9 million in the first quarter of 2004, up from \$8.2 million used in the corresponding period of 2003. The principal movements in cash used in investing activities were due to the investment in, and maturity of, short-term investments.

Cash used in financing activities was \$5.6 million in the first quarter of 2004, compared to \$0.1 million provided in the corresponding period of 2003. The principal factor that contributed to the cash used in financing activities was the cash used of \$8.1 million to repurchase 0.4 million shares of VISX stock on the open market in the first quarter of 2004. This was partially offset by cash received upon the issuance of stock under employee stock programs of \$2.5 million and \$0.1 million in 2004 and 2003, respectively.

On April 4, 2001, our Board of Directors authorized a Stock Repurchase Program under which up to 10 million shares of VISX common stock may be repurchased. In accordance with this authorization and applicable securities laws, we have repurchased 7.5 million shares on the open market cumulatively through March 31, 2004, at a total cost of \$98.6 million. Accordingly, 2.5 million shares remain available as of March 31, 2004 for repurchase under the Board of Directors April 2001 authorization. On May 28, 2003, the Board of Directors authorized the repurchase of an additional 3.5 million shares of VISX stock at a total cost of \$63.0 million, all of which were purchased during the quarter ended June 30, 2003. Before repurchasing shares we consider a number of factors including market conditions, the market price of the stock, and the number of shares needed for employee benefit plans. As a result, we cannot predict the number of shares that we may repurchase in the future.

Purchases of short-term investments represent reinvestment into short-term investments of the proceeds from short-term investments that matured and investment of cash and cash equivalents. As of March 31, 2004, we did not have any borrowings outstanding, nor any credit agreements.

Our normal credit terms granted to customers are net 30 to 60 days. In an effort to promote the growth of the laser vision correction industry and the use of VISX STAR Systems and WaveScan Systems, we provide long-term financing to customers for their purchase of our equipment in certain markets. We consider a number of factors including industry practice, competition, and our evaluation of customers credit worthiness in determining when to offer such financing.

We believe our operations will generate cash in 2004 at a level equal to or greater than in 2003. We believe this will exceed cash required to fund our working capital and capital equipment needs during the coming twelve months. In addition, we have \$100.7 million in cash, cash equivalents and short-term

## **Table of Contents**

investments as of March 31, 2004 to provide for unforeseen contingencies and to support strategic objectives including the development or acquisition of new technologies and our Stock Repurchase Program.

### **Critical Accounting Policies, Estimates and Judgments**

We follow accounting principles generally accepted in the United States ( GAAP ) in preparing our financial statements. As part of this process, we must make many estimates and judgments about future events. These affect the value of the assets and liabilities, contingent assets and liabilities, and revenues and expenses reported in our financial statements. We believe these estimates and judgments are reasonable and we make them in accordance with our accounting policies based on information available at the time. However, actual results could differ from our estimates and could require us to record adjustments to expenses or revenues material to our financial position and results of operations in future periods. We believe our most critical accounting policies, estimates and judgments include the following:

#### *Revenue Recognition*

We are required to ensure that collectibility is reasonably assured before we recognize revenue. Accordingly, we evaluate our customers for credit worthiness and only recognize revenue if we believe that we have reasonable assurance that amounts will be collected. Where we are unable to assess with reasonable assurance that amounts will be collected, we defer revenue recognition until the payments are received. This is occasionally the case with customers who have recently set themselves up in business and typically where the customer is thinly capitalized.

#### *Accounts Receivable*

At the end of each accounting period, we estimate the reserve necessary for accounts receivable that will ultimately not be collected from customers. To develop this estimate, we review all receivables and identify those accounts with problems. For these problem accounts, we estimate individual, specific reserves based on our analysis of the payment history, operations and finances of each account. For all other accounts, we review historical bad debt trends, general and industry specific economic trends, customer concentrations, and current payment patterns to estimate the reserve necessary to provide for payment defaults that cannot be specifically identified but can be expected with reasonable probability to occur in the future. We face two particular challenges in estimating these reserves: concentration of credit with certain large customers and the potential for significant change in the overall health of the national economies in the markets we serve. Unexpected deterioration in the health of either a large customer or a national economy could lead to a material adverse impact on the collectibility of our accounts receivable and our future operating results. Our allowance for doubtful accounts at March 31, 2004 and December 31, 2003 as a percentage of gross accounts receivable was 12.1% and 13.2% respectively. At March 31, 2004, a one-percentage point deviation in our allowance for doubtful accounts as a percentage of accounts receivable would have resulted in an increase or decrease in expense of approximately \$0.3 million.

#### *Inventories*

Adjustments to the carrying value of inventory for excess and obsolete items are based, in part, on our estimate of demand over the following 6 months. This estimate, though based on our historical experience and consideration of other relevant factors, (such as the current economic climate), is subject to some uncertainty. Amounts charged to income for excess and obsolete inventory for the quarters ending March 31, 2004 and 2003 respectively as a percentage of total revenues in those periods, were all less than 1.0%. To date, our estimates have been materially accurate. We do not expect either our



## **Table of Contents**

methodology or the accuracy of our estimates to change significantly in the future unless there are any major changes in our business model, our operating environment or the economy, or the ongoing development of our technology.

### *Legal Contingencies*

At the end of each accounting period, we review all outstanding legal matters. If we believe it is probable that we will incur a loss as a result of the resolution of a legal matter and we can reasonably estimate the amount of the loss, we accrue our best estimate of the potential loss. It is very difficult to predict the future results of complex legal matters, although historically, the amounts we have paid out have been materially similar to the amounts that we have accrued. New developments in legal matters can cause changes in previous estimates and result in significant changes in loss accruals. Currently we are not aware of any pending or threatened legal actions against us that we believe could materially adversely affect our business, financial condition or results of operations. However, we could in the future be subject to litigation claims that could cause us to incur significant expenses and put our business, financial position, and results of operations at material risk.

### **Risk Factors**

This report contains forward-looking statements that involve risk and uncertainty. The factors set forth below, which are not the only risks we face, may cause our actual results to vary from those contemplated by forward-looking statements set forth in this report and should be considered carefully in addition to the other information presented in this report. If any of the following risks actually occur, our business, results of operations or cash flows could be adversely affected. Our results of operations have varied widely in the past and could continue to vary significantly. In addition, our actual results may differ significantly from the results contemplated by the forward-looking statements. Accordingly, we believe that our results of operations in any given period may not be a good indicator of our future performance.

*Market Acceptance.* Our business depends upon broad market acceptance of laser vision correction by both doctors and patients in the United States and key international markets. Laser vision correction has penetrated less than 6% of the eligible United States population, and our profitability and continued growth will be largely dependent on increasing levels of market acceptance and procedure growth, especially with regard to our higher-priced CustomVue procedure. Although laser vision correction offers a more predictable outcome and more precise results than other surgical methods used to correct refractive disorders, it is not without risk. Potential complications and side effects include: post-operative discomfort, corneal haze (an increase in the light scattering properties of the cornea) during healing, glare/halos (undesirable visual sensations produced by bright lights), decreases in contrast sensitivity, temporary increases in intraocular pressure in reaction to procedure medication, modest fluctuations in refractive capabilities during healing, modest decrease in best corrected vision (i.e., with corrective eyewear), unintended over- or under-corrections, regression of effect, disorders of corneal healing, corneal scars, corneal ulcers, and induced astigmatism (which may result in blurred or double vision and/or shadow images). Some consumers may choose not to undergo laser vision correction because of these complications or more general concerns relating to its safety and efficacy or a resistance to surgery in general. Alternatively, some consumers may elect to delay undergoing laser vision correction surgery because they believe improved technology or methods of treatment will be available in the near future. Should either the ophthalmic community or the general population turn away from laser vision correction as an alternative to existing methods of treating refractive vision disorders, or if future technologies replaced laser vision correction, these developments could have a material adverse effect on our business, financial position and results of operations.



**Table of Contents**

*Unfavorable Side Effects.* The possibility of long-term side effects and adverse publicity regarding laser correction surgery could seriously harm our business. Laser vision correction is a relatively new procedure. Consequently, there is no long-term follow-up data beyond ten years that might reveal additional complications or unknown side effects. Any future reported side effects, other adverse events or unfavorable publicity involving patient outcomes resulting from the use of laser vision correction systems manufactured by VISX or any participant in the laser vision correction market, may have a material adverse effect on our business, financial position, and results of operations.

*Government Regulation.* We are subject to extensive government regulation, which increases our costs and could prevent us from selling our products. Government regulation includes inspection of and controls over research and development, testing, manufacturing, safety and environmental controls, efficacy, labeling, advertising, promotion, pricing, record keeping, the sale and distribution of pharmaceutical products and samples and electronic records and electronic signatures. In the United States, we must obtain FDA approval or clearance for each medical device that we market. The FDA approval process is typically lengthy and expensive, and approval is never certain. Products distributed outside of the United States are also subject to government regulation, which may be equally or more demanding. Our new products could take a significantly longer time than we expect to gain regulatory approval and may never gain approval. If a regulatory authority delays approval of a potentially significant product, our market value and operating results may decline. Even if the FDA or another regulatory agency approves a product, the approval may limit the indicated uses for a product, may otherwise limit our ability to promote, sell and distribute a product or may require post-marketing studies. If we are unable to obtain regulatory approval of our products, we will not be able to market these products, which would result in a decrease in our sales. Currently, we are actively pursuing approval for a number of our products from regulatory authorities in a number of countries, including, among others, the United States, countries in the European Union and Japan. Continued growth in our sales and profits will depend, in part, on the timely and successful introduction and marketing of some or all of these products.

The clinical trials required to obtain regulatory approvals are complex and expensive and their outcomes are uncertain. We incur substantial expense for, and devote significant time to, clinical trials but cannot be certain that the trials will ever result in the commercial sale of a product. We may suffer significant setbacks in clinical trials, even after earlier clinical trials showed promising results. Any of our products may produce undesirable side effects that could cause us or regulatory authorities to interrupt, delay or halt clinical trials of a product candidate. We, the FDA, or another regulatory authority may suspend or terminate clinical trials at any time if they or we believe the trial participants face unacceptable health risks.

Noncompliance with applicable United States regulatory requirements can result in fines, injunctions, penalties, mandatory recalls or seizures, suspensions of production, denial or withdrawal of pre-marketing approvals, recommendations by the FDA against governmental contracts and criminal prosecution. The FDA also has authority to request repair, replacement, or the refund of the cost of any device we manufacture or distribute. Regulatory authorities outside of the United States may impose similar sanctions for noncompliance with applicable regulatory requirements.

*Competition.* Intense competition in the laser vision correction industry could result in the loss of customers, an inability to attract new customers, or a decrease in prices for our products. The medical device and ophthalmic laser industries are subject to intense competition and technological change. Not only does laser vision correction compete with more traditional vision correction options such as eyeglasses and contact lenses, it also competes with other technologies and surgical techniques such as intraocular lenses and surgery using different types of lasers. In addition, the market for laser vision

**Table of Contents**

correction systems has become increasingly competitive in recent years as a result of FDA approval of several laser systems. The VISX STAR System competes with products marketed or under development by other laser and medical equipment manufacturers, many of which have greater financial and other resources. Competitors may offer laser systems at a lower price, may price their laser systems as part of a bundle of products or services, may lower the prices they charge for procedures, may develop procedures that involve a lower per procedure cost, or may offer products perceived as preferable to the VISX STAR System. In addition, medical companies, academic and research institutions and others could develop new therapies, including new medical devices or surgical procedures, for the conditions targeted by VISX, which therapies could be more medically effective and less expensive than laser vision correction, and could potentially render laser vision correction obsolete. Any such developments could have a material adverse effect on our business, financial position and results of operations.

*Procedure Market Share.* MarketScope estimated that as at December 31, 2003 we were the leader in the United States procedures market with a market share of over 60%. Because of this position, all of our competitors target us and our market share in order to grow their own revenues. We can give no assurance that we will be able to maintain or grow our existing market share and we may, in fact, be required to incur considerable expenditures in order to maintain that share. Should our procedure market share decline, it could have a material adverse effect on our business, financial position, and results of operations as well as the market price of our common stock.

*Economic Conditions.* Because laser vision correction is not subject to reimbursement from third-party payors such as insurance companies or government programs, the cost of laser vision correction is typically borne by individuals directly. Accordingly, weak or uncertain economic conditions may cause individuals to be less willing to incur the procedure cost associated with laser vision correction as was evidenced by our decline in revenues from 2002 compared to 2001 and from 2001 compared to 2000. A decline in economic conditions especially in the United States, could result in a decline in the number of laser vision correction procedures performed and could have a material adverse effect on our business, financial position, and results of operations.

*Significant Customers.* A significant portion of our revenues is derived from sales to TLC Vision ( TLC ). TLC and its operating subsidiaries accounted for 29% and 13% of our total revenues for the three months ended March 31, 2004 and 2003 respectively. Additionally, TLC, accounted for 24% and 22% of our total receivables at March 31, 2004 and December 31, 2003, respectively. Should we lose a significant customer or if anticipated sales to a significant customer do not materialize, our business, financial position and results of operations may suffer. In addition, should a significant customer become unable to pay balances owed, we would have to increase our charges for bad debt expense which could have a material adverse effect on our business, financial position and results of operations.

*New Technologies.* If we fail to keep pace with advances in our industry or fail to develop new methods of vision correction, customers may not buy our products and our revenue may decline. We must be able to manufacture and effectively market those products and persuade a sufficient number of eye care professionals to use the new products, as well as new methods of vision correction such as our CustomVue procedure, that we introduce. Sales of our existing products may decline rapidly if a new product is introduced by one of our competitors or if we announce a new product that, in either case, represents a substantial improvement over our existing products. A decrease in procedure volume may also occur if consumers elect to delay undergoing laser vision correction surgery because they believe improved technology or methods of treatment will be available in the near future.

*New Products May Not Be Commercially Viable.* While we devote significant resources to research and development, our research and development may not lead to new products that achieve commercial success. The research and development process is expensive, prolonged, and entails considerable

**Table of Contents**

uncertainty. Development of a new medical device, from discovery through testing and registration to initial product launch, typically takes between three and seven years. Each of these periods varies considerably from product to product and country to country. Because of the complexities and uncertainties associated with ophthalmic research and development, products we are currently developing may not complete the development process or obtain the regulatory approvals required to market such products successfully. The products currently in our development pipeline may not be approved by regulatory entities and may not be commercially successful, and our current and planned products could be surpassed by more effective or advanced products.

*Patents and Intellectual Property Disputes.* Our business is dependent on the enforceability and the validity of our United States and foreign patents. We own over 200 United States and foreign patents and have more than 200 patent applications pending. In the past, our patents have been challenged on several fronts and we have asserted our patents against competitors. Generally, these proceedings centered on whether infringement of the patents had occurred, and on the validity or enforceability of the patents. While all of these proceedings have now been resolved, we may assert our patents against competitors in the future. If our patents were found to be invalid or unenforceable (or in the event that parties against whom VISX asserted patent infringement were found not to be infringing our patents) in any future proceedings, our ability to collect license fees from the parties to the litigation or from other sellers or users of laser vision correction equipment in the United States could suffer and our revenues could decline. In addition, other companies own United States and foreign patents covering methods and apparatus for performing corneal surgery with ultraviolet lasers. If we were accused of infringing such competitors' patents and found to have infringed such patents, we could be subject to significant monetary liability and enjoined from distributing our products. Any one of these results could harm our business.

*Product Liability Claims.* We have and may become subject to product liability claims. We could be liable for injuries or damage resulting from use of the VISX STAR System or WaveScan System. In addition, a claim that an injury resulted from a defect in any VISX product, even if successfully defended, could damage our reputation. Although we possess insurance customarily obtained by businesses of our type (including insurance against product liability risks associated with the testing, manufacturing, and marketing of our products), product liability claims in excess of our insurance coverage could have a material adverse effect on our business, financial position, and results of operations.

*Litigation.* In the past, we have been involved in a number of legal proceedings, some of which have resulted in significant legal expenses and settlement costs. In the future, we may become involved in additional legal proceedings and these could lead to additional expenses being incurred.

*International Operations.* We face risks due to our reliance on sales in international markets. During the three months ended March 31, 2004 and 2003, we derived approximately 14% and 21%, respectively, of our revenues from sales to customers outside the United States. To date, all of our sales have been denominated in United States dollars. Our international presence exposes us to risks including:

the need for export licenses;

unexpected regulatory requirements;

tariffs and other potential trade barriers and restrictions;

political, legal and economic instability in foreign markets;

longer accounts receivable cycles;

difficulties in managing operations across disparate geographic areas;

foreign currency fluctuations;

reduced or limited protection of our intellectual property rights in some countries; and

dependence on local distributors.

Page 22 of 29

---

**Table of Contents**

If one or more of these risks materialize, our sales to international customers may decrease and our costs may increase, which could negatively impact our revenues and operating results.

*Distributors.* Internationally, we sell our products through distributors. If we fail to maintain our existing distribution channels or develop additional channels in the future, our ability to sell products internationally could be impaired and our business harmed.

*Third Party Financing Entities.* We have relationships with third party financing entities that purchase our products directly and subsequently lease and/or sell these products to our end-user customers, or provide financing directly to customers who purchase our products directly from us. Should any third party financing entity or entities fail or refuse to pay us in a timely manner or at all, it could negatively affect our cash flows and could have a material adverse effect on our business, financial position and results of operations. In fact, DVI, which provided equipment purchase financing to our customers, entered into Chapter 11 bankruptcy proceedings in August 2003, and as a result, we recorded bad debt expense to increase our reserve for doubtful accounts to cover any remaining exposure on the \$2.3 million of accounts receivables then outstanding from DVI.

*Fixed Short-Term Expenses.* Because our expenses are relatively fixed in the short term, our earnings will decline if we do not meet our projected sales. Any shortfall in revenues below expectations would likely have an immediate impact on our earnings per share, which could adversely affect the market price of our common stock. Our operating expenses, which include sales and marketing, research and development, and general and administrative expenses, are based on our expectations of future revenues and are relatively fixed in the short term. Accordingly, if revenues fall below expectations, we will not be able to reduce our spending rapidly in response to such a shortfall.

*Acquisitions of Businesses or Technology.* We have acquired technology assets and may need to continue to do so to retain our competitive position within the marketplace. If we acquire businesses, new products or technologies in the future, we may be required to amortize significant amounts of identifiable intangible assets and we may record significant amounts of goodwill that will be subject to annual testing for impairment. If we consummate one or more significant future acquisitions in which the consideration consists of stock or other securities, our existing stockholders ownership could be significantly diluted. If we were to proceed with one or more significant future acquisitions in which the consideration included cash, we could be required to use a substantial portion of our available cash. Additionally, such an acquisition could have a substantial impact on our business, our financial position and our results of operations.

*Taxes.* We operate throughout the United States and, consequently, are subject to various federal, state and local taxes, including sales, income, payroll, unemployment, property, franchise, capital and use tax on our operations, payroll, assets and services. Although we believe we have adequate provisions and accruals in our financial statements for tax liabilities, we cannot predict the outcome of all past and future tax assessments. If any taxing authority determines we owe amounts for taxes greater than we expect, our earnings may be negatively affected.

*Key Personnel.* The success of our business depends on the efforts and abilities of our senior management and other key personnel. We do not have long term employment agreements with any of our key personnel. The loss of any of our executive officers or other key employees could result in significant disruption to our ongoing operations and hurt our business. Additionally, our inability to attract new senior executives and key personnel could significantly impact our business results.

*Single Sources For Key Components.* The manufacture of the VISX STAR System and WaveScan System is a complex operation involving numerous procedures. We depend on single and limited sources

## **Table of Contents**

for several key components. If any of these suppliers were to cease providing components, we would be required to locate and contract with a substitute supplier. We could have difficulty identifying a substitute supplier in a timely manner or on commercially reasonable terms. If the production of our products, parts and services were interrupted or could not continue in a cost-effective or timely manner, our business, financial position, and results of operations, could be materially adversely affected.

*Volatility of our Stock Price.* The market price of our common stock has experienced fluctuations and is likely to fluctuate significantly in the future. Our stock price can fluctuate for a number of reasons, including:

announcements about us or our competitors;

results or settlements of litigation;

quarterly variations in operating results;

the introduction or abandonment of new technologies or products;

changes in product pricing policies by us or our competitors;

changes in earnings estimates by analysts or changes in accounting policies; and

economic changes and political uncertainties.

In addition, stock markets have experienced significant price and volume volatility in recent years. This volatility has had a substantial effect on the market prices of securities of many public companies for reasons frequently unrelated or disproportionate to the operating performance of the specific companies. In addition, the securities of many medical device companies, including VISX, have historically been subject to extensive price and volume fluctuations that may affect the market price of their common stock. If these broad market fluctuations continue, they may adversely affect the market price of our common stock.

*Proprietary Information and Inventions Agreements.* We protect our proprietary technology, in part, through proprietary information and inventions agreements with employees, consultants and other parties. These agreements with employees and consultants generally contain standard provisions requiring those individuals to assign to us, without additional consideration, inventions conceived or reduced to practice by them while employed or retained by us, subject to customary exceptions. If any of our employees, consultants or others breach these agreements our competitors may learn of our trade secrets.

*Changes to the Accounting for Stock Options.* The Financial Accounting Standards Board has issued a draft Financial Accounting Standard which includes proposed rule changes requiring expensing of stock options. Currently, we include such expenses on a pro forma basis in the notes to our annual financial statements in accordance with accounting principles generally accepted in the United States but do not include stock option expense for employee options in our reported financial statements. If accounting standards are changed to require us to expense stock options, our reported earnings will decrease significantly and our stock price could decline.

*Exercising of stock options.* As of March 31, 2004, there were an aggregate of 6,301,000 shares of our common stock issuable upon exercise of outstanding vested stock options. If these stock options are exercised, the total number of our traded shares will increase and this could adversely impact our earnings per share.

*Antitakeover Provisions in Our Charter Documents.* In 2000, we adopted a stockholder rights plan. The presence of this plan could make it more difficult for a third party to engage in a takeover attempt, even a takeover attempt in

which the potential purchaser offers to pay a per share price greater than the current market price for our common stock. In addition, the presence of the plan could delay or impede the

**Table of Contents**

removal of incumbent directors. These provisions may also impact the amount of interest investors have in our business.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

There were no material changes during the three months ended March 31, 2004 in our exposure to market risk for changes in interest rates and foreign currency exchange rates.

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments and our investment portfolio to manage our interest rate risk, foreign currency risk or for any other purpose. We invest in high-credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities and by constantly positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer, guarantor or depository. The portfolio includes only marketable securities with active secondary or resale markets to ensure portfolio liquidity.

**Item 4. Controls and Procedures**

VISX management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report (the Evaluation Date ). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the controls and procedures are effective in ensuring that all material information required to be filed in this quarterly report has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, either during the three months ended March 31, 2004 or subsequent to the Evaluation Date.



**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings****Overview**

From time to time, we have been involved in a variety of legal proceedings. For a complete description of legal proceedings, see our annual report on Form 10-K for the year ended December 31, 2003. During the quarter ended March 31, 2004, there were no material developments with respect to such previously existing proceedings and no new material proceedings not previously disclosed, except as follows.

**Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities**

The following table contains information regarding repurchases of our common stock during the quarter:

<b>Period</b>	<b>Total Number of Shares Purchased (1)</b>	<b>Average Price Per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b>
January 1 through January 31, 2004		\$		2,950,600
February 1 through February 29, 2004	365,300	19.52	365,300	2,585,300
March 1 through March 31, 2004	55,000	17.93	55,000	2,530,300
<b>Total</b>	<b>420,300</b>	<b>\$19.31</b>	<b>420,300</b>	

(1) Shares have only been repurchased through publicly announced programs. All repurchases were open-market purchases.

(2) On April 4, 2001 our Board of Directors authorized the repurchase of up to 10 million shares of our common stock. We have repurchased 7.5 million shares cumulatively through March 31, 2004 under the Board of Directors April 2001 authorization. Number of shares does not include an additional 3.5 million shares of our common stock approved for repurchase by our Board of Directors on May 28, 2003, all of which were repurchased during the quarter ended June 30, 2003.

Unless terminated earlier by resolution of our Board of Directors, each share repurchase program expires when we have repurchased all shares authorized for repurchase thereunder.

**Item 5. Other Information**

In accordance with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002, VISX is responsible for disclosing the non-audit services approved by VISX's Audit Committee to be performed by KPMG LLP, VISX's independent auditor. Non-audit services are defined in the law as services other than those provided in connection with an audit or a review of the financial statements of VISX. The non-audit services approved by the Audit Committee in the first quarter are considered by VISX to be audit-related services that closely relate to the financial

**Table of Contents**

audit process. Each of the services has been approved in accordance with a pre-approval from the Audit Committee's Chairman pursuant to delegated authority by the Audit Committee.

During the quarterly period covered by this filing, the Committee approved additional engagements of KPMG LLP for the following non-audit service: tax return preparation, non-audit accounting services, and tax matter consultations concerning federal and state taxes.

**Item 6. Exhibits and Reports on Form 8-K**

*a) Exhibits.*

31.1 Certification of the Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of the Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.1 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

*b) Reports on Form 8-K.*

- (1) Report on 8-K filed on January 27, 2004 under Item 12 (Disclosure of Results of Operations and Financial Condition) regarding VISX's fourth quarter and year end financial results.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

VISX, Incorporated  
*(Registrant)*

May 6, 2004

/s/Elizabeth H. Dávila

---

Elizabeth H. Dávila  
Chairman of the Board and  
Chief Executive Officer

May 6, 2004

/s/Derek A. Bertocci

---

Derek A. Bertocci  
Senior Vice President and  
Chief Financial Officer (*principal  
financial officer*)

May 6, 2004

/s/Martyn J. Webster

---

Martyn J. Webster  
Controller (*principal  
accounting officer*)

Page 28 of 29

---

**Table of Contents**

**Exhibit Index**

31.1 Certification of the Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of the Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.1 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002