1 800 CONTACTS INC
Form 10-Q
November 10, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended October 1, 2005

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

For the transition period from to .

Commission file number: 0-23633

1-800 CONTACTS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**87-0571643**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

66 E. Wadsworth Park Drive, **Draper, UT**	**84020**
(Address of principal executive offices)	(Zip Code)

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

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

ý Yes No o

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

ý Yes No o

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

o Yes No ý

As of November 7, 2005, the Registrant had 13,339,557 shares of Common Stock, par value $0.01 per share, outstanding.

1-800 CONTACTS, INC.

INDEX

PART I. FINANCIAL INFORMATION	
Item 1.	Financial Statements
	Condensed Consolidated Balance Sheets as of January 1, 2005 and October 1, 2005
	Condensed Consolidated Statements of Operations for the Quarter and Three Quarters Ended October 2, 2004 and October 1, 2005
	Condensed Consolidated Statements of Cash Flows for the Three Quarters Ended October 2, 2004 and October 1, 2005
	Notes to Condensed Consolidated Financial Statements
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations
Item 3.	Quantitative and Qualitative Disclosures About Market Risk
Item 4.	Controls and Procedures
PART II. OTHER INFORMATION	
Item 1.	Legal Proceedings.
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds
Item 3.	Defaults Upon Senior Securities
Item 4.	Submission of Matters to a Vote of Security Holders
Item 5.	Other Information
Item 6.	Exhibits

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

1-800 CONTACTS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

(unaudited)

ASSETS

	January 1, 2005	October 1, 2005
CURRENT ASSETS:		
Cash	$ 3,105	$ 226
Accounts receivable, net	3,178	4,247
Other receivables	2,398	2,083
Inventories, net	22,206	27,963
Deferred income taxes	1,328	1,402
Other current assets	1,546	2,541
Total current assets	33,761	38,462
PROPERTY AND EQUIPMENT, net	20,618	25,173
DEFERRED INCOME TAXES	720	908
GOODWILL	34,320	35,223
DEFINITE-LIVED INTANGIBLES, net	17,897	14,864
OTHER ASSETS	1,669	3,398
Total assets	$ 108,985	$ 118,028
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	$ 1,632	$ 1,603
Current portion of capital lease obligations	47	43
Income taxes payable	1,560	171
Accounts payable	9,762	17,386
Accrued liabilities	7,303	10,065
Unearned revenue	3,500	2,036
Total current liabilities	23,804	31,304
LONG-TERM LIABILITIES:		
Line of credit	14,404	19,449
Long-term debt, net of current portion	8,170	6,742
Capital lease obligations, net of current portion	98	60
Deferred income tax liabilities	1,458	188
Unearned revenue, net of current portion	1,667	
Other long-term liabilities	880	736
Total long-term liabilities	26,677	27,175
STOCKHOLDERS EQUITY		
Common stock, 13,299 and 13,340 issued and outstanding, respectively	133	133

Additional paid-in capital		46,061		48,505
Deferred compensation on restricted stock grants		(103)		(666)
Retained earnings		12,218		11,868
Accumulated other comprehensive income (loss)		195		(291)
Total stockholders equity		58,504		59,549
Total liabilities and stockholders equity	$	108,985	$	118,028

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Quarter Ended		Three Quarters Ended	
	October 2, 2004	October 1, 2005	October 2, 2004	October 1, 2005
NET SALES	$ 56,893	$ 60,858	$ 157,713	$ 182,506
COST OF GOODS SOLD	34,889	37,706	97,140	113,178
Gross profit	22,004	23,152	60,573	69,328
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES:				
Advertising	6,533	6,606	22,572	20,264
Legal and professional	1,026	1,210	4,207	3,400
Research and development	567	426	1,902	2,292
Purchased in-process research and development			83	
Other selling, general and administrative	10,789	13,538	31,437	37,359
Total selling, general and administrative expenses	18,915	21,780	60,201	63,315
INCOME FROM OPERATIONS	3,089	1,372	372	6,013
OTHER EXPENSE, net	(216)	(755)	(1,271)	(2,562)
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES	2,873	617	(899)	3,451
PROVISION FOR INCOME TAXES	(1,520)	(1,191)	(1,102)	(3,801)
NET INCOME (LOSS)	$ 1,353	$ (574)	$ (2,001)	$ (350)
PER SHARE INFORMATION:				
Basic and diluted net income (loss) per common share	$ 0.10	$ (0.04)	$ (0.15)	$ (0.03)

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Three Quarters Ended	
	October 2, 2004	October 1, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (2,001)	$ (350)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	5,630	6,572
Amortization of debt issuance costs and discounts	247	138
Foreign currency exchange loss	27	1,390
Stock-based compensation	8	79
Purchased in-process research and development	83	
Loss on disposal of property and equipment	89	519
Deferred income taxes, net of effects of acquisition	(1,439)	(1,463)
Changes in operating assets and liabilities, net of effects of acquisition:		
Accounts receivable, net	(671)	(1,193)
Inventories, net	695	(6,025)
Other receivables	(1,443)	315
Other current assets	333	(1,047)
Income taxes payable	2,170	(1,245)
Accounts payable	(1,621)	5,917
Accrued liabilities	3,014	4,656
Unearned revenue	(158)	(3,110)
Net cash provided by operating activities	4,963	5,153
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(5,996)	(9,549)
Proceeds from sale of property and equipment	3	27
Purchase of definite-lived intangible assets	(3,997)	(610)
Cash paid for acquisition of VisionTec	(3,776)	
Deposits and other	(289)	(2,121)
Net cash used in investing activities	$ (14,055)	$ (12,253)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of common stock options	$ 159	$ 381
Net borrowings on line of credit	16,351	5,045
Principal payments on capital lease obligations	(219)	(35)
Debt issuance costs	(196)	
Principal payments on long-term debt	(8,511)	(1,261)
Proceeds from international government grant	873	
Net cash provided by financing activities	8,457	4,130
EFFECT OF FOREIGN EXCHANGE RATES ON CASH	(67)	91
NET DECREASE IN CASH	(702)	(2,879)
CASH AT BEGINNING OF PERIOD	1,075	3,105
CASH AT END OF PERIOD	$ 373	$ 226
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for interest	$ 964	$ 807
Cash paid for income taxes	370	6,510

SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:

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

As part of the acquisition of ClearLab International in 2002, the Company entered into an agreement to issue 270,000 options to purchase shares of 1-800 CONTACTS, INC. common stock in three equal tranches. The first tranche of 90,000 options vested on July 24, 2005. The Company used the Black-Scholes option-pricing model to determine the fair-value of these options, as of the vesting date. Using this method, the vested options were valued at approximately $1.3 million and the Company recorded this amount as additional purchase consideration, increasing goodwill.

See accompanying notes to condensed consolidated financial statements.

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

NOTE 1. PRESENTATION OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The accompanying condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments), which in the opinion of management, are necessary to present fairly the results of operations of the Company for the periods presented. It is suggested that these condensed consolidated financial statements be read in conjunction with the audited financial statements and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended January 1, 2005.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

NOTE 2. INVENTORIES

Inventories are recorded at the lower of cost (using the first-in, first-out method) or market value. Elements of cost in the Company s manufactured inventories generally include raw materials, direct labor, manufacturing overhead and freight-in. Inventories consisted of the following (in thousands):

		January 1, 2005		October 1, 2005
Purchased contact lenses and accessories	$	16,216	$	19,789
Manufactured inventories:				
Raw materials		930		1,343
Work in process		1,796		1,878
Finished goods contact lenses		3,264		4,953
Total	$	22,206	$	27,963

Provision is made to reduce excess and obsolete inventories to their estimated net realizable values. As of January 1, 2005 and October 1, 2005, reserves for excess and obsolete inventories were approximately $1.2 million and $1.0 million, respectively.

NOTE 3. NET INCOME (LOSS) PER COMMON SHARE

Basic net income (loss) per common share (Basic EPS) excludes dilution and is computed by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per common share (Diluted EPS) reflects the potential dilution that could occur if stock options or other common stock equivalents were exercised or converted into common stock. The computation of Diluted EPS does not assume exercise or conversion of securities that would have an antidilutive effect on net income (loss) per common share. For the quarter and three quarters ended October 1, 2005, options to purchase 1,278,569 and 974,339 shares of common stock, respectively, were not included in the computation of Diluted EPS because the effect would be antidilutive. For the quarter and three quarters ended October 2, 2004, options to purchase 956,071

and 1,257,476 shares of common stock, respectively, were not included in the computation of Diluted EPS because the effect would be antidilutive.

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

	Quarter Ended October 2, 2004			Quarter Ended October 1, 2005		
	Net Income	Shares	Per-Share Amount	Net Loss	Shares	Per-Share Amount
Basic EPS	$ 1,353	13,287	$ 0.10	$ (574)	13,329	$ (0.04)
Effect of stock options		86				
Diluted EPS	$ 1,353	13,373	$ 0.10	$ (574)	13,329	$ (0.04)

	Three Quarters Ended October 2, 2004			Three Quarters Ended October 1, 2005		
	Net Loss	Shares	Per-Share Amount	Net Loss	Shares	Per-Share Amount
Basic EPS	$ (2,001)	13,254	$ (0.15)	$ (350)	13,315	$ (0.03)
Effect of stock options						
Diluted EPS	$ (2,001)	13,254	$ (0.15)	$ (350)	13,315	$ (0.03)

NOTE 4. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) for the quarter and three quarters ended October 2, 2004 and October 1, 2005 consists of the following components (in thousands):

	Quarter Ended		Three Quarters Ended	
	October 2, 2004	October 1, 2005	October 2, 2004	October 1, 2005
Net income (loss)	$ 1,353	$ (574)	$ (2,001)	$ (350)
Foreign currency translation	45	(127)	(125)	(487)
Comprehensive income (loss)	$ 1,398	$ (701)	$ (2,126)	$ (837)

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

NOTE 5. STOCK-BASED COMPENSATION

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

Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, established accounting and disclosure requirements using a fair-value based method of accounting for stock-based employee compensation plans. As permitted by existing accounting standards, the Company has elected to continue to apply the intrinsic-value-based method of accounting described above, and has adopted only the disclosure requirements of SFAS No. 123.

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

	Quarter Ended			
	October 2, 2004		October 1, 2005	
Net income (loss):				
As reported	$	1,353	$	(574)
Fair-value based compensation, net of tax		(380)		(155)
Pro forma	$	973	$	(729)
Basic and diluted net income(loss) per common share:				
As reported	$	0.10	$	(0.04)
Pro forma	$	0.07	$	(0.05)

	Three Quarters Ended			
	October 2, 2004		October 1, 2005	
Net loss:				
As reported	$	(2,001)	$	(350)
Fair-value based compensation, net of tax		(1,208)		(727)
Pro forma	$	(3,209)	$	(1,077)
Basic and diluted net loss per common share:				
As reported	$	(0.15)	$	(0.03)
Pro forma	$	(0.24)	$	(0.08)

The weighted average per share fair value of options granted during the quarter ended October 2, 2004 and the three quarters ended October 2, 2004 was $6.77 and $11.69, respectively. No options were granted during the quarter ended October 1, 2005. The weighted average per share fair value of options granted during the three quarters ended October 1, 2005 was $11.30. The fair value of each option grant has been estimated on the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Quarter Ended		Three Quarters Ended	
	October 2, 2004	October 1, 2005	October 2, 2004	October 1, 2005
Risk-free interest rate	3.6%		3.2%	3.7%
Expected dividend yield	0.0%		0.0%	0.0%
Volatility	65.9%		67.6%	65.5%
Expected life	5 years		5 years	5 years

NOTE 6. RECENT TRANSACTIONS AND AGREEMENTS

Japanese License and Royalty Agreement

On December 15, 2004 the Company signed an agreement which grants Menicon Co., Ltd. (Menicon) exclusive rights to develop, manufacture and market certain disposable contact lenses and related intellectual property in Japan.

Under the terms of the agreement, Menicon licenses from the Company different types of intellectual property, including contact lens material, manufacturing technology and related knowledge. In consideration, Menicon is expected to pay nonrefundable license fees of $18 million, of which $5 million was paid in December 2004 upon signing the agreement. The remaining $13 million is expected to be paid over the next three to five years as the

Company fulfills its obligations and as corresponding milestones relating to Japanese regulatory approval and Menicon s launch of the product in the Japanese market are met. Of the total $18 million license fee, $10 million is guaranteed.

The Company evaluated the agreement under Emerging Issues Task Force 00-21, Revenue Arrangements with Multiple Deliverables, and determined that this arrangement should be considered a single unit of accounting. Therefore, in applying the principles of Staff Accounting Bulletin No. 104 to the license agreement, the Company considered the terms and conditions of the agreement to arrive at a proportional performance methodology of recognizing revenue. Accordingly, the Company is recognizing the guaranteed portion of the license fees from this agreement on a straight-line basis, limited by the amount of cash received, over the period of the Company s continued involvement in meeting its obligations, estimated to be through June of 2007. In the event the Company achieves a milestone (not relating to the guaranteed portion of the license fees) prior to the completion of its obligations under the agreement, the milestone payment will be recognized on a straight-line basis over the remaining period of the Company s continued involvement in meeting its obligations. Upon completion of this agreement, the Company will recognize the remaining milestone payments as the agreed upon milestones are achieved. The Company recorded income of $1.0 million and $3.0 million for the fiscal quarter and three quarters ended October 1, 2005, respectively.

If Menicon has not received regulatory approval on or before December 31, 2009, it may return all intellectual property covered by the agreement and in-process regulatory approvals to the Company, and the Company may pursue the Japanese market on its own and terminate the exclusive agreement.

Under the terms of the agreement, Menicon will also pay royalties for a period of at least 15 years from the product launch date in Japan on contact lenses sold that were manufactured using the licensed technology, with a guaranteed minimum of $5 million per year beginning the earlier of the second year after product launch or 2012. The agreement does not include the sale of any of the Company s current equipment, facilities or capacity and is limited to the Japanese contact lens market.

Optical Retail Store Agreement

During the latter part of 2004, the Company entered into an agreement with a regional optical retail chain in Utah in which the two companies would jointly market and sell contact lenses in Utah. In December 2004, the companies began jointly serving these Utah customers. The agreement is for one year, with one year renewals at the option of both parties.

Under the agreement, the Company fulfills substantially all orders taken at the retail optical chain for contact lenses and both parties share in the operating results of the combined contact lens business based on a certain allocation percentage. However, the Company has guaranteed that the retail chain will receive at least $0.5 million of annual earnings under the arrangement. Additionally, the Company committed to purchase approximately $0.3 million per year in inventory from the retail chain s source of supply. Under the arrangement, the Company records gross revenues for all orders fulfilled and records selling, general and administrative expense for the retail chain s share of the net operating results.

NOTE 7. COMMON STOCK TRANSACTIONS

During the three quarters ended October 1, 2005, employees exercised stock options to purchase 39,903 shares of common stock for a total of approximately $0.4 million. The Company recorded an increase in additional paid-in capital of approximately $0.1 million as a result of the

income tax benefit related to these stock option exercises.

During the three quarters ended October 1, 2005, the Company granted nonqualified stock options to purchase 1,000 shares of common stock to employees of the Company. The exercise price of the options was $22.00 per share, which was not less than the quoted fair market value at the grant date. The options vest equally over a four-year period and expire in five years.

During the three quarters ended October 1, 2005, the Board of Directors granted 30,000 shares of restricted common stock to three employees of the Company. Two of the grants totaling 20,000 shares were valued at the closing stock price of $22.67 on March 21, 2005, the date of the grant. The third grant of 10,000 was valued at the closing stock price of $18.84 on May 2, 2005, the date of the grant. The restrictions on the common stock lapse in equal amounts over a five-year period. The Company recorded expense of approximately $35,000 and $79,000 related to restricted stock during the quarter ended and three quarters ended October 1, 2005, respectively. As of October 1, 2005 approximately $0.7 million has been deferred and will be recognized over the vesting period.

As part of the acquisition of ClearLab International in 2002, the Company entered into an agreement to issue 270,000 options to purchase shares of 1-800 CONTACTS, INC. common stock in three equal tranches. The three tranches of 90,000 options vest on July 24, 2005, 2006 and 2007, respectively. The first tranche of 90,000 options vested on during the third fiscal quarter ended October 1, 2005. The Company used the Black-Scholes option-pricing model to determine the fair-value of these options, as of the vesting date. Using this method, these vested options were valued at approximately $1.3 million and the Company recorded this amount as additional purchase consideration, increasing goodwill. Goodwill associated with the ClearLab International acquisition amounted to approximately $12.9 million as of October 1, 2005.

NOTE 8. DEBT OBLIGATIONS

The Company has a loan agreement with a U.S. bank providing for a revolving credit facility for borrowings of up to $25.6 million as of October 1, 2005, which amount is reduced thereafter on the first day of each September, December, March and June by $0.4 million until the maturity date of February 27, 2007. Additionally, the agreement provides for letters of credit up to a maximum of $15 million outstanding or payable at any time. The loan agreement specifies that if the maximum leverage ratio, as defined in the agreement, is greater than 2.5, then the amounts outstanding on the revolving credit facility together with the amount of all outstanding letters of credit can at no time exceed the Company s book value of inventory. As of October 1, 2005, the Company was not subject to this restriction and could borrow up to $25.6 million. Outstanding borrowings on the revolving credit facility bear interest at a floating rate equal to the lender s prime interest rate plus a margin or the lender s LIBOR rate plus a margin. The interest rate is adjusted quarterly and ranges between prime plus 0.0 percent and prime plus 1.25 percent or between the applicable LIBOR rate plus 2.0 percent and the applicable LIBOR rate plus 3.25 percent, depending on the Company s maximum leverage ratio. As of October 1, 2005, the prime rate margin is 0.0 percent and the LIBOR rate margin is 2.0 percent. Interest is payable monthly. As of October 1, 2005, the Company s outstanding borrowings on the credit facility, including bank overdrafts, were $19.4 million. Of this amount, $10.0 million bore interest at the lender s LIBOR rate plus 2.0 percent (5.83% at October 1, 2005) and the remaining $9.4 million bore interest at the lender s prime rate plus 0.0 percent (6.75% at October 1, 2005). The facility requires the quarterly payment of an unused credit fee which ranges from 0.38 percent to 0.5 percent, depending on the Company s maximum leverage ratio.

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

As of October 1, 2005, the Company had an unsecured, non-interest bearing note to ClearLab International s chief technology officer with a principal balance of SGD$1,375,000 (USD$814,000). The note payable is discounted at 7%. Payments are due in equal monthly installments through July 2007.

As of October 1, 2005, the Company had a term loan payable to a Singapore bank with a principal balance of SGD$6,110,000 (USD$3,618,000) that bears interest at 6.75% and is secured by substantially all of the assets of ClearLab International. Interest payments are due monthly. Principal payments are due in monthly installments through December 2007. This note also contains various financial covenants including minimums on net worth and shareholders funds. 1-800 CONTACTS, INC. has guaranteed this term loan.

As of October 1, 2005, the Company also had a note payable to the former parent of ClearLab International with a principal balance of SGD$6,892,000 (USD$4,082,000) that bears interest at 6% and has a subordinated position to the term loan payable to the Singapore bank. The note payable is discounted at 7%. Interest payments are due monthly. Principal payments are due in monthly installments from January 2008 through December 2009. 1-800 CONTACTS, INC. has guaranteed this note.

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

NOTE 9. COMMITMENTS AND CONTINGENCIES

Legal and Regulatory Matters

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

On October 13, 2005, the Company received a letter from the Federal Trade Commission (FTC) notifying the Company that the FTC had received numerous complaints from eye care providers about the Company s inbound fax system. Copies of the FTC letter and the Company s response to the FTC are available on the Company s website at www.order.1800contacts.com/compliance. The FTC letter states that the complaints allege that [the Company s] fax lines are often busy, and that prescribers are therefore unavailable to communicate with it regarding verification requests.

In response to this letter from the FTC, the Company conducted a thorough review of its systems and found that its verification fax system (provided by a third party with capacity to receive more than a hundred simultaneous faxes) has maintained 99.96% availability to date in 2005. However, the Company points out in its response to the FTC that with millions of orders processed each year by the Company, even this near perfect uptime could result in instances where a small number of prescribers find the system unavailable for a brief period of time. In order to ensure compliance with the FCLCA, the Company suspends shipping during a verification system outage and does not take advantage of any system outages to reduce the eight business hours available to prescribers to respond to verification requests as required by the FCLCA.

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

Advertising Commitments

As of October 1, 2005, the Company had entered into certain noncancelable commitments with various advertising companies that will require the Company to pay approximately $2.2 million and $7.6 million for advertising during the remainder of 2005 and in 2006, respectively.

NOTE 10. SEGMENT INFORMATION

The Company has two operating segments. These operating segments represent components of the Company for which separate financial information is available and are evaluated regularly by management in determination of

resource allocation and performance assessment. The Company s U.S. Retail segment includes the operations of 1-800 CONTACTS, a direct marketer of replacement contact lenses. The Company s International segment includes the operations of ClearLab International and ClearLab UK, which are developers, marketers, manufacturers and distributors of contact lenses. The U.S. Retail segment includes revenue from the optical retail store agreement and the International segment includes revenue from the Japanese license and royalty agreement. Operating segment information for the quarter and three quarters ended October 2, 2004 and October 1, 2005 is as follows (in thousands):

Quarter Ended October 2, 2004	**U.S. Retail**	**International**	**Eliminations**	**Total**
Net sales	$ 54,966	$ 1,927	$	$ 56,893
Gross profit (loss)	22,235	(231)		22,004
Research and development		567		567
Other selling, general and administrative expense	9,701	1,088		10,789
Income (loss) from operations	$ 5,179	$ (2,090)	$	$ 3,089
Quarter Ended October 1, 2005	**U.S. Retail**	**International**	**Eliminations**	**Total**
Net sales (International segment includes intersegment sales of $917)	$ 55,791	$ 5,984	$ (917)	$ 60,858
Gross profit	21,928	1,841	(617)	23,152
Research and development		426		426
Other selling, general and administrative expense	10,998	2,540		13,538
Income (loss) from operations	$ 3,367	$ (1,378)	$ (617)	$ 1,372
Three Quarters Ended October 2, 2004	**U.S. Retail**	**International**	**Eliminations**	**Total**
Net sales	$ 153,159	$ 4,554	$	$ 157,713
Gross profit (loss)	60,990	(417)		60,573
Research and development	536	1,366		1,902
Purchased in-process research and development		83		83
Other selling, general and administrative expense	28,276	3,161		31,437
Income (loss) from operations	$ 5,865	$ (5,493)	$	$ 372
Three Quarters Ended October 1, 2005	**U.S. Retail**	**International**	**Eliminations**	**Total**
Net sales (International segment includes intersegment sales of $1,291)	$ 168,924	$ 14,873	$ (1,291)	$ 182,506
Gross profit	66,972	3,147	(791)	69,328
Research and development		2,292		2,292
Other selling, general and administrative expense	31,870	5,489		37,359
Income (loss) from operations	$ 12,159	$ (5,355)	$ (791)	$ 6,013

The following reconciles total segment income from operations to income (loss) before provision for income taxes for the quarter and three quarters ended October 2, 2004 and October 1, 2005 as follows (in thousands):

	Quarter Ended	
	October 2, 2004	October 1, 2005
Income from operations	$ 3,089	$ 1,372
Interest expense	(374)	(347)
Foreign currency exchange transaction gain (loss)	58	(330)
Other income (expense), net	100	(78)
Income before provision for income taxes	$ 2,873	$ 617

	Three Quarters Ended	
	October 2, 2004	October 1, 2005
Income from operations	$ 372	$ 6,013
Interest expense	(1,176)	(995)
Foreign currency exchange transaction loss	(27)	(1,390)
Other expense, net	(68)	(177)
Income (loss) before provision for income taxes	$ (899)	$ 3,451

Identifiable segment assets are as follows (in thousands):

Fiscal Year Ended January 1, 2005	**U.S. Retail**	**International**	**Total**
Long-lived assets, net	$ 33,374	$ 39,461	$ 72,835
Total assets	56,216	52,769	108,985

Quarter Ended October 1, 2005	**U.S. Retail**	**International**	**Total**