1 800 CONTACTS INC
Form 10-Q
August 12, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark one)

ý	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the quarterly period ended July 3, 2004
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to .

Commission file number: 0-23633

1-800 CONTACTS, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**87-0571643** (I.R.S. Employer Identification No.)
66 E. Wadsworth Park Drive, 3rd Floor **Draper, UT** (Address of principal executive offices)	**84020** (Zip Code)

(801) 924-9800
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

ý Yes o No

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

ý Yes o No

As of August 6, 2004, the Registrant had 13,286,621 shares of Common Stock, par value $0.01 per share, outstanding.

1-800 CONTACTS, INC.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)
(unaudited)

	January 3, 2004	July 3, 2004
ASSETS		
CURRENT ASSETS:		
Cash	$ 1,075	$ 330
Accounts receivable, net	944	1,210
Inventories, net	24,127	25,166
Prepaid income taxes	797	193
Deferred income taxes	548	900
Other current assets	1,752	3,448
Total current assets	29,243	31,247
PROPERTY, PLANT AND EQUIPMENT, net	13,183	17,346
DEFERRED INCOME TAXES	710	922
GOODWILL	33,853	33,768
DEFINITE-LIVED INTANGIBLE ASSETS, net	9,207	16,325
OTHER ASSETS	735	973
Total assets	$ 86,931	$ 100,581
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	$ 3,381	$ 1,253
Current portion of capital lease obligations	191	158
Accounts payable	8,558	8,549
Accrued liabilities	4,847	6,922
Total current liabilities	16,977	16,882
LONG-TERM LIABILITIES:		
Line of credit		17,420
Long-term debt, less current portion	14,683	8,566
Capital lease obligations, less current portion	64	56
Deferred income tax liabilities		2,545
Total long-term liabilities	14,747	28,587
STOCKHOLDERS EQUITY		
Common stock, 13,113 and 13,287 issued, respectively	131	133
Additional paid-in capital	42,346	45,773
Retained earnings	12,834	9,480
Accumulated other comprehensive loss	(104)	(274)
Total stockholders equity	55,207	55,112
Total liabilities and stockholders equity	$ 86,931	$ 100,581

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Quarter Ended		Two Quarters Ended	
	June 28, 2003	July 3, 2004	June 28, 2003	July 3, 2004
NET SALES	$ 46,354	$ 49,971	$ 93,016	$ 100,820
COST OF GOODS SOLD	28,580	30,698	59,140	62,251
Gross profit	17,774	19,273	33,876	38,569
OPERATING EXPENSES:				
Advertising	3,586	7,224	7,380	16,039
Legal and professional	1,755	1,341	3,376	3,181
Research and development	197	443	2,000	1,335
Purchased in-process research and development				83
Other operating	10,104	10,766	18,753	20,648
Total operating expenses	15,642	19,774	31,509	41,286
INCOME (LOSS) FROM OPERATIONS	2,132	(501)	2,367	(2,717)
OTHER EXPENSE, net	(323)	(699)	(823)	(1,055)
INCOME (LOSS) BEFORE BENEFIT (PROVISION) FOR INCOME TAXES	1,809	(1,200)	1,544	(3,772)
BENEFIT (PROVISION) FOR INCOME TAXES	(1,249)	52	(1,472)	418
NET INCOME (LOSS)	$ 560	$ (1,148)	$ 72	$ (3,354)
PER SHARE INFORMATION:				
Basic and diluted net income (loss) per common share	$ 0.04	$ (0.09)	$ 0.01	$ (0.25)

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Two Quarters Ended June 28, 2003	Two Quarters Ended July 3, 2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 72	$ (3,354)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,008	3,606
Amortization of debt issuance costs and discounts	96	197
Purchased in-process research and development		83
Unrealized foreign currency exchange loss	77	85
Loss on sale of property and equipment	6	73
Stock-based compensation	731	
Deferred income taxes, net of effects of acquisition	(59)	(1,101)
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(992)	(275)
Inventories	10,510	(706)
Other current assets	(356)	(1,382)
Accounts payable	(3,115)	(786)
Accrued liabilities	664	1,463
Income taxes payable / prepaid income taxes	1,180	682
Unearned revenue	92	(1)
Net cash provided by (used in) operating activities	11,914	(1,416)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(1,655)	(3,406)
Proceeds from sale of property and equipment	33	4
Purchase of intangible assets	(28)	(1,011)
Cash paid for acquisitions	(7,012)	(3,776)
Deposits and other	(55)	(186)
Net cash used in investing activities	$ (8,717)	$ (8,375)

	Two Quarters Ended	
	June 28, 2003	July 3, 2004
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of common stock options	$ 715	$ 138
Restricted stock grants		6
Net (repayments) borrowings on line of credit	(1,931)	17,420
Debt issuance costs		(193)
Principal payments on capital lease obligations	(206)	(165)
Principal payments on long-term debt	(1,311)	(8,240)
Net cash provided by (used in) financing activities	(2,733)	8,966
EFFECT OF FOREIGN EXCHANGE RATES ON CASH	(1)	80
NET (DECREASE) INCREASE IN CASH	463	(745)
CASH AT BEGINNING OF PERIOD	259	1,075
CASH AT END OF PERIOD	$ 722	$ 330
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for interest	$ 560	$ 641
Cash paid for income taxes	350	

SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:

During the first quarter of 2003, the Company purchased certain assets and assumed certain liabilities of Lens Express and Lens 1st. The purchase consideration included cash of $7,012, common stock with a fair value of $19,859 and assumed operating liabilities of $4,099.

During the second quarter of 2003, the performance guarantee was met relating to 700,000 shares of the Company s restricted common stock held in escrow as partial consideration for the July 2002 acquisition of ClearLab. The Company recorded additional purchase consideration of approximately $16,980 for these shares. The Company recorded this as goodwill, net of a contingent consideration liability recorded at the purchase date. The amount of goodwill as of June 28, 2003 was $11,205 (see Note 6).

During the first quarter of 2004, the Company purchased the stock of VisionTec (subsequently renamed ClearLab UK, Ltd.). The purchase consideration included cash of $3,776 and common stock with a fair value of $3,200 (see Note 6).

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. PRESENTATION OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The accompanying condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments), which in the opinion of management, are necessary to present fairly the results of operations of the Company for the periods presented. It is suggested that these condensed consolidated financial statements be read in conjunction with the audited financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended January 3, 2004.

NOTE 2. INVENTORIES

Inventories are recorded at the lower of cost (using the first-in, first-out method) or market value. Inventories consisted of the following (in thousands):

	January 3, 2004	July 3, 2004
Purchased contact lenses	$ 20,943	$ 20,438
Manufactured inventories:		
Raw materials	429	636
Work in process	2,681	3,831
Finished goods contact lenses	74	261
Total	$ 24,127	$ 25,166

Provision is made to reduce excess and obsolete inventories to their estimated net realizable values. As of January 3, 2004 and July 3, 2004, reserves for excess and obsolete inventories were $623,000 and $1,098,000, respectively.

NOTE 3. NET INCOME (LOSS) PER COMMON SHARE

Basic net income (loss) per common share (Basic EPS) excludes dilution and is computed by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per common share (Diluted EPS) reflects the potential dilution that could occur if stock options or other common stock equivalents were exercised or converted into common stock. The computation of Diluted EPS does not assume exercise or conversion of securities that would have an antidilutive effect on net income (loss) per common share. For the quarter and two quarters ended July 3, 2004, options to purchase 1,415,875 and 1,408,178 shares of common stock, respectively, were not included in the computation of Diluted EPS because the effect would be antidilutive. For the quarter and two quarters ended June 28, 2003, options to purchase 611,448 and 909,465 shares of common stock, respectively, were not included in the computation of Diluted EPS because the effect would be antidilutive.

The following is a reconciliation of the numerator and denominator used to calculate Basic and Diluted EPS (in thousands, except per share amounts):

	Quarter Ended June 28, 2003			Quarter Ended July 3, 2004		
	Net Income	Shares	Per-Share Amount	Net Loss	Shares	Per-Share Amount
Basic EPS	$ 560	12,552	$ 0.04	$ (1,148)	13,286	$ (0.09)
Effect of stock options		210				
Diluted EPS	$ 560	12,762	$ 0.04	$ (1,148)	13,286	$ (0.09)

	Two Quarters Ended June 28, 2003			Two Quarters Ended July 3, 2004		
	Net Income	Shares	Per-Share Amount	Net Loss	Shares	Per-Share Amount
Basic EPS	$ 72	12,269	$ 0.01	$ (3,354)	13,237	$ (0.25)
Effect of stock options		224				
Diluted EPS	$ 72	12,493	$ 0.01	$ (3,354)	13,237	$ (0.25)

NOTE 4. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) for the quarter and two quarters ended June 28, 2003 and July 3, 2004 consists of the following components (in thousands):

	Quarter Ended		Two Quarters Ended	
	June 28, 2003	July 3, 2004	June 28, 2003	July 3, 2004
Net income (loss)	$ 560	$ (1,148)	$ 72	$ (3,354)
Foreign currency translation loss	(442)	(147)	(302)	(170)
Comprehensive income (loss)	$ 118	$ (1,295)	$ (230)	$ (3,524)

The foreign currency translation loss results primarily from changes in exchange rates relative to the U.S. dollar from the translation of the Company s Singapore and United Kingdom subsidiaries financial statements.

NOTE 5. STOCK-BASED COMPENSATION

The Company applies Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations and uses the intrinsic method of accounting for its stock option grants to employees and directors. No compensation expense has been recognized for stock option awards granted at or above fair market value of the stock on the date of grant.

Under Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, compensation expense is recognized for the fair market value of each option as estimated on the date of grant using the Black-Scholes option-pricing model. SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, amends SFAS No. 123, to provide alternative methods of transition for a voluntary change to the fair market value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require new prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has elected to adopt the disclosure only provisions of SFAS No. 148.

If compensation expense for all stock options had been determined consistent with SFAS No. 123, the Company s net income (loss) and basic and diluted net income (loss) per common share would have been as follows (in thousands, except per share amounts):

	Quarter Ended			
	June 28, 2003		July 3, 2004	
Net income (loss):				
As reported	$	560	$	(1,148)
Fair-value based compensation, net of tax		(258)		(412)
Pro forma	$	302	$	(1,560)
Basic and diluted net income(loss) per common share:				
As reported	$	0.04	$	(0.09)
Pro forma	$	0.02	$	(0.12)

	Two Quarters Ended			
	June 28, 2003		July 3, 2004	
Net income (loss):				
As reported	$	72	$	(3,354)
Fair-value based compensation, net of tax		(539)		(828)
Pro forma	$	(467)	$	(4,182)
Basic and diluted net income (loss) per common share:				
As reported	$	0.01	$	(0.25)
Pro forma	$	(0.04)	$	(0.32)

The weighted average per share fair value of options granted during the quarters ended June 28, 2003 and July 3, 2004 and the two quarters ended June 28, 2003 and July 3, 2004 was $14.28 and $9.43, and $13.85 and $12.04, respectively. The fair value of each option grant has been estimated on the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Quarter Ended		Two Quarters Ended	
	June 28, 2003	July 3, 2004	June 28, 2003	July 3, 2004
Risk-free interest rate	2.2%	3.6%	2.6%	3.1%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Volatility	76.1%	67.0%	77.0%	67.8%
Expected life	5 years	5 years	5 years	5 years

NOTE 6. RECENT ACQUISITIONS

VisionTec (subsequently renamed ClearLab UK)

On March 13, 2003, the Company signed a letter of intent with VisionTec, a developer and manufacturer of contact lenses based in the United Kingdom, and certain of its shareholders. The Company agreed to pay VisionTec a non-refundable sum equal to $1.5 million to be used by the entity for research and development activities relating to contact lenses. Of the total, $0.7 million was paid on March 14, 2003, and the remaining $0.8 million was paid on June 13, 2003. In addition, the Company was granted a six-month option to either: (1) acquire all of the shares of common stock of the entity; or (2) acquire from the entity a worldwide license to manufacture, market, sell or otherwise use or exploit specific technology developed by the entity. As consideration for this option, the Company paid $0.1 million to VisionTec on March 14, 2003. In the event that the Company did not exercise the option to purchase the shares of VisionTec, the Company agreed to pay the entity an additional $0.8 million. The Company also reimbursed VisionTec and its shareholders approximately $0.2 million for legal and financial expenses incurred by the entity in connection with the agreement.

On September 12, 2003, the Company exercised the option to acquire all of the shares of common stock of VisionTec. During the period between September 12, 2003 and the closing of the acquisition on February 24, 2004, the Company continued to pay certain fees and expenses of the entity related to the entity s research and development activities. The Company paid approximately $2.1 million to VisionTec from September 12, 2003 through January 3, 2004 and $0.5 million from January 3, 2004 through February 24, 2004, for such research and development activities.

In connection with the agreement, and the transactions discussed above, the Company expensed a total of approximately $3.9 million from March 13, 2003 through January 3, 2004 (inclusive of the $0.2 million in costs) related to these research and development initiatives and $0.5 million in the first quarter of fiscal 2004 ended April 3, 2004.

On February 24, 2004, the Company completed the acquisition of all of the outstanding stock of VisionTec (subsequently renamed ClearLab UK). The consideration paid included approximately $3.8 million in cash (including $0.6 million in transaction costs) and 155,084 shares of the Company s common stock with a fair value of approximately $3.2 million. In addition, the Company has agreed to pay a per unit royalty on the sale of contact lenses to the former shareholders of VisionTec for a period of ten years.

The Company filed a registration statement with the Securities and Exchange Commission (SEC) covering the resale of the 155,084 shares by the former stockholders of VisionTec.

The following sets forth the consideration paid by the Company (in thousands, except share amounts):

Cash	$	3,200
Restricted shares (155,084 shares at $20.634 per share)		3,200
Acquisition expenses		576
Total purchase consideration	$	6,976

The following table sets forth the preliminary allocation of the purchase price to the net tangible and intangible assets acquired (in thousands):

Current assets	$	629
Property, equipment and other long-term assets		2,914
Core technologies		4,791
Patent		3,355
Purchased in-process research and development		83
Current liabilities		(1,523)
Deferred income tax liability		(3,273)
Total	$	6,976

NOTE 2. INVENTORIES

Core technologies and patents are definite-lived intangible assets that are being amortized over twelve years.

NOTE 7. COMMON STOCK TRANSACTIONS

During the two quarters ended July 3, 2004, employees exercised stock options to purchase 18,892 shares of common stock for a total of approximately $138,000. The Company recorded an increase in additional paid-in capital of approximately $85,000 as a result of the income tax benefit related to these stock option exercises.

During the two quarters ended July 3, 2004, the Company granted nonqualified stock options to purchase 128,478 shares of common stock to employees and directors of the Company. The exercise price of the options was $22.00 per share, which was not less than the quoted fair market value at the grant date. The options vest equally over a four-year period and expire in five years.

On February 24, 2004, the Company completed the acquisition of ClearLab UK and issued 155,084 shares of the Company s common stock with a fair value of approximately $3.2 million (see Note 6). The restricted stock was registered with the Securities and Exchange Commission (SEC) on Form S-3 effective June 18, 2004.

NOTE 8. DEBT OBLIGATIONS

Effective February 27, 2004, the Company executed a restated loan agreement with its existing U.S. bank, providing for a revolving credit facility for borrowings of up to $28 million through June 1, 2004, and reducing thereafter on the first day of each September, December, March and June by $0.4 million until the maturity date of February 27, 2007. Additionally, the agreement provides for letters of credit up to a maximum of $15 million outstanding or payable at any time. The executed restated loan agreement specifies that if the maximum leverage ratio, as defined in the restated loan agreement, is greater than 2.5, then the amounts outstanding on the revolving credit facility together with the amount of all outstanding letters of credit can at no time exceed the Company s book value of inventory. As of July 3, 2004, the Company was subject to this restriction and could only borrow up to the $25.2 million book value of its inventory. Outstanding borrowings on the revolving credit facility bear interest at a floating rate equal to the lender s prime interest rate plus a margin or the lender s LIBOR rate plus a margin. The restated loan agreement originally specified that interest based on the lender s prime rate is the prime rate plus 0.75 percent until July 31, 2004, and thereafter is adjusted quarterly, ranging between prime plus 0.0 percent and prime plus 1.25 percent, depending on the Company s maximum leverage ratio. The restated loan agreement also originally specified that interest based on the lender s LIBOR rate is the LIBOR rate for the applicable period plus 2.75 percent until July 31, 2004, and thereafter is adjusted quarterly, ranging between LIBOR plus 2.0 percent and LIBOR plus 3.25 percent, depending on the Company s maximum leverage ratio. On June 25, 2004, the restated loan agreement was modified to stipulate that until the maximum leverage ratio, as defined in the restated loan agreement, is less than or equal to 3.0, the LIBOR rate applicable margin will be 3.25 percent and the prime rate applicable margin will be 1.25 percent. As of July 3, 2004, the Company was subject to these specifications. Interest is payable monthly. As of July 3, 2004, the Company s outstanding borrowings on the credit facility, including bank overdrafts, were $17.4 million. Of this amount, $12.0 million bore interest at the lender s LIBOR rate plus 3.25 percent (4.54% at July 3, 2004) and the remaining $5.4 million bore interest at the lender s prime rate plus 1.25 percent (5.50% at July 3, 2004). The facility requires the payment of an unused credit fee, which is also determined by the Company s maximum leverage ratio. The unused credit fee is payable quarterly at 0.5 percent until July 31, 2004. Thereafter, the unused credit fee is adjusted quarterly, ranging from 0.38 percent to 0.5 percent, depending on the Company s maximum leverage ratio.

All outstanding balances on this credit facility are secured by substantially all of the Company s U.S. assets, subsidiary debt instruments, 100 percent ownership interests in all domestic subsidiaries and 65 percent ownership interests in foreign subsidiaries directly owned by the Company. The new loan agreement includes various financial covenants including a capital expenditure limit, a maximum leverage ratio, a minimum working capital requirement, a minimum fixed charge coverage ratio and a minimum net worth requirement. The new loan agreement does not permit the Company or its subsidiaries to dissolve, sell, dispose or merge all of their assets or acquire all of the assets of any entity without the written consent of the U.S. bank, unless the transaction meets the definition of a Permitted Acquisition Basket , as defined in the agreement. The new loan agreement also places a limit on the amount the Company can loan to any entity, outside the normal course of business. Additionally, the agreement does not permit the Company to declare or pay any cash dividends, to repurchase its stock or to perform other similar equity transactions prior to December 31, 2005; thereafter, such transactions are subject to other terms. This agreement defines several customary events of default including any material adverse change or any event that occurs which may cause a material adverse change in the Company s or its subsidiaries condition.

NOTE 2. INVENTORIES

The June 25, 2004 modification to the restated loan agreement also modified the maximum leverage ratio financial covenant. As of July 3, 2004, the Company was in compliance with all applicable covenants, as modified and clarified by the U.S. bank.

The Company s Singapore bank term loan contains various financial covenants including minimums on net worth and shareholders funds of the Singapore operations. As of July 3, 2004, the Company was in compliance with all applicable covenants. 1-800 CONTACTS, INC. has guaranteed this term loan.

Cross default clauses exist such that if the Company were in default on its U.S. debt, the Company would also be in default on its Singapore debt. If the Company were in default on its Singapore bank term loan, the Company would also be in default on its note payable to the parent of IGEL and its restated loan agreement with its U.S. bank.

NOTE 9. COMMITMENTS AND CONTINGENCIES

Legal Matters

The sale and delivery of contact lenses are governed by both Federal and state laws and regulations, including the recently enacted federal Fairness to Contact Lens Consumer Act (FCLCA). The FCLCA requires that contact lenses only be sold to consumers based on a valid prescription. Satisfying this prescription requirement obligates the seller either to obtain a copy of the prescription itself or to verify the prescription by direct communication with the customer s prescriber. Consistent with this requirement, the Company s current operating practice is to require all customers to provide either a valid copy of their prescription or the contact information for their prescribers so that the Company can verify their prescriptions by direct communication with their prescribers. If the Company does not have a valid copy of the customer s prescription, the Company directly communicates to the customer s prescriber the precise prescription information received from the customer and informs the prescriber that it will proceed with the sale based on this prescription information unless the prescriber advises it within eight business hours that such prescription information is expired or otherwise invalid. If the prescriber properly advises the Company within this time period that the customer s prescription is expired or otherwise invalid, the Company s practice is to cancel the customer s order. On the other hand, if the prescriber either advises the Company that the prescription is valid or fails to properly respond within the communicated time period, the Company s practice is to complete the sale based on the prescription information communicated to the prescriber, as expressly permitted by the FCLCA. The Company retains copies of the written prescriptions that it receives and maintains records of its communications with its customers prescribers.

On April 7, 1999, the Kansas Board of Examiners in Optometry (KBEO) commenced a civil action against the Company in the District Court of Shawnee County, Kansas. The complaint was amended on May 28, 1999, and alleges that on one or more occasions the Company sold contact lenses in the state of Kansas without receipt of a prescription. The amended complaint seeks an order enjoining the Company from further engaging in the alleged activity, and does not seek monetary damages. The Company filed an answer to the amended complaint denying all material allegations, and setting forth several affirmative defenses. The Company has vigorously defended this lawsuit, which has now been pending for over five (5) years. In June, 2002, the court granted a summary judgment motion in favor of the KBEO. However, the court made no findings of any violations of Kansas law, and based its decision on a Kansas optometry law that has been repealed and amended by the Kansas legislature. The Company appealed this decision, and on November 7, 2003, the Kansas Court of Appeals reversed the trial court s order, and remanded the case back to the trial court for further proceedings. Thus, as a result of the Appellate court s order, there was no injunction against the Company as of November 7, 2003. Following receipt of the Appellate Court s order, the parties each submitted proposed orders to the trial court. The KBEO asked the court to re-enter summary judgment in its favor, and to reinstate the injunction, and the Company asked the court to dismiss the case, based either on the lack of any basis for injunctive relief, or because the case is now moot based on changes to Kansas law which took effect while the case was pending on appeal, or based on the recent passage of the FCLCA which took effect on February 4,

2004. By order dated April 30, 2004, the trial court reinstated the injunction prohibiting the Company from selling contact lenses without a valid prescription under K.S.A. 65-1504b unless and until a determination is made that the Fairness to Contact Lens Consumers Act (FCLCA) preempts its enforcement. The Company has filed a motion asking the Court to clarify its injunction, to provide that Defendant is required to comply with the prescription verification requirements set forth in the new federal law in order to obtain a valid prescription as required by K.S.A. 65-1504b or, alternatively, to amend or alter its Order deny plaintiff s motion for summary judgment, granting summary judgment to defendant and entering an order denying the requested injunctive relief, based in part on the preemptive effect of the FCLCA. This motion remains pending.

Since the FCLCA was enacted last year, the Company has continued to adhere to the prescription verification procedures set forth in this new federal law. To the extent K.S.A. 65-1504 continues to have any application at all, the Company believes that by complying with the FCLCA it does not run afoul of K.S.A. 65-1504 and therefore intends to continue adhering to the prescription verification procedures set forth in the FCLCA. On June 29, 2004, the FTC issued a rule confirming that the FCLCA preempts state laws that purport to require stricter prescription verification procedures or that are otherwise inconsistent with the FCLCA. Accordingly, the Company does not believe that K.S.A. 65-1504 does or can require it to change its existing business practices in any way. However, should any claim or interpretation regarding K.S.A. 65-1504 be advanced to the contrary, the Company is prepared to vigorously contest any such claim or interpretation.

From time to time the Company is involved in other legal matters generally incidental to its business. It is the opinion of management, after consultation with legal counsel, that, except for legal and professional fees that the Company incurs from time to time, the ultimate dispositions of these matters will not have a material impact on the financial position, liquidity, or results of operations of the Company. However, there can be no assurance that the Company will be successful in its efforts to satisfactorily resolve these matters and the ultimate outcome could result in a material negative impact on the Company s financial position, liquidity, or results of operations.

Advertising Commitments

As of July 3, 2004, the Company had entered into certain noncancelable commitments with various advertising companies that will require the Company to pay approximately $7.5 million for advertising during the remainder of 2004.

Purchase Commitments

As of July 3, 2004, the Company had entered into certain noncancelable commitments with a certain supplier that will require the Company to purchase approximately $8.5 million of inventory during the third quarter of fiscal 2004.

NOTE 10. SEGMENT INFORMATION

As a result of the acquisition of IGEL (ClearLab International) in the third quarter of fiscal 2002 and the recently acquired VisionTec (ClearLab UK), the Company has two operating segments. These operating segments represent components of the Company for which separate financial information is available and evaluated regularly by management in determining resource allocation and performance assessment. The Company s U.S. Retail segment includes the operations of 1-800 CONTACTS and the operations from the Lens Express and Lens [s]1 acquisitions. The Company s International segment includes the operations of ClearLab International and ClearLab UK, both of which are developers and manufacturers of contact lenses. Operating segment information for the quarter and two quarters ended June 28, 2003 and July 3, 2004 are as follows (in thousands):

	Quarter Ended					
	June 28, 2003			July 3, 2004		
	U.S. Retail	International	Total	U.S. Retail	International	Total
Net sales	$ 44,701	$ 1,653	$ 46,354	$ 48,742	$ 1,229	$ 49,971
Gross profit (loss)	17,045	729	17,774	19,825	(552)	19,273
Research and development	147	50	197		443	443
Other operating expense	8,592	1,512	10,104	9,606	1,160	10,766
Income (loss) from operations	3,055	(923)	2,132	1,835	(2,336)	(501)

	Two Quarters Ended					
	June 28, 2003			July 3, 2004		
	U.S. Retail	International	Total	U.S. Retail	International	Total
Net sales	$ 89,832	$ 3,184	$ 93,016	$ 98,193	$ 2,627	$ 100,820
Gross profit (loss)	32,793	1,083	33,876	38,755	(186)	38,569
Research and development	1,909	91	2,000	536	799	1,335
Purchased in-process research and development					83	83
Other operating expense	16,617	2,136	18,753	18,575	2,073	20,648
Income (loss) from operations	3,666	(1,299)	2,367	686	(3,403)	(2,717)

Identifiable segment assets are as follows (in thousands):

	January 3, 2004			July 3, 2004		
	U.S. Retail	International	Total	U.S. Retail	International	Total
Long-lived assets, net	$ 30,615	$ 25,628	$ 56,243	$ 30,728	$ 36,711	$ 67,439
Total assets	56,274	30,657	86,931	57,173	43,408	100,581

NOTE 11. VENDOR REBATE AND INCENTIVE ARRANGEMENTS

The Company enters into arrangements to receive cash consideration from certain of its vendors. The arrangements include manufacturer rebates and cooperative marketing program reimbursements. Cash consideration from some vendor agreements are dependent upon reaching minimum purchase thresholds. The Company evaluates the likelihood of reaching purchase thresholds using past experience and current year forecasts. When rebates can be reasonably estimated, the Company records a portion of the rebate as it makes progress towards the purchase threshold. In accordance with EITF 02-16, it is generally presumed that amounts received from vendors are a reduction of the prices paid for their products. Therefore, that cash consideration is reflected as a reduction of cost of goods sold if the inventory has been sold by the Company or a reduction of inventory if the product inventory is still on hand at the reporting date. When the Company receives reimbursements for specific, incremental, identifiable advertising costs incurred for advertising the vendors products, the cash consideration received is recorded as a reduction to advertising expense in the Company s consolidated statements of operations.

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

Overview

The Company is a leading direct marketer of replacement contact lenses and also conducts contact lens manufacturing, development, and distribution operations in Singapore and the United Kingdom. The Company sells all of the popular brands of contact lenses, including those manufactured by Johnson & Johnson Vision Care, CIBA Vision, Bausch & Lomb, Ocular Sciences and CooperVision.

International Operations (ClearLab)**.** On July 24, 2002, the Company completed the acquisition of certain net assets and the majority of the business operations of IGEL (subsequently renamed ClearLab International), a developer and manufacturer of contact lenses based in Singapore. ClearLab International is the principal marketing organization for the Company s international wholesale manufacturing and distribution business, focusing on the marketing of contact lens products to major retailers and distributors, as well as providing contract manufacturing capacity for other contact lens manufacturers. ClearLab International manufactures a wide range of frequent replacement spherical and toric lenses and is focused on developing new lens materials.

On February 24, 2004, the Company acquired VisionTec, a developer and manufacturer of daily contact lenses based in the United Kingdom. VisionTec has developed a method for low cost, high quality production of daily disposable contact lenses using a unique proprietary material. VisionTec has subsequently been renamed ClearLab UK Ltd (ClearLab UK). The business operates as a research and development and manufacturing affiliate of ClearLab International. The Company has recently completed the testing of ClearLab UK s manufacturing capabilities, began shipping its daily disposable contact lenses, and is currently expanding its production capabilities. The Company will increase its product offerings to the international markets throughout the remainder of fiscal 2004 from its production facilities in Singapore and the U.K.

ClearLab International s and ClearLab UK s development and manufacturing capabilities also provide the Company with greater access to future contact lens products for the U.S. retail market. This is critical to the Company s strategy should the Company s access to contact lenses from the major contact lens manufacturers be disrupted, curtailed or otherwise negatively impacted, or if the manufacturers do not provide the Company with contact lenses at competitive pricing and with competitive marketing support.

Johnson & Johnson Vision Care Agreement. In December 2002, the Company announced that it had reached an agreement with Johnson & Johnson Vision Care to become an authorized retailer of Johnson & Johnson Vision Care contact lenses. The Company modified its operating systems in connection with this agreement. The Company implemented new prescription verification procedures for Johnson & Johnson Vision Care by geographic region based on time zone. The Company began this implementation in February 2003 and completed it in April 2003. The Company began buying direct from Johnson & Johnson Vision Care during March 2003.

This direct relationship with Johnson & Johnson Vision Care has lowered the Company s product acquisition costs and allowed it to offer rebates and other incentives not previously available to its customers who wear Johnson & Johnson Vision Care lenses. The Company has also been able to reduce its inventory investment by purchasing a more balanced mix of products at lower prices than it has historically been able to obtain through indirect sources. This agreement also resolved long-standing disputes.

Cole National Marketing Agreement. On June 30, 2003, the Company and Cole National Corporation (Cole) announced that they had signed an agreement under which the Company s customers can receive discounted eye exams and value pricing on eyeglasses, sunglasses and other vision products that the Company does not sell from a network of doctors contracted with Cole Managed Vision and associated with more than 1,500 Pearle Vision, Pearle VisionCare, Sears Optical and Target Optical stores in the U.S. During the second quarter of fiscal 2004, the Company and Cole extended this agreement through March 31, 2005. Under this agreement, Cole is offering its network of doctors to the Company to be used for contacts lens exam referrals and the Company retains the contact lens business of customers referred to Cole stores.

As part of the agreement, the Company and Cole have also worked together on a variety of cross-marketing programs and promotions of their respective products in select test markets. The goal of these cross-marketing programs is to find other ways that the Company and Cole can help create value together.

Lens Express / Lens 1st. On January 30, 2003, the Company acquired certain assets and assumed certain liabilities of Lens Express LLC and Camelot Ventures/CJ, L.L.C. d/b/a Lens 1st (collectively, the Seller), two leading U.S. mail order contact lens retailers. The assets acquired included databases, customer information, web sites and Internet addresses or domain names, telephone numbers, certain specified contracts and intellectual property rights. In addition, acquired assets included certain property, equipment, inventories, receivables and prepaid expenses. With the exception of specifically identified liabilities, the Company did not assume the liabilities of the Seller. The liabilities assumed by the Company included certain of the Seller s identified contracts, accounts payable, accrued liabilities, certain customer program obligations and severance obligations as of January 30, 2003.

During the first quarter of fiscal 2004, the Company completed the consolidation of a majority of the operating facilities acquired from Lens 1st into its principal operating facilities in Utah.

Supplier Agreements. During the latter part of 2003, the Company reached agreements with its top three vendors for improved pricing and marketing support. This support will come in the form of cooperative marketing and rebate programs designed to promote the manufacturer s products and build sales. As part of its ongoing relationship with its suppliers, the Company periodically reviews its specific marketing plans and negotiates cooperative marketing programs with these vendors.

Regulatory Considerations

***Fairness to Contact Lens Consumer Act*.** In November 2003, Congress passed the Fairness to Contact Lens Consumer Act (FCLCA), which establishes a national uniform standard for both eye care practitioners and direct marketers with regard to releasing and verifying consumer contact lens prescriptions as well as other requirements relating to the sale of contact lenses. The FCLCA became effective February 4, 2004, and now requires all eye care practitioners to give patients a copy of their prescription as soon as they have been fitted for contact lenses, whether the patients ask for it or not. It also requires all eye care practitioners to respond to direct marketers requests to verify consumer prescriptions and provides that their failure to respond within eight business hours shall result in the prescription being presumed valid, thereby eliminating the ability of eye care practitioners to impede sales by direct marketers simply by ignoring or refusing to respond to their requests to verify prescriptions. The FCLCA also provides that prescriptions will be valid for a minimum of at least one year (absent some special medical reason justifying a shorter period) and that the time for expiration shall not begin to run until the eye care practitioner has given the patient a copy of his or her prescription. It also directs the Federal Trade Commission (FTC) to promulgate implementing rules and to conduct a study examining the strength of competition in the market for contact lenses and to submit a report to Congress within twelve months of the FCLCA effective date. This FTC study will specifically address, among other things, the use of doctor exclusive brands (i.e., contact lenses available only for sale from an eye care practitioner) and other practices that impede competition.

The FCLCA also requires that contact lenses only be sold to consumers based on a valid prescription. Satisfying this prescription requirement obligates the seller either to obtain a copy of the prescription itself or to verify the prescription by direct communication with the customer s prescriber. Consistent with this requirement, the Company s current operating practice is to require all customers to provide either a valid copy of their prescription or the contact information for their prescriber so that the Company can verify their prescription by direct communication with their prescriber. If the Company does not have a valid copy of the customer s prescription, the Company directly communicates to the customer s prescriber the precise prescription information received from the customer and informs the prescriber that it will proceed with the sale based on this prescription information unless the prescriber advises it within eight business hours that such prescription information is expired or otherwise invalid. If the prescriber properly advises the Company within this time period that the customer s prescription is expired or otherwise invalid, the Company s practice is to cancel the customer s order. On the other hand, if the prescriber either advises the Company that the prescription is valid or fails to respond properly within the required time period, the Company s practice is to complete the sale based on the prescription information communicated to the prescriber, as expressly permitted by the FCLCA. The Company retains copies of the written prescriptions that it receives and maintains records of its communications with the customer s prescriber.

Net sales for fiscal 2003 and the first two quarters of fiscal 2004 were negatively impacted by canceled orders due to the Company s implementation of its prescription verification procedures, including, most significantly, those implemented as part of the Johnson & Johnson Vision Care agreement in 2003, and the revisions to the Company s prescription verification procedures instituted on February 4, 2004 in response to the FCLCA. The Company is taking steps to recover these canceled orders principally by offering to its customers who do not hold a valid prescription for contact lenses referrals for contact lens exams to a Cole doctor under the Cole agreement. The Company is uncertain as to the ultimate impact its revised prescription verification procedures will have on future net sales, and the Company is uncertain as to the number of canceled orders that can subsequently be recovered through its doctor network referral program with Cole.

Results of Operations

The Company s fiscal year consists of a 52/53-week period ending on the Saturday nearest to December 31. Fiscal 2004 is a 52-week year and will end on January 1, 2005.

The following table presents the Company s results of operations expressed as a percentage of net sales for the periods indicated:

	Quarter Ended		Two Quarters Ended	
	June 28, 2003	July 3, 2004	June 28, 2003	July 3, 2004
NET SALES	100.0%	100.0%	100.0%	100.0%
COST OF GOODS SOLD	61.7	61.4	63.6	