CUTERA INC
Form 10-Q
August 07, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period _____ to_____. Commission file number: 000-50644

Cutera, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**77-0492262**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. employer identification no.)**

3240 Bayshore Blvd., Brisbane, California 94005

(Address of principal executive offices)

(415) 657-5500

(Registrant's telephone number, including area code)

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

requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such

shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See definitions of "large accelerated filer," "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the

Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.):
Yes No

The Registrant had 13,836,800 shares of common stock, $0.001 par value per share, outstanding as of July 31, 2018.

CUTERA, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CUTERA, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

(unaudited)

	June 30, 2018	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$18,432	$14,184
Marketable investments	10,573	21,728
Accounts receivable, net	22,122	20,777
Inventories	30,138	28,782
Other current assets and prepaid expenses	3,469	2,903
Total current assets	84,734	88,374
Property and equipment, net	2,632	2,096
Deferred tax asset	21,219	19,055
Goodwill	1,339	1,339
Other long-term assets	5,807	374
Total assets	$115,731	$111,238
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$10,743	$7,002
Accrued liabilities	22,756	26,848
Deferred revenue	9,288	9,461
Total current liabilities	42,787	43,311
Deferred revenue, net of current portion	2,519	2,195
Income tax liability	386	379
Other long-term liabilities	665	460

Total liabilities	46,357	46,345
Commitments and Contingencies (Note 14)		
Stockholders’ equity:		
Common stock, $0.001 par value; authorized: 50,000,000 shares; issued and outstanding: 13,824,252 and 13,477,973 shares at June 30, 2018 and December 31, 2017, respectively	14	13
Additional paid-in capital	66,291	62,025
Accumulated deficit	3,156	2,947
Accumulated other comprehensive loss	(87)	(92)
Total stockholders’ equity	69,374	64,893
Total liabilities and stockholders’ equity	$115,731	$111,238

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

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CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2018	**2017**	**2018**	**2017**
Net revenue:				
Products	$37,650	$31,727	$66,914	$56,202
Service	4,903	4,662	9,764	9,486
Total net revenue	42,553	36,389	76,678	65,688
Cost of revenue:				
Products	17,045	13,840	30,967	24,984
Service	3,131	1,503	6,000	4,137
Total cost of revenue	20,176	15,343	36,967	29,121
Gross profit	22,377	21,046	39,711	36,567
Operating expenses:				
Sales and marketing	15,535	12,787	28,623	23,560
Research and development	4,095	2,981	7,651	5,926
General and administrative	4,902	3,548	10,341	6,764
Total operating expenses	24,532	19,316	46,615	36,250
Income (loss) from operations	(2,155)	1,730	(6,904)	317
Interest and other income (expense), net	(129)	276	(31)	549
Income (loss) before income taxes	(2,284)	2,006	(6,935)	866
Provision (benefit) for income taxes	(712)	59	(3,331)	(59)
Net income (loss)	$(1,572)	$1,947	$(3,604)	$925
Net income (loss) per share:				
Basic	$(0.11)	$0.14	$(0.26)	$0.07
Diluted	$(0.11)	$0.13	$(0.26)	$0.06
Weighted-average number of shares used in per share calculations:				
Basic	13,709	13,935	13,649	13,888
Diluted	13,709	14,629	13,649	14,633

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

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CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	**2017**	**2018**	**2017**
Net income (loss)	$(1,572)	$1,947	$(3,604)	$925
Other comprehensive income (loss):				
Available-for-sale investments				
Net change in unrealized gains (losses) on available-for-sale investments	18	5	(4)	8
Less: Reclassification adjustment for gains (losses) on investments recognized during the period	—	—	9	(4)
Net change in unrealized gains and losses on available-for-sale investments	18	5	5	4
Tax provision	—	—	—	—
Other comprehensive income (loss), net of tax	18	5	5	4
Comprehensive income (loss)	$(1,554)	$1,952	$(3,599)	$929

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

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CUTERA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Six Months Ended June 30,	
	2018	**2017**
Cash flows from operating activities:		
Net income (loss)	$(3,604)	$925
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Stock-based compensation	3,893	2,626
Depreciation of tangible assets	544	492
Amortization of contract acquisition costs	822	—
Change in deferred tax assets	(3,324)	—
Provision for doubtful accounts receivable	487	(3)
Other	(25)	(42)
Changes in assets and liabilities:		
Accounts receivable	(1,832)	(1,641)
Inventories	(1,356)	(1,936)
Other current assets and prepaid expenses	(569)	(545)
Other long-term assets	(1,578)	(1)
Accounts payable	3,741	1,695
Accrued liabilities	(4,325)	1,534
Other long-term liabilities	70	—
Deferred revenue	546	784
Income tax liability	7	2
Net cash provided by (used in) operating activities	(6,503)	3,890
Cash flows from investing activities:		
Acquisition of property, equipment and software	(581)	(210)
Disposal of property and equipment	38	40
Proceeds from sales of marketable investments	13,044	6,754
Proceeds from maturities of marketable investments	2,500	24,812
Purchase of marketable investments	(4,390)	(25,863)
Net cash provided by investing activities	10,611	5,533
Cash flows from financing activities:		
Repurchase of common stock	—	(7,041)

Proceeds from exercise of stock options and employee stock purchase plan	3,038	3,871
Taxes paid related to net share settlement of equity awards	(2,664)	(1,167)
Payments on capital lease obligations	(234)	(182)
Net cash provided by (used) in financing activities	140	(4,519)
Net increase in cash and cash equivalents	4,248	4,904
Cash and cash equivalents at beginning of period	14,184	13,775
Cash and cash equivalents at end of period	$18,432	$18,679
Supplemental disclosure of non-cash items:		
Assets acquired under capital lease	$533	$257

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

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CUTERA, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Description of Operations and Principles of Consolidation

Cutera, Inc. ("Cutera" or the "Company") is a global provider of laser and other energy-based aesthetic systems for practitioners worldwide. The Company designs, develops, manufactures, and markets laser and other energy-based product platforms for use by physicians and other qualified practitioners which enable them to offer safe and effective aesthetic treatments to their customers. The Company currently markets the following key system platforms: *excel V, excel HR, enlighten, Juliet, Secret RF, truSculpt* and *xeo*. The Company's systems offer multiple hand pieces and applications, which allow customers to upgrade their systems. The sales of (i) systems, system upgrades and hand pieces ("Systems" revenue); (ii) hand piece refills applicable to *Titan, truSculpt 3D* and *truSculpt iD*, as well as single use disposable tips applicable to *Juliet, Secret RF* ("Consumables" revenue); and (iii) the distribution of third party manufactured skincare products ("Skincare" revenue); and are collectively classified as "Products" revenue. In addition to Products revenue, the Company generates revenue from the sale of post-warranty service contracts, parts, detachable hand piece replacements (except for *Titan*, *truSculpt 3D* and *truSculpt iD*) and service labor for the repair and maintenance of products that are out of warranty, all of which is classified as "Service" revenue.

Headquartered in Brisbane, California, the Company has wholly-owned subsidiaries that are currently operational in Australia, Belgium, Canada, France, Germany, Hong Kong, Japan, Spain, Switzerland and the United Kingdom. These subsidiaries market, sell and service the Company's products outside of the United States.

Unaudited Interim Financial Information

In the opinion of the Company, the accompanying unaudited condensed consolidated financial statements included in this report reflect all adjustments (consisting of only normal recurring adjustments) necessary for a fair statement of its financial position as of June 30, 2018, its results of operations for the three and six months periods ended June 30, 2018, and 2017, comprehensive income (loss) for the three and six months periods ended June 30, 2018 and 2017, and cash flows for the six months ended June 30, 2018, and 2017. The December 31, 2017 condensed consolidated balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles in the United States of America ("GAAP"). The results for interim periods are not necessarily indicative of the results for the entire year or any other interim period. The accompanying condensed

consolidated financial statements should be read in conjunction with the Company’s previously filed audited financial statements and the related notes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2017 filed with the Securities and Exchange Commission (the “SEC”) on March 26, 2018.

Use of Estimates

The preparation of interim Condensed Consolidated Financial Statements in conformity with GAAP requires the Company’s management to make estimates and assumptions that affect the amounts reported of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial Statements and the accompanying notes, and the reported amounts of revenue and expenses during the reported periods. Actual results could differ materially from those estimates.

On an ongoing basis, the Company evaluates their estimates, including those related to warranty obligation, sales commission, accounts receivable and sales allowances, valuation of inventories, fair values of goodwill, useful lives of property and equipment, assumptions regarding variables used in calculating the fair value of the Company's equity awards, expected achievement of performance based vesting criteria, fair value of investments, the standalone selling price of the Company's products and services, the customer life and period of benefit used to capitalize and amortize contracts acquisition costs, variable consideration, contingent liabilities, recoverability of deferred tax assets, and effective income tax rates, among others. Management bases their estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Risks and Uncertainties

The Company's future results of operations involve a number of risks and uncertainties. Factors that could affect the Company's future operating results and cause actual results to vary materially from expectations include, but are not limited to, rapid technological change, continued acceptance of the Company's products, stability of world financial markets, cybersecurity breaches and other disruptions that could compromise the Company’s information or results, management of international activities, competition from substitute products and larger companies, ability to obtain regulatory approval, government regulations, patent and other litigations, ability to protect proprietary technology from counterfeit versions of the Company's products, strategic relationships and dependence on key individuals. If the Company fails to adhere to ongoing Food and Drug Administration (the "FDA") Quality System Regulation, the FDA may withdraw its market clearance or take other action. The Company's manufacturers and suppliers may encounter supply interruptions or problems during manufacturing due to a variety of reasons, including failure to comply with applicable regulations, including the FDA's Quality System Regulation, equipment malfunction and environmental factors, any of which could delay or impede the Company's ability to meet demand.

Comparability

The Company adopted the new revenue standard effective January 1, 2018, using the modified retrospective method. Prior period financial statements were not retrospectively restated. The consolidated balance sheet as of December 31, 2017 and results of operations for the three and six months ended June 30, 2017 were prepared using an accounting standard that was different than that in effect for the three and six months ended June 30, 2018. As a result the consolidated balance sheets as of June 30, 2018 and December 31, 2017 are not directly comparable, nor are the condensed consolidated statement of operations for the three and six months ended June 30, 2018 and June 30, 2017.

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Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers," amending revenue recognition guidance and requiring more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The amended guidance, herein referred to as Topic 606, is effective for annual and interim reporting periods beginning after December 15, 2017, with early adoption permitted for public companies effective for annual and interim reporting periods beginning after December 15, 2016. The Company adopted the new revenue standard in the first quarter of fiscal year 2018 using the modified retrospective method. The Company recognized the cumulative effect of applying the new revenue standard as an adjustment to retained earnings. The comparative information has not been restated and continues to be reported under the accounting standards in effect for the period presented.

See Note 2 – Revenue Recognition, for additional accounting policy and transition disclosures.

Other Accounting Pronouncements Not Yet Adopted

In June 2018, the FASB issued ASU No. 2018-07, "Compensation –Stock Compensation (Topic 718): Improvement to Nonemployee Share-Based Payment Accounting". The new guidance changes the accounting for nonemployee awards including: (1) Equity-classified share-based payment awards issued to nonemployees will be measured on the grant date, instead of the previous requirement to remeasure the awards through the performance completion date, (2) For performance conditions, compensation cost associated with the award will be recognized when the achievement of the performance condition is probable, rather than upon achievement of the performance condition, and (3) The current requirement to reassess the classification (equity or liability) for nonemployee awards upon vesting will be eliminated, except for awards in the form of convertible instruments. The new guidance also clarifies that any share-based payment awards issued to customers should be evaluated under ASC 606. The amendments in the new guidance are effective for annual and interim reporting periods beginning after December 15, 2018, with early adoption permitted for public companies, but no earlier than an entity's adoption date of Topic 606. The Company will adopt the new standard effective January 1, 2019. The Company is still currently evaluating the impact of adopting the new standard.

In February 2016, the FASB issued ASU No. 2016-02, "Leases" (Topic 842), which amends the existing accounting standards for leases. The new standard requires lessees to record a right-of-use asset and a corresponding lease liability on the balance sheet (with the exception of short-term leases). The new standard also requires expanded disclosures regarding leasing arrangements. The new standard becomes effective for the Company in the first quarter of fiscal year 2019 and early adoption is permitted. The new standard is required to be adopted using the modified retrospective approach and requires application of the new standard at the beginning of the earliest comparative period presented. The Company finances its fleet of vehicles used by its field sales and service employees and has facility leases. Several of the Company's customers finance purchases of its system products through third party lease

companies and not directly with the Company. The Company does not believe that the new standard will change customer buying patterns or behaviors for its products. The Company will adopt the new standard effective January 1, 2019. The Company expects that upon adoption, right-of-use assets and lease liabilities will be recognized in the balance sheet in amounts that will be material.

Note 2. Revenue recognition

The Company adopted ASC Topic 606, "Revenue from Contracts with Customers," on January 1, 2018, applying the modified retrospective method to all contract agreements that were not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported under the accounting standards in effect for the prior period. A cumulative catch up adjustment was recorded to beginning retained earnings to reflect the impact of all existing arrangements under Topic 606.

Upon adoption of the Topic 606, the Company recorded an increase to retained earnings, net of deferred tax liability of $3.8 million (Note 12) for contracts still in force as of January 1, 2018 for the following items in the first and second quarters of 2018:

$237,000 reduction in deferred revenue balances for the differences in the amount of revenue recognition for the Company’s revenue streams as a result of allocation of revenue based on standalone selling prices to the Company’s various performance obligations.
$151,000 increase in deferred revenue balances, related to the accretion of financing costs for multi-year post-warranty service contracts for customers who pay more than one year in advance of receiving the service. The Company estimated interest expense for such advance payments under the new revenue standard.
$210,000 for variable consideration on sale transactions.
$4.7 million for the capitalization of the incremental contract acquisition costs, such as sales commissions paid in connection with system sales. These contract acquisition costs were capitalized and will be amortized over the period of anticipated support renewals. The Company expensed such costs when incurred under the prior guidance.
$1.2 million deferred tax liability related to the direct tax effect of the ASC 606 adoption.

The Company’s revenue consists of product and service revenue resulting from the sale of systems, training on the systems, extended service contracts, consumables and other accessories. The Company accounts for a contract with a customer when there is a legally enforceable contract between the Company and the customer, the rights of the parties are identified, the contract has commercial substance, and collectability of the contract consideration is probable. Revenues are recognized when control of the promised goods or services are transferred to the Company’s customers, in an amount that reflects the consideration that the Company expects to receive in exchange for those goods or services.

The Company's system sale arrangements generally contain multiple products and services. For these bundled sale arrangements, the Company accounts for individual products and services as separate performance obligations if they are distinct, which is if a product or service is separately identifiable from other items in the bundled package, and if a customer can benefit from it on its own or with other resources that are readily available to the customer. The Company’s system sale arrangements include a combination of the following performance obligations: The System and software license (considered as one performance obligation), system accessories (hand pieces), training, other accessories, extended service contracts and marketing services. For the Company’s system sale arrangements that include an extended service contract, the period of service commences at the expiration of the Company’s standard warranty offered at the time of the system sale. The Company considers the extended service contracts terms in the arrangements that are legally enforceable to be performance obligations. Other than extended service contracts and marketing services (which are satisfied over time), the Company generally satisfies all of the performance obligations at a point in time. Systems, system accessories (hand pieces), training, and time and material services are also sold on a stand-alone basis.

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The following table summarizes the effects of adopting Topic 606 on the Company's condensed consolidated balance sheet as of June 30, 2018:

	As reported under Topic 606	Adjustments	Balances under Prior GAAP
	(In thousands)		
Other long-term assets	$5,807	$ 5,325	$482
Deferred tax asset	21,219	(1,160)	22,379
Accrued liabilities	22,756	(111)	22,867
Deferred revenue	11,807	(255)	11,552
Retained earnings (deficit)	3,156	4,530	(1,374)

The following table summarizes the effects of adopting Topic 606 on the Company's condensed consolidated income statement for the three months ended June 30, 2018:

	As reported under Topic 606	Adjustments	Balances under Prior GAAP
	(In thousands)		
Products revenue	$37,650	$ 55	$37,595
Service revenue	4,903	69	4,834
Sales and marketing	15,535	(463)	15,998
Interest and other income, net*	(129)	(64)	(65)

The following table summarizes the effects of adopting Topic 606 on Company's condensed consolidated income statement for the six months ended June 30, 2018:

	As reported under Topic 606	Adjustments	Balances under Prior GAAP
	(In thousands)		
Products revenue	$66,914	$ 65	$66,849
Service revenue	9,764	133	9,631
Sales and marketing	28,623	(648)	29,271
Interest and other income, net*	(31)	(129)	98

** Included in interest and other income, net, is the estimated interest expense for advance payment related to service contracts under the new revenue standard.*

Adoption of the standard had no impact on total net cash from or used in operating, investing, or financing activities within the condensed consolidated statements of cash flows.

As part of the Company's adoption of ASC 606, the Company elected to use the following practical expedients: (i) not to adjust the promised amount of consideration for the effects of a significant financing component when the Company expects, at contract inception, that the period between the Company's transfer of a promised product or service to a customer and when the customer pays for that product or service will be one year or less; (ii) to expense costs as incurred for costs to obtain a contract when the amortization period would have been one year or less; (iii) not to recast revenue for contracts that begin and end in the same fiscal year; and (iv) not to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer.

Note 3. Cash, Cash Equivalent and Marketable Investments

The Company invests its cash primarily in money market funds and in highly liquid debt instruments of U.S. federal and municipal governments and their agencies, commercial paper and corporate debt securities. All highly liquid investments with stated maturities of three months or less from date of purchase are classified as cash equivalents; all highly liquid investments with stated maturities of greater than three months are classified as marketable investments. The majority of the Company’s cash and investments are held in U.S. banks and its foreign subsidiaries maintain a limited amount of cash in their local banks to cover their short term operating expenses.

The Company determines the appropriate classification of its investments in marketable securities at the time of purchase and re-evaluates such designation at each balance sheet date. The Company’s marketable securities have been classified and accounted for as available-for-sale securities. Investments with remaining maturities of more than one

year are viewed by the Company as available to support current operations, and are classified as current assets under the caption marketable investments in the accompanying condensed consolidated balance sheets. Investments in marketable securities are carried at fair value, with the unrealized gains and losses reported as a component of stockholders' equity. Any realized gains or losses on the sale of marketable securities are determined on a specific identification method, and such gains and losses are reflected as a component of interest and other income, net.

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The following tables summarize the components, and the unrealized gains and losses position, related to the Company's cash, cash equivalents and marketable investments (in thousands) as of June 30, 2018 and December 31, 2017:

June 30, 2018	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Market Value**
Cash and cash equivalents:				
Cash	$ 15,545	$ —	$ —	$ 15,545
Money market funds	2,887	—	—	2,887
Total cash and cash equivalents	18,432	—	—	18,432
Marketable investments:				
U.S. government notes	6,012	—	(8)	6,004
Municipal securities	200	—	(1)	199
Corporate debt securities	4,388	—	(18)	4,370
Total marketable investments	10,600	—	(27)	10,573
Total cash, cash equivalents and marketable investments	$ 29,032	$ —	$ (27)	$ 29,005

December 31, 2017	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Market Value**
Cash and cash equivalents:				
Cash	$ 14,058	$ —	$ —	$ 14,058
Money market funds	126	—	—	126
Total cash and cash equivalents	14,184	—	—	14,184
Marketable investments:				
U.S. government notes	11,885	—	(15)	11,870
Municipal securities	201	—	(1)	200
Commercial paper	1,836	—	(3)	1,833
Corporate debt securities	7,838	2	(15)	7,825
Total marketable investments	21,760	2	(34)	21,728
Total cash, cash equivalents and marketable investments	$ 35,944	$ 2	$ (34)	$ 35,912

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As of June 30, 2018 and December 31, 2017, net unrealized losses were $27,000 and $34,000, respectively, and were related to interest rate changes on available-for-sale marketable investments. The Company has concluded that it is more-likely-than-not that the securities will be held until maturity or the recovery of their cost basis. No securities were in an unrealized loss position for more than 12 months.

The following table summarizes the contractual maturities of the Company's available-for-sale securities, classified as marketable investments as of June 30, 2018 (in thousands):

	Amount
Due in less than one year	$ 9,573
Due in 1 to 3 years	1,000
Total marketable investments	$ 10,573

Note 4. Fair Value of Financial Instruments

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, the Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible as well as considers counterparty credit risk in its assessment of fair value. Carrying amounts of the Company's financial instruments, including cash equivalents, accounts receivable, accounts payable and accrued liabilities, approximate their fair values as of the balance sheet dates because of their generally short maturities. The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below in accordance to ASC 820:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities.

Level 2: Directly or indirectly observable inputs as of the reporting date through correlation with market data, including quoted prices for similar assets and liabilities in active markets and quoted prices in markets that are not active. Level 2 also includes assets and liabilities that are valued using models or other pricing methodologies that do not require significant judgment since the input assumptions used in the models, such as interest rates and volatility factors, are corroborated by readily observable data from actively quoted markets for substantially the full term of the

financial instrument.

Level 3: Unobservable inputs that are supported by little or no market activity and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

In determining fair value, the Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible as well as considers counterparty credit risk in its assessment of fair value.

As of June 30, 2018, financial assets measured and recognized at fair value on a recurring basis and classified under the appropriate level of the fair value hierarchy as described above were as follows (in thousands):

June 30, 2018	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash equivalents:				
Money market funds	$2,887	$—	$ —	$2,887
Marketable investments:				
Available-for-sale securities	—	10,573	—	10,573
Total assets at fair value	$2,887	$10,573	$ —	$13,460

As of December 31, 2017, financial assets measured and recognized at fair value on a recurring basis and classified under the appropriate level of the fair value hierarchy as described above were as follows (in thousands):

December 31, 2017	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash equivalents:				
Money market funds	$126	$—	$ —	$126
Marketable investments:				
Available-for-sale securities	—	21,728	—	21,728
Total assets at fair value	$126	$21,728	$ —	$21,854

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The Company's Level 1 financial assets are money market funds with fair values that are based on quoted market prices. The Company's Level 2 investments include U.S. government-backed securities and corporate securities that are valued based upon observable inputs that may include benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data including market research publications. The average remaining maturity of the Company's Level 2 investments as of June 30, 2018 is less than 7 months and all of these investments are rated by S&P and Moody's at A or better. The Company recognizes transfers between levels of the fair value hierarchy as of the end of the reporting period. There were no transfers within the hierarchy during the quarter and year ended June 30, 2018 and December 31, 2017, respectively.

Note 5. Balance Sheet Details

Inventories

As of June 30, 2018 and December 31, 2017, inventories consist of the following (in thousands):

	June 30, 2018	**December 31, 2017**
Raw materials	$17,875	$ 19,160
Work in progress	2,846	2,744
Finished goods	9,417	6,878
Total	$30,138	$ 28,782

Accrued Liabilities

As of June 30, 2018 and December 31, 2017, accrued liabilities consist of the following (in thousands):

	June 30, 2018	**December 31, 2017**

Accrued payroll and related expenses	$10,712	$ 12,567
Sales and marketing accruals	2,283	3,710
Warranty liability	3,561	3,508
Sales tax	2,388	2,920
Other	3,812	4,143
Total	$22,756	$ 26,848

Note 6. Warranty and Service Contracts

The Company has a direct field service organization in the U.S. Internationally, the Company provides direct service support through its wholly-owned subsidiaries in Australia, Belgium, Canada, France, Hong Kong, Japan, and Switzerland, as well as through third-party service providers in Spain and the United Kingdom. In several other countries, where the Company does not have a direct presence, the Company provides service through a network of distributors and third-party service providers.

After the original warranty period, maintenance and support are offered on a service contract basis or on a time and materials basis. The Company provides for the estimated cost to repair or replace products under warranty at the time of sale. The following table provides the changes in the product warranty accrual for the three and six months ended June 30, 2018 and 2017 (in thousands):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2018	**2017**	**2018**	**2017**
Beginning Balance	$3,373	$2,735	$3,508	$2,461
Add: Accruals for warranties issued during the period	2,311	1,944	4,575	4,079
Less: Settlements made during the period	(2,123)	(1,802)	(4,522)	(3,663)
Ending Balance	$3,561	$2,877	$3,561	$2,877

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Note 7. Revenue

Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for promised goods or services. The Company's performance obligations are satisfied either over time or at a point in time. Revenue from performance obligations that are transferred to customers over time accounted for approximately 9% of the Company's total revenue for the six months ended June 30, 2018.

The Company's system sale arrangements generally contain multiple products and services. For these bundled sale arrangements, the Company accounts for individual products and services as separate performance obligations if they are distinct, which is if a product or service is separately identifiable from other items in the bundled package, and if a customer can benefit from it on its own or with other resources that are readily available to the customer. The Company's system sale arrangements include a combination of the following performance obligations: the system and software license (considered as one performance obligation), system accessories (hand pieces), training, other accessories, extended service contracts and marketing services.

For the Company's system sale arrangements that include an extended service contract, the period of service commences at the expiration of the Company's standard warranty offered at the time of the system sale. The Company considers the extended service contracts terms in the arrangements that are legally enforceable to be performance obligations. Other than extended service contracts and marketing services (which are satisfied over time), the Company generally satisfies all of the performance obligations at a point in time. System, system accessories (hand pieces), training, time and material services are also sold on a stand-alone basis, and related performance obligations are satisfied at a point in time. For contracts with multiple performance obligations, the Company allocates the transaction price of the contract to each performance obligation, on a relative basis using its standalone selling price. The stated contract value is the transaction price to be allocated to the separate performance obligations.

Nature of Products and Services

Systems

System revenue represents the sale of a system or an upgrade of an existing system. A system consists of a console that incorporates a universal graphic user interface, a laser and or other energy based module, control system software and high voltage electronics, as well as one or more hand pieces. However, depending on the application, the laser or other energy based module is sometimes contained in the hand piece such as with the Company's Pearl and Pearl Fractional applications instead of within the console.

The Company offers customers the ability to select the system that best fits their practice at the time of purchase and then to cost-effectively add applications to their system as their practice grows. This provides customers the flexibility to upgrade their systems whenever they choose and provides us with a source of additional Systems revenue.

The Company has concluded that the system or upgrade and the right to use the embedded software represent a single performance obligation as the software license is integral to the functionality of the system or upgrade.

The Company considers set-up or installation an immaterial promise as set-up or installation for systems other than *enlighten* systems takes only a short time. The related costs to complete set-up or installation are immaterial to the Company. The *enlighten* system is one performance obligation and the calibration or installation service is a separate performance obligation.

For systems sold directly to end-customers that are credit approved, revenue is recognized when the Company transfers control to the end-customer, which occurs when the product is shipped to the customer or when the customer receives the product, depending on the nature of the arrangement. The Company recognizes revenue on cash basis for system sales to international direct end-customer sales that have not been credit approved, after satisfying all remaining obligations of the agreement. For systems sold through credit approved distributors, revenue is recognized at the time of shipment. The Company’s system arrangements generally do not provide a right of return. The Company provides a standard one-year warranty coverage for all systems sold to end-customers to cover parts and service, and extended service plans that vary by the type of product and the level of service desired.

The Company typically receives payment for its system consoles and other accessories within 30 days of shipment. Certain international distributor arrangements allow for longer payment terms.

Skincare products

The Company sells third-party manufactured skincare products in Japan. The Company purchases and inventories these third-party skincare products from the manufacturers and sells them to licensed physicians. The Company acts as the principal in this arrangement, as it determines the price to charge customers for the skincare products, and controls the products before they are transferred to the customer. Skincare products are typically sold in contracts in which the skincare products represent the sole performance obligations. The Company recognizes revenue for skincare products at a point in time, generally upon shipment.

Consumables (Other accessories)

The Company treats its customers' purchase of replacement *Titan, truSculpt 3D* and *truSculpt iD* hand pieces as Consumable revenue, which provides the Company with a source of recurring revenue from existing customers. The Company's recently launched *Juliet* and *Secret RF* products have single use disposable tips which need to be replaced after every treatment. Sale of these consumable tips further enhance the Company's recurring revenue stream. Hand piece refills of the Company's legacy *truSculpt* product are accounted for in accordance with the Company's standard warranty and service contract policies.

Extended contract services

The Company offers post-warranty services to its customers through extended service contracts that cover preventive maintenance and or replacement parts and labor for a term of one, two, or three years, or by direct billing for detachable hand piece replacements, parts and labor. These post-warranty services serve as additional sources of recurring revenue from the Company's installed product base. Service revenue is recognized over time as the customers benefit from the service throughout the service period. Revenue related to services performed on a time-and-materials basis is recognized when performed. For the Company's performance obligations recognized over time, revenue is generally recognized using a time-based measure of progress reflecting generally consistent efforts to satisfy those performance obligations throughout the arrangement term.

Training

Sales of system to customers include training on the system to be provided within 90 days of purchase. The Company considers training as a separate performance obligation as customers can immediately benefit from the training due to the fact that the customer already has the system. Training is also sold separately from systems. The Company recognizes revenue for training when the training is provided. Training is not required for customers to use the systems.

Customer Marketing Support

In North America, the Company offers marketing and consulting phone support to its customers who purchase its *truSculpt 3D* and *truSculpt iD* systems. These customer marketing support services include a practice development model and marketing training, performed remotely with ongoing phone consultations for six months from date of purchase. The Company considers customer marketing support a separate performance obligation, and

allocates and recognizes revenue over the six-month term of support. The Company determines the standalone selling price based on cost plus a margin.

Significant Judgments

More judgments and estimates are required under Topic 606 than were required under the previous revenue recognition guidance, Topic 605. Revenue recognition under Topic 606 for the Company's arrangements may be dependent on contract-specific terms.

The *enlighten* system includes the related software license as one performance obligation and the calibration/installation services are accounted for as separate performance obligations. The calibration/installation is a separate performance obligation for the *enlighten* system because a knowledgeable third-party could perform this service.

The Company has however concluded that set-up or installation for all other systems (excluding the *enlighten* system) is perfunctory as the set-up or installation for systems other than *enlighten* take only a short time and the related costs to complete set-up or installation are immaterial.

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Judgment is required to determine the standalone selling price ("SSP") for each distinct performance obligation. The Company estimates SSPs for each performance obligation as follows:

Systems: The SSPs for systems are based on directly observable sales in similar circumstances to similar customers. When SSP is not directly observable, the Company estimates SSP using the expected cost plus margin approach.

Training: SSP is based on observable price when sold on a standalone basis.

Extended warranty: SSP is based on observable price when sold on a standalone basis (by customer type).

Marketing program: SSP is estimated based on cost plus margin.

The Company will combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract. If a group of agreements are so closely related that they are, in effect, part of a single arrangement, such agreements are deemed to be one arrangement for revenue recognition purposes. The Company exercises significant judgment to evaluate the relevant facts and circumstances in determining whether the separate agreements should be accounted for separately or as, in substance, a single arrangement. The Company’s judgments about whether a group of contracts comprise a single arrangement can affect the allocation of consideration to the distinct performance obligations, which could have an effect on results of operations for the periods involved.

The Company is required to estimate the total consideration expected to be received from contracts with customers. In limited circumstances, the consideration expected to be received is variable based on the specific terms of the contract or based on the Company’s expectations of the term of the contract. Generally, the Company has not experienced significant returns or refunds to customers. These estimates require significant judgment and the change in these estimates could have an effect on its results of operations during the periods involved.

Deferred Sales Commissions

Incremental costs of obtaining a contract, including sales commissions, are capitalized and amortized on a straight-line basis over the expected customer relationship period if the Company expects to recover those costs. The Company uses the portfolio method to recognize the amortization expense related to these capitalized costs related to initial

contracts and such expense is recognized over a period associated with the revenue of the related portfolio, which is generally two to three years for the Company’s product and service arrangements.

Total capitalized costs as of June 30, 2018 were $5.3 million and are included in other long-term assets in the Company’s condensed consolidated balance sheet. Amortization of this asset was $0.4 million and $0.8 million, respectively, during the three and six months ended June 30, 2018 and is included in sales and marketing expense in the Company’s condensed consolidated statements of operations.

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Note 8. Contract balance

The Company’s service contracts include an upfront payment for the one, two or three-year contract terms. The timing of receipt of payment and timing of performance of the services create timing differences that result in deferred revenue on the Company’s condensed consolidated balance sheet. The advance payments under these contracts are recorded in deferred revenue, and the Company recognizes the revenue when earned. Contracted but unsatisfied performance obligations were approximately $11.8 million as of June 30, 2018, of which the Company expects to recognize approximately 78% of the revenue over the next 12 months and the remainder thereafter.

The Company's deferred contract revenue consists of service revenue, training and product revenue. Deferred contract revenue balance is comprised mainly of Service revenue. The Company generates Service revenue from the sale of extended service contracts and from time and material services provided to customers who are not under a warranty or extended service contract. Service contract revenue is recognized on a straight-line basis over the period of the applicable contract. Service revenue from time and material services is recognized as the services are provided.

The following table provides changes in the deferred contract revenue balance for the three and six months ended June 30, 2018 and 2017 (in thousands):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2018	**2017**	**2018**	**2017**
Beginning Balance	$11,015	$9,555	$11,656	$9,431
Add: Payments received	4,739	3,721	8,416	7,112
Less: Revenue recognized	(3,947)	(3,263)	(8,265)	(6,530)
Ending Balance	$11,807	$10,013	$11,807	$10,013

Costs for extended service contracts for the three and six months ended June 30, 2018, were $2.0 million and 3.9 million, respectively.

Note 9. Stockholders’ Equity and Stock-based Compensation Expense

In 1998, the Company adopted the 1998 Stock Plan, or 1998 Plan, under which 4,650,000 shares of the Company's common stock were reserved for issuance to employees, directors and consultants. On January 12, 2004, the Board of Directors adopted the 2004 Equity Incentive Plan. A total of 1,750,000 shares of common stock were originally reserved for issuance pursuant to the 2004 Equity Incentive Plan. In addition, the shares reserved for issuance under the 2004 Equity Incentive Plan included shares reserved but un-issued under the 1998 Plan and shares returned to the 1998 Plan as the result of termination of options or the repurchase of shares. In 2012 the stockholders approved a "fungible share" provision whereby each full-value award issued under the 2004 Equity Incentive Plan results in a requirement to subtract 2.12 shares from the shares reserved under the Plan.

Activity under the Company's Amended and Restated 2004 Equity Incentive Plan, as amended, is summarized as follows:

		Options Outstanding	
	Shares Available for Grant	**Number of Stock Options Outstanding**	**Weighted-Average Exercise Price**
Balance, December 31, 2017	1,494,865	839,919	$ 16.46
Options granted	(21,010)	21,010	50.65
Stock awards granted[(1)]	(395,511)	—	—
Options exercised	—	(188,859)	9.98
Options canceled	43,833	(43,833)	20.33
Stock awards canceled[(1)]	93,390	—	—
Balance, June 30, 2018	1,215,567	628,237	$ 19.28

(1) *The Company has a "fungible share" provision in its Amended and Restated 2004 Equity Incentive Plan whereby for each full-value award (RSU/PSU) issued or canceled under the Plan requires the subtraction or add back of 2.12 shares from or to the Shares Available for Grant, respectively.*

Under the 2004 Equity Incentive Plan, as amended, the Company issued 346,279 shares of common stock during the six months ended June 30, 2018, in conjunction with stock options exercised and the vesting of RSUs and PSUs.

As of June 30, 2018, there was approximately $19.8 million of unrecognized compensation expense, net of projected forfeitures, for stock options and stock awards. The expense is expected to be recognized over the remaining weighted-average period of 2.5 years. The actual expense recorded in the future may be higher or lower based on a number of factors, including, actual forfeitures experienced and the degree of achievement of the performance goals related to the PSUs granted.

Non-Employee Stock-Based Compensation

The Company granted 3,384 RSUs and 3,384 PSUs to non-employees during the six months ended June 30, 2018, and 7,745 stock options and 2,478 RSUs during the year ended December 31, 2017. The stock options vest over 4 years at 25% on the first anniversary of the grant date and 1/48th each month thereafter. The RSUs vest over 4 years at 25% on each anniversary of the grant date, whiles vesting of the PSUs is subject to the recipient's continued service and achievement of pre-established metrics. These RSUs/PSUs and stock options were granted in exchange for consulting services to be rendered and are measured and recognized as they are earned. The Company revalues stock options granted to non-employees at each reporting date as the underlying equity instruments vest.

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Stock-based Compensation Expense

Stock-based compensation expense by department recognized during the three and six months ended June 30, 2018 and 2017 were as follows (in thousands):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2018	**2017**	**2018**	**2017**
Cost of revenue	$227	$147	$380	$276
Sales and marketing				
Employee	660	401	1,112	821
Non-Employee	55	—	92	—
Research and development	262	239	453	476
General and administrative	1,002	444	1,856	1,053
Total stock-based compensation expense	$2,206	$1,231	$3,893	$2,626

Note 10. Net Loss Per Share

Basic net income (loss) per share is computed using the weighted-average number of shares outstanding during the period. In periods of net income, diluted shares outstanding include the dilutive effect of in-the-money equity awards (stock options, restricted stock units, performance stock units and employee stock purchase plan contributions), which is calculated based on the average share price for each fiscal period using the treasury stock method. In accordance with ASC 260, the assumed proceeds under the treasury stock method include the average unrecognized compensation expense of in-the money stock options and restricted stock units. This results in the assumed buyback of additional shares, thereby reducing the dilutive impact of equity awards.

Diluted earnings per share is the same as basic earnings per share for the periods in which the Company had a net loss because the inclusion of outstanding common stock equivalents would be anti-dilutive.

The following table sets forth the computation of basic and diluted net income (loss) and the weighted average number of shares used in computing basic and diluted net income (loss) per share (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net income (loss)	$(1,572)	$1,947	$(3,604)	$925
Denominator				
Weighted average shares of common stock outstanding used in computing net income (loss) per share, basic	13,709	13,935	13,649	13,888
Dilutive effect of incremental shares and share equivalents	—	694	—	745
Weighted average shares of common stock outstanding used in computing net income (loss) per share, diluted	13,709	14,629	13,649	14,633
Net income (loss) per share:				
Net income (loss) per share, basic	$(0.11)	$0.14	$(0.26)	$0.07
Net income (loss) per share, diluted	$(0.11)	$0.13	$(0.26)	$0.06

The following numbers of shares outstanding, prior to the application of the treasury stock method, were excluded from the computation of diluted net income (loss) per common share for the period presented because including them would have had an anti-dilutive effect (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Options to purchase common stock	710	66	758	53
Restricted stock units	449			