

VISX INC  
Form 10-Q  
August 06, 2004

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

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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 June 30, 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

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**VISX, INCORPORATED**

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

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**Delaware**

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**06-1161793**

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

*(IRS Employer  
Identification No.)*

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

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*(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 July 31, 2004: 49,486,504

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

	<b>June 30, 2004</b>	<b>December 31, 2003</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 23,406	\$ 24,895
Short-term investments	90,846	61,181
Accounts receivable, net of allowance for doubtful accounts of \$3,622 and \$4,195 respectively	25,321	27,432
Inventories	12,707	11,219
Deferred tax assets and prepaid expenses	18,240	20,477
	<hr/>	<hr/>
Total current assets	170,520	145,204
<b>Property and Equipment, net</b>	3,924	3,851
<b>Long-Term Deferred Tax and Other Assets</b>	12,704	14,908
	<hr/>	<hr/>
Total assets	\$ 187,148	\$ 163,963
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities:</b>		
Accounts payable	\$ 5,306	\$ 3,442
Accrued liabilities and other current liabilities	35,226	34,722
	<hr/>	<hr/>
Total current liabilities	40,532	38,164
	<hr/>	<hr/>
<b>Stockholders Equity:</b>		
Common stock: \$.01 par value, 180,000,000 shares authorized; 64,990,089 shares issued at June 30, 2004 and December 31, 2003, respectively	650	650
Additional paid-in capital	193,642	201,108

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Treasury stock, at cost 15,604,824 and 16,295,297 shares, at June 30, 2004 and December 31, 2003 respectively	(250,939)	(258,218)
Accumulated other comprehensive income	45	341
Retained earnings	<u>203,218</u>	<u>181,918</u>
 Total stockholders' equity	 <u>146,616</u>	 <u>125,799</u>
 Total liabilities and stockholders' equity	 <u>\$ 187,148</u>	 <u>\$ 163,963</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 OPERATIONS**  
(In thousands, except per share amounts)

	<b>Three months ended June 30,</b>		<b>Six months ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(unaudited)</b>			
<b>Revenues:</b>				
License and other revenues	\$30,231	\$20,064	\$ 62,718	\$39,741
System revenues	7,303	7,681	13,379	17,607
Service and parts revenues	5,442	4,241	10,684	9,071
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total revenues	42,976	31,986	86,781	66,419
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Costs and Expenses:</b>				
Cost of license and other revenues	864	707	1,844	1,539
Cost of system revenues	6,814	7,185	12,105	15,564
Cost of service and parts revenues	4,028	3,498	7,626	7,111
Selling, general and administrative	10,475	10,854	20,232	20,308
Research, development and regulatory	5,451	4,789	10,495	8,835
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total costs and expenses	27,632	27,033	52,302	53,357
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Income From Operations</b>	15,344	4,953	34,479	13,062
Interest and other income	458	1,818	786	2,761
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Income Before Provision For Income Taxes</b>	15,802	6,771	35,265	15,823
Provision for income taxes	(6,258)	(2,673)	(13,965)	(6,249)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Net Income</b>	\$ 9,544	\$ 4,098	\$ 21,300	\$ 9,574
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Earnings Per Share</b>				
Basic	\$ 0.19	\$ 0.08	\$ 0.44	\$ 0.19
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

Diluted	\$ 0.19	\$ 0.08	\$ 0.42	\$ 0.19
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Shares Used For Earnings Per Share</b>				
Basic	48,996	50,076	48,834	50,705
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Diluted	50,832	51,406	50,622	51,601
	<u>          </u>	<u>          </u>	<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>Six months ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(unaudited)</b>	
<b>Cash flows from operating activities:</b>		
Net income	\$ 21,300	\$ 9,574
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,422	3,477
Provision for doubtful accounts receivable	(137)	(53)
Increase (decrease) in cash flows from changes in operating assets and liabilities:		
Accounts receivable	2,242	(2,534)
Inventories	(5,881)	(6,271)
Deferred tax assets and prepaid expenses	3,066	5,123
Long-term deferred tax and other assets	2,254	2,120
Accounts payable	1,864	665
Accrued liabilities and other current liabilities	493	(10,742)
	<hr/>	<hr/>
Net cash provided by operating activities	<hr/> 29,623	<hr/> 1,359
<b>Cash flows from investing activities:</b>		
Capital expenditures	(990)	(649)
Cash paid for acquisition of intangibles		(5,900)
Purchase of available for sales securities	(43,979)	(35,944)
Proceeds from maturities of available for sale securities	14,038	82,071
	<hr/>	<hr/>
Net cash provided by (used in) investing activities	<hr/> (30,931)	<hr/> 39,578
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock	15,026	939
Repurchases of common stock	(15,213)	(63,000)
	<hr/>	<hr/>
Net cash used in financing activities	<hr/> (187)	<hr/> (62,061)



	<u>          </u>	<u>          </u>
Effect of exchange rate changes on cash and cash equivalents	<u>          6          </u>	<u>          (9)          </u>
Net decrease in cash and cash equivalents	(1,489)	(21,133)
Cash and cash equivalents, beginning of period	<u>24,895</u>	<u>37,687</u>
Cash and cash equivalents, end of period	<u>\$ 23,406</u>	<u>\$ 16,554</u>
<b>Supplemental Cash Flow Information</b>		
Cash paid for income taxes	<u>\$ 12,356</u>	<u>\$ 2,169</u>
Non-cash investing activities:		
Inventory transferred to deferred costs under operating leases	<u>\$ 4,385</u>	<u>\$ 3,396</u>

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****June 30, 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 generally accepted accounting principles 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. The results of operations for the three and six months ended June 30, 2004 are not necessarily indicative of the results for the entire year or any other period.

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 periods. 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 June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
NET INCOME	\$ 9,544	\$ 4,098	\$21,300	\$ 9,574
BASIC EARNINGS PER SHARE				
Income available to common shareholders	\$ 9,544	\$ 4,098	\$21,300	\$ 9,574
Weighted average common shares outstanding	48,996	50,076	48,834	50,705
Basic Earnings Per Share	\$ 0.19	\$ 0.08	\$ 0.44	\$ 0.19
DILUTED EARNINGS PER SHARE				
Income available to common shareholders	\$ 9,544	\$ 4,098	\$21,300	\$ 9,574
Weighted average common shares outstanding	48,996	50,076	48,834	50,705
Dilutive potential common shares from stock options	1,836	1,330	1,788	896

Weighted average common shares and dilutive potential common shares	<u>50,832</u>	<u>51,406</u>	<u>50,622</u>	<u>51,601</u>
Diluted Earnings Per Share	<u>\$ 0.19</u>	<u>\$ 0.08</u>	<u>\$ 0.42</u>	<u>\$ 0.19</u>

Options to purchase 1,804,000 and 4,716,000 shares with a weighted average exercise price of \$36.25 and \$24.52 during the three month periods ended June 30, 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.

Options to purchase 2,068,000 and 6,095,000 shares with a weighted average exercise price of \$34.45 and \$22.35 during the six month periods ended June 30, 2004 and 2003, respectively, were excluded

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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.

*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 June 30,</b>		<b>Six Months Ended June 30,</b>	
		<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Net Income	As Reported	\$ 9,544	\$ 4,098	\$21,300	\$ 9,574
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(2,284)	(2,349)	(4,231)	(4,164)
Net Income	Pro Forma	\$ 7,260	\$ 1,749	\$17,069	\$ 5,410
Basic Earnings Per Share	As Reported	\$ 0.19	\$ 0.08	\$ 0.44	\$ 0.19
	Pro Forma	0.15	0.03	0.35	0.11
Diluted Earnings Per Share	As Reported	\$ 0.19	\$ 0.08	\$ 0.42	\$ 0.19
	Pro Forma	0.14	0.03	0.34	0.11

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**

**Six Months**

	<b>Ended June 30,</b>		<b>Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Expected life of options (in years)	4.31	2.93	5.24	4.27
Expected life of ESPP rights (in years)	1.25	1.25	1.25	1.25
Volatility for options	62%	61%	71%	75%
Volatility for ESPP rights	59%	60%	59%	60%
Risk free interest rate for options	3.61%	1.68%	2.95%	2.49%
Risk free interest rate for ESPP rights	1.72%	1.61%	1.72%	1.61%
Dividend yield	0.0%	0.0%	0.0%	0.0%

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The weighted average fair value of options granted under our stock option plans during the three and six month periods ended June 30, 2004 was \$11.17 and \$12.22, respectively. The weighted average fair value per share of options granted under the ESPP during both the three and six month periods ended June 30, 2004 was \$4.69.

The weighted average fair value of options granted under our stock option plans during the three and six month periods ended June 30, 2003 was \$6.93 and \$4.96, respectively. The weighted average fair value per share of options granted under the ESPP during both the three and six month periods ended June 30, 2003 was \$3.63.

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 18% and 15% of total revenues for the three month periods ended June 30, 2004 and June 30, 2003 respectively, and 16% and 19% of total revenues for the six month periods ended June 30, 2004 and June 30, 2003 respectively. We did not generate export revenues to any country that equaled or exceeded 10% of our total revenues for the three and six month periods ended June 30, 2004 and June 30, 2003. In the following table we have presented our export revenues by geographic region (in thousands):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Europe	1,558	1,523	3,538	3,480
Americas (excluding the United States)	883	871	1,779	1,816
Asia and Other	5,318	2,557	8,457	7,036
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
	\$7,759	\$4,951	\$13,774	\$12,332
	<u>          </u>	<u>          </u>	<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 17% and 18% of total revenues for the three month periods ended June 30, 2004 and 2003 and 20% and 13% of total revenues for the three month periods ended March 31, 2004 and 2003 respectively. For the six

month periods ended June 30, 2004 and 2003 TLC accounted for 19% and 16% of total revenues. TLC accounted for 17% and 22% of our total receivables at June 30, 2004 and December 31, 2003, respectively. Additionally, Taiwan Hwa-In Corporation accounted for 13% of our total receivables at June 30, 2004.

**Table of Contents****3. Inventories**

Components of inventories are as follows (in thousands):

	<b>June 30, 2004</b>	<b>December 31, 2003</b>
	<b>(Unaudited)</b>	
Raw materials and subassemblies	\$ 8,169	\$ 7,786
Work-in-process	1,719	1,321
Finished goods	2,819	2,112
	<u>\$12,707</u>	<u>\$11,219</u>

**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 June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Net income	\$9,544	\$ 4,098	\$21,300	\$ 9,574
Other comprehensive income (net of related tax effects)				
Decrease in accumulated unrealized holding gains on available-for-sale securities	(334)	(1,210)	(276)	(1,332)
Change in accumulated foreign currency translation adjustment	(31)	(9)	(20)	(9)
	<u>\$9,179</u>	<u>\$ 2,879</u>	<u>\$21,004</u>	<u>\$ 8,233</u>

**5. Warranty Obligations**

Changes in product warranty obligations for the periods ended June 30, 2004 and 2003 are as follows (unaudited, in thousands):



	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Balance as of the beginning of the period	\$1,346	\$1,980	\$1,779	\$ 1,963
Expense accrued	342	630	328	1,398
Cost of services provided	(112)	(947)	(531)	(1,698)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Balance as of the end of the period	<u>\$1,576</u>	<u>\$1,663</u>	<u>\$1,576</u>	<u>\$ 1,663</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

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applicable securities laws, we have repurchased 7.8 million shares cumulatively on the open market through June 30, 2004 at a total cost of \$105.6 million. Accordingly, 2.2 million shares remain available as of June 30, 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 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.

## **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 increase customer acceptance of laser vision correction surgery; 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; the possibility that we may repurchase shares of our common stock in 2004; our belief that these will not be a near-term change in our level of capital expenditures; our belief that our revenue and profit in 2004 will continue to improve compared to 2003; our belief that operating expenses will increase approximately 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 further improvement in the United States economy and increased adoption by our customers of our CustomVue product will cause license and other revenues to increase in 2004 compared to



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2003; our belief that system revenue for the remainder of 2004 will be less than in 2003; our current operations plan for the remainder of 2004 regarding legal expenses and administrative spending; our projection that research and development expense will be higher in the second half of 2004 compared to the first half 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 involved. In the United States, we charge a license fee for our standard procedure and 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 our standard procedure we charge a small price per procedure for the treatment card. For our CustomVue procedure we charge a significantly higher price per procedure.

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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 have approximately 60% market share for procedures performed in the United States. According to MarketScope, we have held at least 60% market share since 1997.

Licensing revenues comprise the majority of our revenues and carry a gross profit margin of approximately 97%. Licensing revenues also generated in excess of 90% of our gross profit dollars in the three and six month periods ended June 30, 2004. Such revenues are predominantly derived from license fees from our United States customers. Licensing revenues grew 51% and 58% in the three and six month periods ended June 30, 2004 compared with the corresponding periods in 2003. We evaluate this aspect of our business by tracking the following:

The number of procedures sold;

Trends in procedure 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 0.7 million shares of stock in the first six months of 2004 and may repurchase additional shares through the remainder of 2004. We will also continue to investigate areas where we can expand our business. This could result in using cash for the acquisition of technology or a business. Our capital expenditures have been in the range of \$2.4 million to \$4 million per year in the past five years. We do not expect to exceed this level of expenditures in 2004. We have no long term debt.

Looking to the remainder of 2004, our business is highly leveraged on procedure volume and 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 continued growth. Laser vision correction has penetrated approximately 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

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higher-priced CustomVue procedure. We expect that ongoing technical advances, such as the CustomVue procedure, will enhance the quality of patients' vision and 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, expanding the potential for growth in procedures, CustomVue adoption and licensing revenue.

Our competition. Competition in the laser vision correction market is intense which creates pricing pressure on our products. Additionally, most of our competitors have greater resources and a stronger international market presence. As a result the competition to obtain procedure market share is intense.

The United States economy. We have always charged a license fee for procedures sold in the United States. Therefore it remains by far our most significant market for licensing revenue. As such, economic conditions in the United States 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 the continued improvements in the United States economy and consumer confidence have provided 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 continue to improve as compared to 2003 as a result of various factors including continued conversion to the CustomVue procedure, maintenance of our United States market share, and improvements in the United States economy. For 2004, we anticipate that operating expenses will increase approximately 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 June 30,</b>			<b>Six Months Ended June 30,</b>		
	<b>2004</b>	<b>2003</b>	<b>Change</b>	<b>2004</b>	<b>2003</b>	<b>Change</b>
License and other revenues	\$30,231	\$20,064	51%	\$62,718	\$39,741	58%
<i>Percent of total revenues</i>	<i>70.3%</i>	<i>62.7%</i>		<i>72.3%</i>	<i>59.8%</i>	
System revenues	7,303	7,681	(5)%	13,379	17,607	(24)%
<i>Percent of total revenues</i>	<i>17.0%</i>	<i>24.0%</i>		<i>15.4%</i>	<i>26.5%</i>	
Service and parts revenues	5,442	4,241	28%	10,684	9,071	18%
<i>Percent of total revenues</i>	<i>12.7%</i>	<i>13.3%</i>		<i>12.3%</i>	<i>13.7%</i>	
Total revenues	\$42,976	\$31,986	34%	\$86,781	\$66,419	31%

*License and other revenues*

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License and other revenues increased by \$10.1 million to \$30.2 million for the three months ended June 30, 2004 from \$20.1 million for the three months ended June 30, 2003. The increase was primarily attributable to increased adoption of our new CustomVue procedure and 18% 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. License and other revenues increased by \$23.0 million to \$62.7 million for the six months ended June 30, 2004 from \$39.7 million for the six months ended June 30, 2003. The increase was also primarily attributable to increased adoption of our CustomVue procedure and procedure growth in the United States. In the United States, CustomVue procedures represented approximately 35% of the procedure orders in the six month period ended June 30, 2004.

Based on economists' views of 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 decreased by \$0.4 million to \$7.3 million for the three months ended June 30, 2004 from \$7.7 million for the three months ended June 30, 2003. More VISX STAR Systems were shipped during the three months ended June 30, 2004 as compared to the comparable period of 2003. However a greater amount were shipped under operating leases during the three months ended June 30, 2004. Under rental or operating lease agreements for systems, rental revenue is recognized over the term of the agreement. System revenues decreased by \$4.2 million to \$13.4 million for the six months ended June 30, 2004 from \$17.6 million for the six months ended June 30, 2003 due to fewer VISX STAR System sales due primarily to softness of laser markets and competitive pricing pressures.

For both comparative periods, there were fewer WaveScan System sales in 2004 as compared to 2003 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 six months ended June 30, 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.

We believe that system revenue for the remainder of 2004 will be less than in 2003.



**Table of Contents***Service and parts revenues*

Service and parts revenues increased by \$1.2 million to \$5.4 million for the three months ended June 30, 2004 from \$4.2 million for the three months ended June 30, 2003. Service and parts revenues increased by \$1.6 million to \$10.7 million for the six months ended June 30, 2004 from \$9.1 million for the six months ended June 30, 2003. The increases were higher than the comparable periods of 2003 due primarily to higher procedure volumes and the resultant higher revenues derived from customers that purchased service on a per procedure basis.

	Three Months Ended June 30,			Six Months Ended June 30,		
	2004	2003	Change	2004	2003	Change
Cost of license and other revenue	\$ 864	\$ 707	22%	\$ 1,844	\$ 1,539	20%
<i>Percent of related revenues</i>	2.9%	3.5%		2.9%	3.9%	
Cost of system revenues	6,814	7,185	(5)%	12,105	15,564	(22)%
<i>Percent of related revenues</i>	93.3%	93.5%		90.5%	88.4%	
Cost of service and parts revenues	4,028	3,498	15%	7,626	7,111	7%
<i>Percent of related revenues</i>	74.0%	82.5%		71.4%	78.4%	
Selling, general and administrative	10,475	10,854	(3)%	20,232	20,308	
<i>Percent of total revenues</i>	24.4%	33.9%		23.3%	30.6%	
Research, develop. and regulatory	5,451	4,789	14%	10,495	8,835	19%
<i>Percent of total revenues</i>	12.7%	15.0%		12.1%	13.3%	

*Cost of license and other revenues*

Cost of license and other revenues increased by \$0.2 million to \$0.9 million for the three months ended June 30, 2004 from \$0.7 million for the three months ended June 30, 2003. Cost of license and other revenues increased by \$0.3 million to \$1.8 million for the six months ended June 30, 2004 from \$1.5 million for the six months ended June 30, 2003. These increases were due to the increased number of procedures when compared to the related periods in 2003. 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 by \$0.4 million to \$6.8 million for the three months ended June 30, 2004 from \$7.2 million for the three months ended June 30, 2003. Cost of system revenues decreased by \$3.5 million to \$12.1 million for the six months ended June 30, 2004 from \$15.6 million for the six months ended June 30, 2003. These decreases in cost of system revenues were due primarily to the decrease of revenues from the sales of lasers, upgrades and WaveScan Systems. The gross profit margin decreased as the competitive pricing pressure reduced the average selling price with no corresponding reduction in average cost.

*Cost of service and parts revenues*

Cost of service and parts revenues increased by \$0.5 million to \$4.0 million for the three months ended June 30, 2004 from \$3.5 million for the three months ended June 30, 2003. Cost of service and parts revenues increased primarily due to higher costs to service a larger installed base of products in the



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United States. The overall gross profit margin increased to 26% in the three months ended June 30, 2004 compared to 18% in the corresponding quarter of 2003 as labor service costs are relatively fixed and parts usage does not typically increase linearly with procedure volume. We also incurred significant service costs in the second quarter of 2003 associated with the launch of our CustomVue procedure. Cost of service and parts revenues increased by \$0.5 million to \$7.6 million for the six months ended June 30, 2004 from \$7.1 million for the six months ended June 30, 2003. The increase is primarily due to higher costs to service a larger installed based of Wavescan Systems.

*Selling, general and administrative expenses*

Selling, general and administrative expenses decreased by \$0.4 million to \$10.5 million for the three months ended June 30, 2004 from \$10.9 million for the three months ended June 30, 2003. The change reflects primarily the following items:

General expenses decreased by \$1.2 million primarily due to higher costs incurred in 2003 associated with the filing of the 2003 proxy statement and stockholder vote;

Marketing costs decreased by \$0.5 million primarily due to a reduction in professional media costs in 2004 compared to those incurred in 2003 associated with the launch of CustomVue in June 2003;

Legal expenses increased in 2004 as expenses in 2003 included the benefit of a \$0.7 million insurance reimbursement; and

Administrative expenses increased \$0.7 million primarily due to the costs of compliance with the provisions of the Sarbanes Oxley Act.

Selling, general, and administrative expenses were largely unchanged for the six months ended June 30, 2004 from the corresponding period of the prior year. Increased legal expenses were offset by lower marketing costs for the reasons noted above.

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

A net increase in legal expenses in 2004 as the second half of 2003 benefited from the non-recurring receipt of insurance reimbursements of legal expenses totaling approximately \$3.2 million; and

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.

*Research and development and regulatory expenses*

Research and development and regulatory expenses increased by \$0.7 million to \$5.5 million for the three months ended June 30, 2004 from \$4.8 million for the three months ended June 30, 2003. Research and development and regulatory expenses increased by \$1.7 million to \$10.5 million for the six months ended June 30, 2004 from \$8.8 million for the six months ended June 30, 2003. These increases relate primarily to our ongoing focus on next generation technologies and developments for laser vision correction, including:

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 project that research and development expense will be higher in the second half of 2004 compared to the first half of 2004 as we continue to invest in new technology.

**Table of Contents***Interest and other income*

Interest and other income decreased by \$1.3 million to \$0.5 million for the three months ended June 30, 2004 from \$1.8 million for the three months ended June 30, 2003. In 2003 we sold available for sale securities to repurchase shares of VISX stock. This led to a \$1.2 million realized gain on available-for-sale securities in the three months ended June 30, 2003. The holding gains were previously recorded in accumulated other comprehensive income, and were recognized in interest and other income upon realization in 2003. Interest income decreased by \$2.0 million to \$0.8 million for the six months ended June 30, 2004 from \$2.8 million for the six months ended June 30, 2003. Lower average yields on our portfolio and lower cash investment balances also contributed to the decrease in interest income compared to the first six months of 2003.

*Income tax provision*

Our effective tax rate of 39.6% remained approximately constant in the three and six months ended June 30, 2004 compared to the corresponding periods of 2003.

**Liquidity and Capital Resources**

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

	<b>June 30, 2004</b>	<b>December 31, 2003</b>
Cash, cash equivalents and short-term investments	\$ 114,252	\$ 86,076
Working capital	129,988	107,040
Stockholders equity	146,616	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 in the consolidated statements of operations.

Cash, cash equivalents and short-term investments were \$114.3 million at June 30, 2004, an increase of \$28.2 million compared with December 31, 2003. It was impacted principally by:

Positive cash flow from operating activities of \$29.6 million;

Proceeds from issuance of common stock related to employee participation in employee stock programs generating \$15.0 million;

Stock repurchases of \$15.2 million; and

Capital expenditures of \$1.0 million.



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Operating activities generated \$29.6 million in cash in the six months ended June 30, 2004 up from \$1.4 million provided in the six months ended June 30, 2003. In the first half of 2004 we:

Generated \$25.6 million of cash from net income plus non-cash related expenses;

Decreased accounts receivable by \$2.2 million due primarily to the collection of outstanding balances. Days sales outstanding in accounts receivable was 54 days at the end of the second quarter of 2004 as compared to 77 days at the comparable point in 2003; and

Decreased deferred tax assets and prepaid expenses due primarily to the utilization of prepaid tax assets. Net cash used in investing activities was \$31.0 million in the six months ended June 30, 2004 down from \$39.6 million net cash provided in the six months ended June 30, 2003. The principal movements in cash used in investing activities in the first half of 2004 were due to the investments in, and maturities of, short-term investments. Net cash provided by investing activities in the first half of 2003 consisted primarily of the investments in, and maturities of, short-term investments offset by a payment of \$5.9 million for acquired patents and technology from 20/10 Perfect Vision Optische Gerate GmbH.

Cash used in financing activities was \$0.2 million in the six months ended June 30, 2004 down from \$62.1 million cash used in the six months ended June 30, 2003. The principal factor that contributed to the cash used in financing activities was the use of \$15.2 million to repurchase 0.7 million shares of VISX stock on the open market in the first half of 2004 compared to the \$63.0 million used to repurchase 3.5 million shares during the first half of 2003. This was offset by cash received upon the issuance of stock under employee stock programs of \$15.0 million and \$0.9 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 7.8 million shares on the open market cumulatively through June 30, 2004, at a total cost of \$105.6 million. Accordingly, 2.2 million shares remain available as of June 30, 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 June 30, 2004, we did not have any borrowings outstanding, nor any credit agreements.

Our normal credit terms granted to customers are net 30 to net 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 continue to 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 \$114.3 million in cash, cash equivalents and short-term investments as of June 30, 2004 to provide for unforeseen contingencies and to support strategic objectives including the development or acquisition of new technologies and our Stock Repurchase Program.





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### **Critical Accounting Policies**

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 June 30, 2004 and December 31, 2003 as a percentage of gross accounts receivable was 12.5% and 13.3% respectively. At June 30, 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 three and six month periods ending June 30, 2004 and June 30, 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 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.

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### *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 approximately 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.

*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

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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 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

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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 Corporation ( TLC ). Sales to TLC, accounted for 20% and 13% of total revenues for the three month periods ended March 31, 2004 and 2003 and 17% and 18% of total revenues for the three month periods ended June 30, 2004 and 2003, respectively. For the six month periods ended June 30, 2004 and 2003 TLC accounted for 19% and 16% of total revenues. TLC accounted for 17% and 22% of our total receivables at June 30, 2004 and December 31, 2003, respectively. Additionally, Taiwan Hwa In Corporation ( Taiwan-Hwa ) accounted for 13% of our total receivables at June 30, 2004. 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

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success. The research and development process is expensive, prolonged, and entails considerable 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. Sales to customers outside the United States represented 18% and 16% of our total revenues for the three and six months ended June 30, 2004 and 15% and 19% of our total revenues for the three and six months ended June 30, 2003. 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;

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foreign currency fluctuations;

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

dependence on local distributors.

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





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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 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 June 30, 2004, there were an aggregate of 5,543,427 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.

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*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 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 six months ended June 30, 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 period covered by this report or subsequent to the Evaluation Date.

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

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 June 30, 2004, there were no material developments with respect to such previously existing proceedings and no new material proceedings not previously disclosed

**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>
April 1 through April 30, 2004	20,000	\$22.26	20,000	2,510,300
May 1 through May 31, 2004	63,200	22.25	63,200	2,447,100
June 1 through June 30, 2004	217,900	24.07	217,900	2,229,200
<b>Total</b>	<b>301,100</b>	<b>\$23.57</b>	<b>301,100</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 7.8 million shares cumulatively through June 30, 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.

**Table of Contents****Item 4. Submission of Matters to a Vote of Security Holders**

At VISX, Incorporated's Annual Stockholders' Meeting on May 13, 2004, stockholders (1) elected each of the director nominees, (2) approved an amendment increasing the number of shares reserved for issuance under the Company's 2000 Stock Plan, (3) approved the Company's Performance Incentive Plan, and (4) ratified the appointment of the Company's independent auditors. The results of the voting were as follows:

	<b>Number of Shares</b>	
	<b>Voted For</b>	<b>Withheld</b>
Proposal 1. To elect a board of directors to hold office until the next annual stockholders meeting or until their respective successors have been elected or appointed.		
E. Davila	42,624,103	1,476,938
L. De Buono	41,969,597	2,131,444
G. French	40,857,117	3,243,924
J. Galiardo	40,845,652	3,255,389
J. Holmes	40,969,345	3,131,696
G. Petersmeyer	41,109,804	2,991,237
R. Sayford	40,851,626	3,249,415

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	Number of Shares			
	Voted For	Voted Against	Abstain	Broker Non-Votes
Proposal 2. To approve an amendment increasing the number of shares reserved for issuance under the Company's 2000 Stock Plan.	21,980,785	9,053,543	85,786	12,980,927 <sup>1</sup>
Proposal 3. To approve the Company's Performance Incentive Plan.	29,002,470	2,015,601	102,043	12,980,927 <sup>1</sup>
Proposal 4. To ratify the appointment of the Company's independent auditors.	40,766,409	3,283,766	50,866	0

<sup>1</sup> Pursuant to Section 216 of the Delaware General Corporation Law, the affirmative vote of the majority of the votes cast was required to pass Proposals 2 and 3. Significantly fewer shares voted on each of Proposals 2 and 3 than voted on Proposal 1, the election of directors, and Proposal 4, the ratification of the appointment of the Company's auditors.

Broker non-votes accounted for this difference in voted shares. For certain types of non-routine proposals, such as Proposals 2 and 3, brokers do not have the discretionary authority to vote their clients' shares, and therefore they must refrain from voting on such proposals in the absence of instructions from their clients. Broker non-votes are counted for purposes of determining whether a quorum exists but not for purposes of determining whether a proposal has passed.

**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 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



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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

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b) *Reports on Form 8-K.*

- (1) Report on 8-K filed on April 21, 2004 under Item 12 (Disclosure of Results of Operations and Financial Condition) regarding VISX's first quarter financial results

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**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)

August 6, 2004

/s/ Elizabeth H. Dávila

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

August 6, 2004

/s/ Derek A. Bertocci

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

August 6, 2004

/s/ Martyn J. Webster

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

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**Exhibit Index**

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