ADVANCED MEDICAL OPTICS INC
Form 10-Q
August 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

or

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 001-31257

ADVANCED MEDICAL OPTICS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE (State or other jurisdiction of incorporation or organization)	**33-0986820** (I.R.S. Employer Identification No.)
1700 E. St. Andrew Place **Santa Ana, California** (Address of principal executive offices)	**92705** (Zip Code)

Registrant s telephone number, including area code **714/247-8200**

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 o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

As of July 31, 2006, there were 59,324,607 shares of common stock outstanding.

ADVANCED MEDICAL OPTICS, INC.
FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2006

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Advanced Medical Optics, Inc.
Unaudited Consolidated Statements of Operations
(In thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2006	**June 24, 2005**	**June 30, 2006**	**June 24, 2005**
Net sales	$ 257,041	$ 227,092	$ 495,269	$ 419,610
Cost of sales (Note 3)	92,373	87,478	179,208	157,917
Gross profit	164,668	139,614	316,061	261,693
Selling, general and administrative	105,389	97,596	200,828	181,409
Research and development	16,565	13,948	33,538	26,300
Business repositioning (Note 3)	17,720		46,974	
In-process research and development		451,450		451,450
Operating income (loss)	24,994	(423,380)	34,721	(397,466)
Non-operating expense (income):				
Interest expense	8,028	8,911	12,535	14,738
Unrealized (gain) loss on derivative instruments	2,464	(458)	2,902	(990)
Loss due to early retirement of convertible senior subordinated notes	15,798	545	15,798	545
Other, net	544	(1,413)	1,548	(1,742)
	26,834	7,585	32,783	12,551
Earning (loss) before income taxes	(1,840)	(430,965)	1,938	(410,017)
Provision for income taxes	863	7,150	2,012	14,273
Net loss	$ (2,703)	$ (438,115)	$ (74)	$ (424,290)
Net loss per share :				
Basic and Diluted	$ (0.04)	$ (9.53)	$	$ (10.17)
Weighted average number of shares outstanding:				
Basic and Diluted	67,166	45,965	67,694	41,719

See accompanying notes to unaudited consolidated financial statements.

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Advanced Medical Optics, Inc.
Unaudited Consolidated Balance Sheets
(In thousands, except share data)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets		
Cash and equivalents	$ 40,843	$ 40,826
Trade receivables, net	231,602	238,761
Inventories	118,583	104,820
Deferred income taxes	66,925	66,476
Other current assets	27,129	28,122
Income taxes	10,242	
Total current assets	495,324	479,005
Property, plant and equipment, net	126,791	115,725
Deferred income taxes	12,099	12,626
Other assets	63,366	52,473
Intangibles assets, net	486,125	495,609
Goodwill	842,967	825,284
Total assets	$ 2,026,672	$ 1,980,722
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Short-term borrowings	$ 155,000	$ 60,000
Accounts payable	60,592	64,045
Accrued compensation	43,844	43,406
Other accrued expenses.	85,114	90,666
Income taxes		1,434
Deferred income taxes	775	565
Total current liabilities	345,325	260,116
Long-term debt	871,105	500,000
Deferred income taxes	179,427	182,179
Other liabilities	30,445	28,365
Commitments and contingencies		
Stockholders equity		
Preferred stock, $.01 par value; 5,000,000 shares authorized; none issued		
Common stock, $.01 par value; 240,000,000 shares authorized; 59,294,365 and 67,832,010 shares issued	593	678
Additional paid-in capital	1,394,699	1,586,864
Accumulated deficit	(819,630)	(557,586)
Accumulated other comprehensive income (loss)	24,732	(19,870)
Less treasury stock, at cost (1,397 shares)	(24)	(24)
Total stockholders equity	600,370	1,010,062
Total liabilities and stockholders equity	$ 2,026,672	$ 1,980,722

See accompanying notes to unaudited consolidated financial statements.

Advanced Medical Optics, Inc.
Unaudited Consolidated Statements of Cash Flows
(In thousands)

	Six Months Ended June 30, 2006	June 24, 2005
Cash flows from operating activities:		
Net loss	$ (74)	$ (424,290)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Amortization of debt issuance costs	4,207	3,733
Depreciation and amortization	33,856	18,863
In-process research and development		451,450
Loss due to early retirement of convertible senior subordinated notes	15,798	545
Loss on investments and assets	2,481	264
Tax benefit from issuance of stock under stock plans		3,520
Excess tax benefits from stock-based compensation	(5,458)	
Unrealized loss (gain) on derivatives	2,902	(990)
Expense of compensation plan	10,262	267
Changes in assets and liabilities:		
Trade receivables, net	13,549	(15,065)
Inventories	(11,626)	(24,389)
Other current assets	(851)	3,506
Accounts payable	(6,511)	(8,631)
Accrued expenses and other liabilities	(3,474)	(30,039)
Income taxes	(1,110)	6,943
Other non-current assets and liabilities	(8,620)	4,887
Net cash provided by (used in) operating activities	45,331	(9,426)
Cash flows from investing activities:		
Acquisition of businesses, net of cash acquired		(36,867)
Additions to property, plant and equipment	(15,140)	(7,608)
Proceeds from sale of property, plant and equipment		167
Additions to capitalized internal-use software	(1,201)	(7,085)
Additions to demonstration and bundled equipment	(5,446)	(5,391)
Net cash used in investing activities	(21,787)	(56,784)
Cash flows from financing activities:		
Short-term borrowings	95,000	105,000
Repayment of long-term debt	(144,693)	(44,495)
Financing related costs	(10,284)	(2,959)
Proceeds from issuance of long-term debt	500,000	
Proceeds from issuance of common stock	29,488	10,204
Net proceeds from settlement of interest rate swaps		777
Repurchase and retirement of common stock	(500,000)	
Excess tax benefits from stock-based compensation	5,458	
Net cash (used in) provided by financing activities	(25,031)	68,527
Effect of exchange rates on cash and equivalents	1,504	(2,327)
Net increase (decrease) in cash and equivalents	17	(10
Cash and equivalents at beginning of period	40,826	49,455
Cash and equivalents at end of period	$ 40,843	$ 49,445
Supplemental non-cash investing and financing activities:		
Exchange of convertible notes into common stock	$	$ 3,000
Acquisition of VISX, Incorporated	$	$ 1,203,185

See accompanying notes to unaudited consolidated financial statements.

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Advanced Medical Optics, Inc.
Notes to Unaudited Consolidated Financial Statements

Note 1: Basis of Presentation

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments necessary (consisting only of normal, recurring adjustments) for a fair statement of the financial information contained therein. These statements do not include all disclosures required by accounting principles generally accepted in the United States of America for annual financial statements and should be read in conjunction with the audited consolidated financial statements of Advanced Medical Optics, Inc. (the Company or AMO) for the year ended December 31, 2005. The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the year ending December 31, 2006.

All material intercompany balances have been eliminated.

Stock-Based Compensation

AMO has an Incentive Compensation Plan (ICP) that provides for the granting of stock options, restricted stock and restricted stock units to directors, employees and consultants. The Company has two Employee Stock Purchase Plans (ESPP) for United States and international employees, respectively, which allow employees to purchase AMO common stock. A total of 5 million shares of common stock have been authorized for issuance under the ICP. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R) as discussed below.

Adoption of SFAS 123R

Prior to January 1, 2006, the Company s stock-based compensation plans were accounted for under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and the disclosure only provisions of SFAS 123. Accordingly, no compensation expense was recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. The fair value, as determined on the date of grant, of restricted stock awards was recognized as compensation expense ratably over the respective vesting period. Additionally, the ESPP qualified as non-compensatory plans under APB 25; therefore, no compensation cost was recorded in relation to the discount offered to employees for purchases made under the ESPP. In addition, the Company s unearned compensation balance at January 1, 2006 was reclassified to additional paid-in capital upon the adoption of SFAS 123R.

On January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R, requiring recognition of expenses equivalent to the fair value of stock-based compensation awards. The Company has elected to use the modified prospective application transition method as permitted by SFAS 123R and therefore has not restated the financial results reported in prior periods. Under this transition method, stock-based compensation expense for the three and six months ended June 30, 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, as adjusted for estimated forfeitures. Compensation expense for all stock-based compensation awards granted subsequent to January 1, 2006 are based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R.

Additionally, under SFAS 123R, the ESPP is considered a compensatory plan and requires recognition of compensation expense for purchases of common stock made under the ESPP. The Company recognizes compensation expense for stock option and ESPP awards on a straight-line basis over the vesting period. Compensation expense related to the restricted stock and restricted stock units is recognized over the requisite service periods of the awards, consistent with the Company s practices under SFAS 123 prior to January 1, 2006.

Stock-Based Compensation Expense

Total stock-based compensation expense included in the unaudited consolidated statements of operations for the three and six months ended June 30, 2006 is as follows (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of sales	$ 617	$ 1,157
Operating Expenses -		
Research and development	577	1,057
Selling, general and administrative	3,997	8,048
	4,574	9,105
Pre-tax expense	5,191	10,262
Income tax benefit	(1,704)	(3,387)
Net of tax expense	$ 3,487	$ 6,875

At June 30, 2006, total pre-tax compensation costs related to unvested stock-based awards granted to employees and directors under the Company s stock option plan, ESPP and restricted stock awards which are not yet recognized were approximately $36.6 million, net of estimated forfeitures. These costs are expected to be recognized over a weighted-average period of 3.0 years.

Net cash proceeds from the exercise of stock options were $27.1 million and $8.1 million for the six month periods ended June 30, 2006 and June 24, 2005, respectively. In accordance with SFAS 123R, the cash flows resulting from excess tax benefits (tax benefits related to the excess of proceeds from employees exercises of stock options over the stock-based compensation cost recognized for those options) are classified as financing cash flows in the Company s unaudited consolidated statement of cash flows. During the six months ended June 30, 2006, the Company recorded $5.5 million of excess tax benefits as a financing cash inflow. Prior to the adoption of SFAS 123R, excess tax benefits of $3.5 million during the six months ended June 24, 2005 were classified as an operating cash inflow.

The Company issues new shares to satisfy option exercises.

Determining Fair Value

Valuation Method - The Company estimates the fair value of stock options granted and ESPP purchase rights using the Black-Scholes option-pricing model and a single option award approach.

Expected Term - The expected term represents the period the Company s stock-based awards are expected to be outstanding and was determined based on historical experience with similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of its stock-based awards.

Expected Volatility - The computation of expected volatility is based on a combination of historical and market-based implied volatility. Implied volatility is based on publicly traded options of the Company s common stock with a term of one year or greater.

Risk-Free Interest Rate - The risk-free interest rate used in the Black-Scholes valuation method is based on the implied yield currently available on U.S. Treasury securities with an equivalent remaining term.

Expected Dividend - No dividends are expected to be paid.

Estimated Forfeitures - When estimating forfeitures, the Company considers voluntary termination behavior as well as analysis of actual option forfeitures.

The fair value of the Company s stock based compensation granted to employees for the three and six months ended June 30, 2006 was estimated using the following weighted-average assumptions:

	Incentive Compensation Plans		Employee Stock Purchase Plans	
Expected life in years	6.1		0.5	
Expected volatility	28.9	%	32.9	%
Risk-free interest rate	5.0	%	5.0	%
Expected dividends				
Weighted average fair value	$ 17.66		$ 11.51	

Stock Options

Stock options granted to employees are generally exercisable at a price equal to the fair market value of the common stock on the date of the grant and vest at a rate of 25% per year beginning twelve months after the date of grant. Grants under these plans expire ten years from the date of grant.

The following is a summary of stock option activity (in thousands, except per share amounts):

	Number of Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Outstanding at December 31, 2005	8,858		$ 22.79		
Granted	634		45.26		
Exercised	(1,264	)	21.41		
Forfeitures and cancellations	(60	)	31.44		
Expirations	(6	)	19.97		
Outstanding at June 30, 2006	8,162		$ 24.69	6.6	$ 212,270
Vested and expected to vest at June 30, 2006	8,044		$ 24.57	6.7	$ 210,188
Exercisable at June 30, 2006	5,448		$ 20.58	5.9	$ 164,083

The aggregate intrinsic value in the table above represents the difference between the exercise price of the underlying awards and the quoted price of the company s common stock for the options that were in-the-money at June 30, 2006. During the six months ended June 30, 2006, the aggregate intrinsic value of options exercised under the Company s stock option plans was $30.3 million determined as of the date of option exercise.

Employee Stock Purchase Plans

Under the ESPP, eligible employees may authorize payroll deductions of up to 10% of their regular base salary to purchase shares at the lower of 85% of the closing price of the Company s common stock on the first or last day of the six-month purchase period. In the second quarter of 2006, 78,000 shares of common stock were issued under the ESPP in the aggregate amount of $2.4 million as the most recent purchase period ended on April 28, 2006. As of June 30, 2006 employee withholdings under the ESPP aggregated $0.8 million.

Restricted Stock

Restricted stock awards are granted at a price equal to the fair market value of the common stock on the date of the grant, subject to forfeiture if employment terminates prior to the release of restrictions, which is generally three years from the date of grant. During this restriction period, ownership of the shares cannot be transferred. Restricted stock has the same cash dividend and voting rights as other common stock and is considered to be currently issued and outstanding. The cost of the awards, determined to be the fair market value of the shares at the date of grant, is expensed ratably over the period the restrictions lapse.

The following table summarizes the restricted stock award activity for the six months ended June 30, 2006 (in thousands, except per share amounts):

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested stock at December 31, 2005	101	$ 38.79
Granted	275	49.67
Vested	(37)	38.23
Forfeited	(2)	38.43
Nonvested stock at June 30, 2006	337	$ 47.73

Performance-Based Awards

In February 2006, the Company s Board of Directors approved a 2006 performance award program under the Company s incentive compensation plan (the 2006 Program), which provides the opportunity for certain executives to earn long-term incentive compensation awards based upon specified measures. The potential maximum aggregate award value for the 2006 program is $2.7 million. The award determination will be based upon the Total Shareholder Return (TSR) (the increase or decrease in the Company s common stock price) over a two-year period beginning January 1, 2005 compared to a peer group composed of various entities within the bio-technology and medical device industries. Awards will have been determined to be earned if the Company s TSR is in excess of the 50th percentile of the peer group. When the TSR equals the 75th percentile of the peer group, the maximum amount will have been earned. Awards are to be settled in a number of restricted stock shares or units equal to the value of the award amount divided by the fair market value of the Company s common stock on the date the performance criteria is deemed to have been met. The restricted stock shares or units will have the same terms and conditions as other restricted shares or units issued under the Company s ICP. The estimated fair value of the 2006 Program was $0.8 million on the grant date using a lattice-based valuation model. Compensation expense is being recognized over a four-year period from the program approval date through the end of the expected vesting period of the restricted stock awards. The associated compensation expense during the three months and six months ended June 30, 2006 was less than $0.1 million.

Pro-forma Disclosures under SFAS 123 for Periods Prior to Fiscal 2006

The following table illustrates the effect on net loss and net loss per share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation during the three and six months period ended June 24, 2005 (in thousands, except per share amounts):

	Three Months Ended June 24, 2005	Six Months Ended June 24, 2005
Net loss, as reported	$ (438,115)	$ (424,290)
Stock-based compensation expense included in reported net earnings, net of tax	119	163
Stock-based compensation expense determined under fair value based method, net of tax	(2,579)	(4,876)
Pro forma net loss	$ (440,575)	$ (429,003)
Loss per share as reported:		
Basic and diluted	$ (9.53)	$ (10.17)
Pro forma loss per share:		
Basic and diluted	$ (9.59)	$ (10.28)

For the purpose of the weighted average estimated fair value calculations, the fair value of the Company s stock based compensation granted to employees for the three and six months ended June 24, 2005 was estimated using the following weighted-average assumptions:

	Incentive Compensation Plans		Employee Stock Purchase Plans	
Expected life in years	5.0		0.5	
Expected volatility	36.0	%	44.13	%
Risk-free interest rate	3.8	%	3.2	%
Expected dividends				
Weighted average fair value	$ 14.49		$ 9.84	

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Note 2: Acquisition of VISX, Incorporated (VISX)

On May 27, 2005, pursuant to the Agreement and Plan of Merger (Merger Agreement), dated as of November 9, 2004, as amended, by and among AMO, Vault Merger Corporation, a wholly owned subsidiary of AMO, and VISX, AMO completed its acquisition of VISX, for total consideration of approximately $1.38 billion, consisting of approximately 27.8 million shares of AMO common stock, the fair value of VISX stock options converted to AMO stock options and approximately $176.2 million in cash (VISX Acquisition). VISX products include the *VISX STAR* Excimer Laser System, the *VISX WaveScan* System and *VISX* treatment cards. As a result of the VISX Acquisition, the Company became a leader in the design and development of proprietary technologies and systems for laser vision correction of refractive vision disorders.

The VISX Acquisition has been accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed are recorded at the date of acquisition at their respective fair values.

The following unaudited pro forma information assumes the VISX Acquisition occurred on January 1, 2005. These unaudited pro forma results have been prepared for informational purposes only and do not purport to represent what the results of operations would have been had the VISX Acquisition occurred as of the date indicated, nor of future results of operations. The unaudited pro forma results for the three and six months ended June 24, 2005 are as follows (in thousands, except per share data):

	Three Months Ended June 24, 2005		Six Months Ended June 24, 2005	
Net sales:				
Cataract/Implant	$	127,726	$	244,456
Laser Vision Correction	45,123		98,404	
Eye Care	83,073		156,919	
	$	255,922	$	499,779
Net earnings (1)	3,968		27,235	
Earnings per share:				
Basic (2)	$	0.06	$	0.42
Diluted (3)	$	0.06	$	0.40

(1) The unaudited pro forma information for the three months and six months ended June 24, 2005 includes a $6.6 million and a $13.3 million increase in amortization related to management s estimate of the fair value of intangible assets acquired as the result of the VISX Acquisition and a $2.8 million and $5.7 million increase in interest expense resulting from additional borrowings incurred to fund the cash portion of the VISX Acquisition and related costs and amortization of deferred financing costs.

(2) The weighted average number of shares outstanding used for the computation of basic earnings per share for the three and six months ended June 24, 2005 reflects the issuance of 27.8 million shares of AMO s common stock to VISX stockholders.

(3) The weighted average number of shares outstanding used for the computation of diluted earnings per share for the three and six months ended June 24, 2005 reflects the issuance of 27.8 million shares of AMO s common stock to VISX shareholders and the dilutive effect of approximately 3.4 million shares and 3.5 million shares of VISX options exchanged for AMO stock options.

Note 3: Product Rationalization and Business Repositioning

On October 31, 2005, the Company s Board of Directors approved a product rationalization and repositioning plan covering the discontinuation of non-strategic cataract surgical and eye care products and the elimination or redeployment of resources that support these product lines. The plan also includes organizational changes and potential reductions in force in manufacturing, sales and marketing associated with these product lines, as well as organizational changes in research and development and other corporate functions designed to align the organization with our strategy and strategic business unit organization.

The plan further calls for increasing the Company s investment in key growth opportunities, specifically the Company s refractive implant product line and international laser vision correction business, and accelerating the implementation of productivity initiatives. Following an analysis of its IOL manufacturing capabilities in the second quarter of 2006, the Company has decided to consolidate certain operations. In addition, the Company expanded the scope of its eye care rationalization initiatives in order to maximize manufacturing capacity and seize growth opportunities. Total cumulative charges of $99.8 million have been incurred through June 30, 2006.

Certain foreign jurisdictions have laws and regulations which require consultations and negotiations with works councils, labor organizations and local authorities. The outcome of these discussions will determine, in part, the restructuring steps to be implemented and the associated costs. Therefore, the final costs of the business repositioning plan may be significantly different from the Company s initial estimates.

In the three months ended June 30, 2006, the Company incurred $25.1 million of pre-tax charges, which included $7.4 million for inventory, manufacturing related and other charges included in cost of sales and $17.7 million included in operating expenses. Charges included in operating expenses comprised severance, relocation and other one-time termination benefits of $11.9 million, productivity and brand repositioning costs of $4.9 million, asset write-downs of $0.7 million and contractual obligations of $0.2 million. In the six months ended June 30, 2006, the Company incurred $57.5 million of pre-tax charges, which included $10.5 million for inventory, manufacturing related and other charges included in cost of sales and $47.0 million included in operating expenses. Charges included in operating expenses comprised productivity and brand repositioning costs of $31.1 million, severance, relocation and other one-time termination benefits of $13.5 million, asset write-downs of $2.1 million and contractual obligations of $0.3 million

Business repositioning charges and related activity in the accrual balances during the six months ended June 30, 2006 were as follows (in thousands):

Business Repositioning Costs Reported In:	**Balance at December 31, 2005**	**Costs Incurred**	**Cash Payments**	**Non-Cash Adjustments**	**Balance at June 30, 2006**
Cost of sales -					
Inventory, manufacturing and other charges	$	$ 10,513	$	$ (10,513)	$
Operating Expenses -					
Severance, relocation and related costs	8,779	13,497	(9,972)		12,304
Asset write-downs		2,096		(2,096)	
Contractual obligations	2,641	250	(141)		2,750
Productivity initiatives and brand repositioning costs	883	31,131	(29,641)		2,373
	12,303	46,974	(39,754)	(2,096)	17,427
	$ 12,303	$ 57,487	$ (39,754)	$ (12,609)	$ 17,427

Productivity initiatives and brand repositioning costs resulted from the Company s investment in key growth opportunities, specifically the Company s refractive implant product line, international laser vision correction business and expanded eye care rationalization, and the implementation of productivity improvements in manufacturing operations, distribution, customer service and corporate functions. Severance, relocation and related costs were incurred for worldwide workforce reductions due to the Company s discontinuing certain non-core products and infrastructure and process improvements associated with the Company s productivity initiatives. The majority of these costs in the three and six months ended June 30, 2006 occurred in Europe. Asset write-downs resulted from the impairment and disposal of long-lived assets from the reduction in expected future cash flows from certain discontinued non-core products and relocation of certain facilities. The fair values of impaired assets were based on probability weighted expected cash flows as determined in accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-lived Assets .

Note 4: Composition of Certain Financial Statement Captions

Inventories:

(In thousands)	**June 30, 2006**	**December 31, 2005**
Finished goods, including consignment inventory of $14,956 and $11,890 in 2006 and 2005, respectively	$ 79,837	$ 66,492
Work in process	13,101	13,148
Raw materials	25,645	25,180
	$ 118,583	$ 104,820

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Intangible assets, net

(In thousands)	Useful Life (Years)	June 30, 2006 Gross Amount	Accumulated Amortization	December 31, 2005 Gross Amount	Accumulated Amortization
Amortizable Intangible Assets:					
Licensing	3 5	$ 4,590	$ (4,178)	$ 4,590	$ (4,113)
Technology rights	8 19	358,698	(44,294)	348,379	(26,128)
Trademarks	13.5	16,144	(2,782)	14,689	(1,995)
Customer relationships	5	22,400	(4,853)	22,400	(2,613)
		401,832	(56,107)	390,058	(34,849)
Nonamortizable Tradename (VISX)	Indefinite	140,400		140,400	
		$ 542,232	$ (56,107)	$ 530,458	$ (34,849)

The amortizable intangible assets balance increased due to the impact of foreign currency fluctuation. Amortization expense was $10.2 million and $19.9 million for the three and six months ended June 30, 2006, $4.7 million and $7.6 million for the three and six months ended June 24, 2005, respectively, and is recorded in selling, general and administrative in the accompanying unaudited consolidated statements of operations. Amortization expense is expected to be $39.7 million in 2006, $38.5 million in 2007 and 2008, $38.3 million in 2009 and $35.7 million in 2010. Actual amortization expense may vary due to the impact of foreign currency fluctuations.

Goodwill

(In thousands)	June 30, 2006	December 31, 2005
Goodwill:		
Eye Care	$ 29,555	$ 28,817
Cataract/Implant	338,915	317,451
Laser Vision Correction	474,497	479,016
	$ 842,967	$ 825,284

Effective January 1, 2006, the Company s reportable segments are represented by three business units: Cataract/Implant, Laser Vision Correction and Eye Care (See Note 9, Business Segment Information). The change in goodwill during the six months ended June 30, 2006 is due to an adjustment of Laser Vision Correction goodwill of $4.5 million as a result of excess tax benefits from the exercise of converted VISX stock options that were fully vested at the acquisition date and the impact of foreign currency fluctuations on the Eye Care and Cataract/Implant segments. The Company performed its annual impairment test of goodwill during the second quarter of 2006 and determined there was no impairment.

Note 5: Debt

At June 30, 2006, an aggregate principal amount of $251.1 million of 2½ % convertible senior subordinated notes due July 15, 2024 (2½ % Notes), an aggregate principal amount of $120.0 million of 1.375% convertible senior subordinated notes due July 1, 2025 (1.375% Notes), an aggregate principal amount of $500.0 million of 3.25% of convertible senior subordinated notes due 2026 (3.25% Notes), and a balance of $155.0 million under the senior revolving credit facility were outstanding. The convertible notes may be converted, at the option of the holders, on or prior to the final maturity date under certain circumstances, none of which had occurred as of June 30, 2006. Upon conversion of the convertible notes, the Company will satisfy in cash the conversion obligation with respect to the principal amount of the convertible notes, with any remaining amount of the conversion obligation to be satisfied in shares of common stock. As a result of this election, the Company also is required to satisfy in cash its obligations to repurchase any convertible notes that holders may put to the Company on January 15, 2010, July 15, 2014 and July 15, 2019 for the 2½ % Notes, on July 1, 2011, July 1, 2016 and July 1, 2021 for the 1.375% Notes, and on August 1, 2014, August 1, 2017, and August 1, 2021 for the 3.25% Notes.

At June 30, 2006, approximately $8.6 million of the senior revolving credit facility was reserved to support letters of credit issued on the Company s behalf for normal operating purposes and the Company has approximately $146.4 million undrawn and available revolving loan commitments.

Borrowings under the revolving credit facility, if any, bear interest at current market rates plus a margin based upon the Company s ratio of debt to EBITDA, as defined. The incremental interest margin on borrowings under the revolving credit facility decreases as the Company s ratio of debt to EBITDA decreases to specified levels. Under the senior credit facility, certain transactions may trigger mandatory prepayment of borrowings, if any. Such transactions may include equity or debt offerings, certain asset sales and extraordinary receipts. The Company pays a quarterly fee (2.95% per annum at June 30, 2006) on the average balance of outstanding letters of credit and a quarterly commitment fee (0.50% per annum at June 30, 2006) on the average unused portion of the revolving credit facility.

The senior credit facility provides that the Company will maintain certain financial and operating covenants which include, among other provisions, maintaining specific leverage and coverage ratios. Certain covenants under the senior credit facility may limit the incurrence of additional indebtedness. The senior credit facility prohibits dividend payments. The Company was in compliance with these covenants at June 30, 2006. The senior credit facility is collateralized by a first priority perfected lien on, and pledge of, all of the combined Company s present and future property and assets (subject to certain exclusions), 100% of the stock of the domestic subsidiaries, 66% of the stock of foreign subsidiaries and all present and future intercompany debts.

As of June 30, 2006, the aggregate maturities of total long-term debt of $871.1 million are due after 2010. Revolving loan borrowings of $155.0 million at June 30, 2006 have been classified as current liabilities in the accompanying unaudited consolidated balance sheet.

3.25% Convertible Senior Subordinated Notes Due 2026

In June 2006, the Company completed a private placement of $500 million aggregate principal amount of its 3.25% Notes due August 1, 2026. Interest on the 3.25% Notes is payable on February 1 and August 1 of each year, commencing on February 1, 2007. The 3.25% Notes are convertible into 16.7771 shares of the Company s common stock for each $1,000 principal amount of the 3.25% Notes (which represents an initial conversion price of approximately $59.61 per share), subject to adjustment. The 3.25% Notes may be converted, at the option of the holders, into cash or under certain circumstances, cash and shares of the Company s common stock at any time on or prior to the trading day preceding July 1, 2014, only under the following circumstances:

- during the five business days after any five consecutive trading-day period in which the trading price per $1,000 principal amount of the 3.25% Notes for each day of such measurement period was less than 98% of the conversion value. This conversion feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value was assigned at issuance and at June 30, 2006;

- during any fiscal quarter subsequent to September 30, 2006, if the closing sale price of the Company s common stock measured over a specified number of trading days is above 130% of the conversion then in effect;

- if a fundamental change occurs; or

- upon the occurrence of specified corporate transactions.

On and after July 1, 2014, to (and including) the trading day preceding the maturity date, subject to prior redemption or repurchase, the 3.25% Notes will be convertible into cash and, if applicable, shares of the Company s common stock regardless of the foregoing circumstances.

The Company may redeem some or all of the 3.25% Notes for cash, on or after August 4, 2014, for a price equal to 100% of the principal amount plus accrued and unpaid interest, including contingent interest, if any, to, but excluding the redemption date.

The 3.25% Notes contain put options, which may require the Company to repurchase in cash all or a portion of the 3.25% Notes on August 1, 2014, August 1, 2017, and August 1, 2021 at a repurchase price equal to 100% of the principal amount plus accrued and unpaid interest, including contingent interest, if any, to, but excluding the repurchase date.

Beginning with the six-month interest period commencing August 1, 2014, the Company will pay contingent interest during any six-month interest period if the trading price of the 3.25% Notes for each of the five trading-days ending on the second trading day immediately preceding the first day of the applicable six-month interest period equals or exceeds 120% of the principal amount of the 3.25% Notes. The contingent interest payable will equal 0.25% of the average trading price of $1,000 principal amount of the 3.25% Notes during the five trading days immediately preceding the first day of the applicable six-month interest period. This contingent interest payment feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value has been assigned at issuance and at June 30, 2006.

On or prior to August 1, 2014, upon the occurrence of a fundamental change, under certain circumstances, the Company will provide for a make whole amount by increasing, for the time period described herein, the conversion rate by a number of additional shares for any conversion of the 3.25% Notes in connection with such fundamental change transactions. The amount of additional shares will be determined based on the price paid per share of the Company s common stock in the transaction constituting a fundamental change and the effective date of such transaction.

This make whole premium feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value has been assigned at issuance and at June 30, 2006.

In connection with the sale of the 3.25% Notes, the Company entered into a registration rights agreement with the initial purchasers of the 3.25% Notes. Under the registration rights agreement, the Company has agreed to use its reasonable best efforts to file with the Securities and Exchange Commission within 90 days of the date thereof a shelf registration statement with respect to the resale of the 3.25% Notes and the shares of AMO common stock, if any, issuable upon conversion of the Notes, and to have the shelf registration statement declared effective within 180 days after the original issuance of the notes. If the Company fails to comply with certain of its obligations under the registration rights agreement, it will be required to pay additional interest on the notes.

In addition, the Company entered into an accelerated share repurchase arrangement with a third party to use the proceeds from the issuance of the 3.25% Notes to purchase $500.0 million of AMO common stock at a volume weighted price per share over the term of the agreement. As of June 30, 2006, the third party had delivered to the Company in the aggregate, 10.1 million shares of AMO common stock with future delivery of up to an additional 1.2 million shares, resulting in a total of up to 11.3 million shares, depending on the volume weighted average share price per share during a calculation period beginning June 14, 2006 and ending no later than March 7, 2007. Repurchased shares were retired upon delivery to the Company. The Company also repurchased $128.9 million of aggregate principal amount of convertible senior subordinated notes ($98.9 million of the principal amount of the 2.5% Notes and $30.0 million of the principal amount of the 1.375% Notes) utilizing borrowings under its senior credit facility. The Company incurred a loss on debt extinguishment of $15.8 million and wrote-off debt issuance costs of $2.4 million in the three months ended June 30, 2006 in conjunction with the note repurchases.

Note 6: Related Party Transactions

As of June 30, 2006, an interest-free relocation loan of $0.5 million, collateralized by real property, was outstanding from the chief executive officer. The principal amount of the loan is payable upon the earlier to occur of (a) 60 days following the chief executive officer s termination of employment; (b) the date of the sale or other transfer of the property or (c) July 3, 2007. This relocation loan is evidenced by a promissory note dated July 3, 2002, prior to the adoption of the Sarbanes-Oxley Act of 2002.

Note 7: Earnings Per Share

Basic earnings per share is calculated by dividing net earnings by the weighted average number of common shares outstanding during the period. Diluted earnings per share is calculated by adjusting net earnings and the weighted average outstanding shares, assuming the conversion of all potentially dilutive convertible securities, stock options and stock purchase plan awards.

Statement of Financial Accounting Standards No. 128, Earnings per Share, requires that stock options, nonvested shares and similar equity instruments granted by the Company be treated as potential common shares outstanding in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect of in-the-money options which is calculated based on the average market price of the Company s common stock for each fiscal period using the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares.

The three and six month periods ended June 30, 2006 exclude the aggregate dilutive effect of approximately 2.4 million shares for stock options, ESPP and unvested restricted stock as the effect would be antidilutive due to the net loss in each of these periods. The three and six month periods ended June 24, 2005 exclude the aggregate dilutive effect of approximately 2.7 million shares for stock options, ESPP unvested restricted stock and 3.5% convertible senior subordinated notes as the effect would be antidilutive due to the net loss in each of these periods.

The Company will settle in cash the principal amount of the 2 ½% Notes, 1.375% Notes, and the 3.25% Notes. In addition, there were no potentially dilutive common shares associated with the 2 ½% Notes, the 1.375% Notes, and the 3.25% Notes as the Company s average stock prices during the three and six months ended June 30, 2006 were less than the conversion prices of the respective notes.

Note 8: Other Comprehensive Income (Loss)

The following table summarizes the components of comprehensive income (loss) (in thousands):