

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 September 30, 2019

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
(State or other jurisdiction of incorporation or organization)

77-0492262
(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)

Not applicable
(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
|----------------------------------|-------------------|---|
| Common Stock (\$0.001 par value) | CUTR | The NASDAQ Stock Market, LLC |

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 every Interactive Data File required to be submitted 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 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 the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act:

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 number of shares of Registrant's common stock issued and outstanding as of November 1, 2019 was 14,233,487.

CUTERA, INC.

FORM 10-Q

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In this Quarterly Report on Form 10-Q, “Cutera,” “the Company,” “we,” “us” and “our” refer to Cutera, Inc. and its consolidated subsidiaries.

This report may contain references to the Company’s proprietary intellectual property, including among others, trademarks for its systems and ancillary products, *AcuTip*®, *CoolGlide*®, *CoolGlide excel*®, *enlighten*®, *excel HR*®, *excel V*®, *excel V+*®, *LimeLight*®, *MyQ*®, *Pearl*®, *PicoGenesis*™, *ProWave*®, *Solera*®, *Titan*®, *truSculpt*®, *truSculpt flex*, *Vantage*®, and *xeo*®.

These trademarks and trade names are the property of Cutera or the property of our consolidated subsidiaries and are protected under applicable intellectual property laws. Solely for convenience, our trademarks and tradenames referred to in this Quarterly Report on Form 10-Q may appear without the ® or ™ symbols, but such references are not intended to indicate in any way that the Company will not assert, to the fullest extent under applicable law, its rights to these trademarks and tradenames.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)

CUTERA, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)
(unaudited)

| | September 30, 2019 | December 31, 2018 |
|--|-----------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 22,879 | \$ 26,052 |
| Marketable investments | 6,448 | 9,523 |
| Accounts receivable, net | 23,222 | 19,637 |
| Inventories | 34,042 | 28,014 |
| Other current assets and prepaid expenses | 5,334 | 3,972 |
| Total current assets | 91,925 | 87,198 |
| Property and equipment, net | 2,771 | 2,672 |
| Deferred tax asset | 459 | 457 |
| Operating lease right-of-use assets | 8,332 | — |
| Goodwill | 1,339 | 1,339 |
| Other long-term assets | 6,410 | 5,971 |
| Total assets | \$ 111,236 | \$ 97,637 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 14,140 | \$ 11,279 |
| Accrued liabilities | 28,096 | 23,300 |
| Operating lease liabilities | 634 | — |
| Extended warranty liability | 2,232 | 3,159 |
| Deferred revenue | 10,164 | 9,882 |
| Total current liabilities | 55,266 | 47,620 |
| Deferred revenue, net of current portion | 3,309 | 2,684 |
| Income tax liability | 93 | 394 |
| Operating lease liabilities, net of current portion | 7,888 | — |
| Other long-term liabilities | 690 | 553 |
| Total liabilities | 67,246 | 51,251 |
| Commitments and Contingencies (Notes 12 and 13) | | |
| Stockholders' equity: | | |
| Common stock, \$0.001 par value; authorized: 50,000,000 shares; issued and outstanding: 14,199,821 and 13,968,852 shares at September 30, 2019 and December 31, 2018, respectively | 14 | 14 |
| Additional paid-in capital | 78,305 | 70,451 |
| Accumulated deficit | (34,270) | (24,010) |
| Accumulated other comprehensive loss | (59) | (69) |
| Total stockholders' equity | 43,990 | 46,386 |
| Total liabilities and stockholders' equity | \$ 111,236 | \$ 97,637 |

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

CUTERA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|------------------|------------------------------------|-------------------|
| | 2019 | 2018 | 2019 | 2018 |
| Net revenue: | | | | |
| Products | \$ 40,315 | \$ 35,675 | \$ 113,045 | \$ 102,589 |
| Service | 5,802 | 4,898 | 16,872 | 14,662 |
| Total net revenue | <u>46,117</u> | <u>40,573</u> | <u>129,917</u> | <u>117,251</u> |
| Cost of revenue: | | | | |
| Products | 16,343 | 15,909 | 50,278 | 46,876 |
| Service | 3,541 | 2,779 | 10,266 | 8,779 |
| Total cost of revenue | <u>19,884</u> | <u>18,688</u> | <u>60,544</u> | <u>55,655</u> |
| Gross profit | <u>26,233</u> | <u>21,885</u> | <u>69,373</u> | <u>61,596</u> |
| Operating expenses: | | | | |
| Sales and marketing | 17,691 | 14,479 | 50,786 | 43,102 |
| Research and development | 3,643 | 3,244 | 10,622 | 10,895 |
| General and administrative | 7,308 | 5,160 | 18,100 | 15,501 |
| Total operating expenses | <u>28,642</u> | <u>22,883</u> | <u>79,508</u> | <u>69,498</u> |
| Loss from operations | (2,409) | (998) | (10,135) | (7,902) |
| Interest and other expense, net | (146) | (49) | (180) | (80) |
| Loss before income taxes | (2,555) | (1,047) | (10,315) | (7,982) |
| Income tax expense (benefit) | 73 | (174) | (55) | (3,505) |
| Net loss | <u>\$ (2,628)</u> | <u>\$ (873)</u> | <u>\$ (10,260)</u> | <u>\$ (4,477)</u> |
| Net loss per share: | | | | |
| Basic | <u>\$ (0.19)</u> | <u>\$ (0.06)</u> | <u>\$ (0.73)</u> | <u>\$ (0.33)</u> |
| Diluted | <u>\$ (0.19)</u> | <u>\$ (0.06)</u> | <u>\$ (0.73)</u> | <u>\$ (0.33)</u> |
| Weighted-average number of shares used in per share calculations: | | | | |
| Basic | <u>14,182</u> | <u>13,851</u> | <u>14,095</u> | <u>13,717</u> |
| Diluted | <u>14,182</u> | <u>13,851</u> | <u>14,095</u> | <u>13,717</u> |

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

CUTERA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(in thousands)
(unaudited)

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-----------------|--------------------------|-------------------|
| | September 30, | | September 30, | |
| | 2019 | 2018 | 2019 | 2018 |
| Net loss | \$ (2,628) | \$ (873) | \$ (10,260) | \$ (4,477) |
| Other comprehensive loss: | | | | |
| Available-for-sale investments | | | | |
| Net change in unrealized gains on available-for-sale investments | 1 | 13 | 10 | 9 |
| Less: Reclassification adjustment for (gains) losses on investments recognized during the period | — | — | — | 9 |
| Net change in unrealized gains and losses on available-for-sale investments | 1 | 13 | 10 | 18 |
| Tax provision | — | — | — | — |
| Other comprehensive income, net of tax | 1 | 13 | 10 | 18 |
| Comprehensive loss | <u>\$ (2,627)</u> | <u>\$ (860)</u> | <u>\$ (10,250)</u> | <u>\$ (4,459)</u> |

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

CUTERA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands, except share amounts)
(unaudited)

Nine and Three Months Ended September 30, 2019

| | Common Stock | | Additional Paid-in Capital | Retained Earnings (Accumulated Deficit) | Accumulated Other Comprehensive Income (loss) | Total Stockholders' Equity |
|---|---------------------|---------------|---|--|--|---|
| | Shares | Amount | | | | |
| Balance at December 31, 2018 | 13,968,852 | \$ 14 | \$ 70,451 | \$ (24,010) | \$ (69) | \$ 46,386 |
| Issuance of common stock for employee purchase plan | 53,803 | — | 833 | — | — | 833 |
| Exercise of stock options | 79,420 | — | 767 | — | — | 767 |
| Issuance of common stock in settlement of restricted and performance stock units, net of shares withheld for employee taxes, and stock awards | 97,746 | — | (750) | — | — | (750) |
| Stock-based compensation expense | — | — | 7,004 | — | — | 7,004 |
| Net loss | — | — | — | (10,260) | — | (10,260) |
| Net change in unrealized loss on available-for-sale investments | — | — | — | — | 10 | 10 |
| Balance at September 30, 2019 | <u>14,199,821</u> | <u>\$ 14</u> | <u>\$ 78,305</u> | <u>\$ (34,270)</u> | <u>\$ (59)</u> | <u>\$ 43,990</u> |

| | Common Stock | | Additional Paid-in Capital | Retained Earnings (Accumulated Deficit) | Accumulated Other Comprehensive Income (loss) | Total Stockholders' Equity |
|---|---------------------|---------------|---|--|--|---|
| | Shares | Amount | | | | |
| Balance at July 1, 2019 | 14,142,296 | \$ 14 | \$ 74,870 | \$ (31,642) | \$ (60) | \$ 43,182 |
| Exercise of stock options | 38,966 | — | 437 | — | — | 437 |
| Issuance of common stock in settlement of restricted and performance stock units, net of shares withheld for employee taxes, and stock awards | 18,559 | — | (180) | — | — | (180) |
| Stock-based compensation expense | — | — | 3,178 | — | — | 3,178 |
| Net loss | — | — | — | (2,628) | — | (2,628) |
| Net change in unrealized loss on available-for-sale investments | — | — | — | — | 1 | 1 |
| Balance at September 30, 2019 | <u>14,199,821</u> | <u>\$ 14</u> | <u>\$ 78,305</u> | <u>\$ (34,270)</u> | <u>\$ (59)</u> | <u>\$ 43,990</u> |

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

CUTERA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(in thousands, except share amounts)
(unaudited)

Nine and Three Months Ended September 30, 2018

| | Common Stock | | Additional Paid-in Capital | Retained Earnings (Accumulated Deficit) | Accumulated Other Comprehensive Income (loss) | Total Stockholders' Equity |
|---|---------------------|---------------|---|--|--|---|
| | Shares | Amount | | | | |
| Balance at December 31, 2017 | 13,477,973 | \$ 13 | \$ 62,025 | \$ 2,947 | \$ (92) | \$ 64,893 |
| Adjustment to opening balance for ASC 606 adoption | — | — | — | 3,813 | — | 3,813 |
| Issuance of common stock for employee purchase plan | 34,776 | — | 1,154 | — | — | 1,154 |
| Exercise of stock options | 241,021 | 1 | 2,448 | — | — | 2,449 |
| Issuance of common stock in settlement of restricted and performance stock units, net of shares withheld for employee taxes, and stock awards | 136,820 | — | (2,971) | — | — | (2,971) |
| Stock-based compensation expense | — | — | 5,524 | — | — | 5,524 |
| Net loss | — | — | — | (4,477) | — | (4,477) |
| Net change in unrealized loss on available-for-sale investments | — | — | — | — | 18 | 18 |
| Balance at September 30, 2018 | <u>13,890,590</u> | <u>\$ 14</u> | <u>\$ 68,180</u> | <u>\$ 2,283</u> | <u>\$ (74)</u> | <u>\$ 70,403</u> |

| | Common Stock | | Additional Paid-in Capital | Retained Earnings (Accumulated Deficit) | Accumulated Other Comprehensive Income (loss) | Total Stockholders' Equity |
|---|---------------------|---------------|---|--|--|---|
| | Shares | Amount | | | | |
| Balance at July 1, 2018 | 13,824,252 | \$ 14 | \$ 66,291 | \$ 3,156 | \$ (87) | \$ 69,374 |
| Exercise of stock options | 52,162 | — | 565 | — | — | 565 |
| Issuance of common stock in settlement of restricted and performance stock units, net of shares withheld for employee taxes, and stock awards | 14,176 | — | (307) | — | — | (307) |
| Stock-based compensation expense | — | — | 1,631 | — | — | 1,631 |
| Net loss | — | — | — | (873) | — | (873) |
| Net change in unrealized loss on available-for-sale investments | — | — | — | — | 13 | 13 |
| Balance at September 30, 2018 | <u>13,890,590</u> | <u>\$ 14</u> | <u>\$ 68,180</u> | <u>\$ 2,283</u> | <u>\$ (74)</u> | <u>\$ 70,403</u> |

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

CUTERA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | Nine Months Ended September 30, | |
|---|--|------------------|
| | 2019 | 2018 |
| Cash flows from operating activities: | | |
| Net loss | \$ (10,260) | \$ (4,477) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Stock-based compensation | 7,004 | 5,524 |
| Depreciation of tangible assets | 1,184 | 849 |
| Amortization of contract acquisition costs | 2,169 | 1,304 |
| Change in deferred tax asset | (2) | (3,507) |
| Provision for doubtful accounts receivable | 647 | 877 |
| Other | 55 | 215 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (4,232) | (5,544) |
| Inventories | (6,028) | (2,540) |
| Other current assets and prepaid expenses | (1,423) | (797) |
| Other long-term assets | (2,608) | (2,301) |
| Accounts payable | 2,861 | 6,319 |
| Accrued liabilities | 4,900 | (4,177) |
| Extended warranty liabilities | (927) | — |
| Other long-term liabilities | (140) | 105 |
| Deferred revenue | 907 | 58 |
| Income tax liabilities | (301) | (27) |
| Net cash used in operating activities | <u>(6,194)</u> | <u>(8,119)</u> |
| Cash flows from investing activities: | | |
| Acquisition of property, equipment and software | (524) | (1,214) |
| Disposal of property and equipment | 45 | 41 |
| Proceeds from sales of marketable investments | — | 13,044 |
| Proceeds from maturities of marketable investments | 11,450 | 8,050 |
| Purchase of marketable investments | (8,304) | (4,390) |
| Net cash provided by investing activities | <u>2,667</u> | <u>15,531</u> |
| Cash flows from financing activities: | | |
| Proceeds from exercise of stock options and employee stock purchase plan | 1,600 | 3,603 |
| Taxes paid related to net share settlement of equity awards | (750) | (2,971) |
| Payments on finance lease obligations | (496) | (362) |
| Net cash provided by financing activities | <u>354</u> | <u>270</u> |
| Net increase (decrease) in cash and cash equivalents | (3,173) | 7,682 |
| Cash and cash equivalents at beginning of period | 26,052 | 14,184 |
| Cash and cash equivalents at end of period | <u>\$ 22,879</u> | <u>\$ 21,866</u> |
| Supplemental disclosure of non-cash items: | | |
| Assets acquired under finance lease | <u>\$ 903</u> | <u>\$ 610</u> |

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

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”) provides energy-based aesthetic systems for practitioners worldwide. The Company designs, develops, manufactures, distributes and markets energy-based product platforms for use by physicians and other qualified practitioners, enabling them to offer safe and effective aesthetic treatments to their customers. The Company currently markets the following system platforms: *excel*, *enlighten*, *Juliet*, *Secret RF*, *truSculpt* and *xeo*. Several of the Company’s systems offer multiple hand pieces and applications, providing customers the flexibility to upgrade their systems. The sales of (i) systems, system upgrades, and hand pieces (collectively “Systems” revenue); (ii) replacement hand pieces, *truSculpt iD* and *truSculpt flex* cycle refills, as well as single use disposable tips applicable to *Juliet* and *Secret RF* (“Consumables” revenue); and (iii) the distribution of third party manufactured skincare products (“Skincare” revenue); 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*, *truSculpt iD* and *truSculpt flex*) and service labor for the repair and maintenance of products that are out of warranty, all of which are collectively classified as “Service” revenue.

Headquartered in Brisbane, California, the Company operates wholly-owned subsidiaries in Australia, Belgium, Canada, France, Germany, Hong Kong, Japan, Spain, Switzerland and the United Kingdom. The Company’s wholly owned subsidiary in Italy is currently dormant. These active subsidiaries market, sell and service the Company’s products outside of the United States. The Condensed Consolidated Financial Statements include the accounts of the Company and its subsidiaries. All inter-company transactions and balances have been eliminated.

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 September 30, 2019 and 2018, its results of operations, comprehensive income (loss), consolidated statements of changes in equity for the three and nine months ended September 30, 2019 and 2018, and cash flows for the nine months ended September 30, 2019 and 2018. The December 31, 2018 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 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, 2018 filed with the Securities and Exchange Commission (the “SEC”) on March 18, 2019.

Accounting Policies

These unaudited Condensed Consolidated Financial Statements are prepared in accordance with the rules and regulations of the SEC applicable to interim financial statements. While these statements reflect all normal recurring adjustments that are, in the opinion of management, necessary for fair presentation of the results of the interim period, they do not include all of the information and footnotes required by GAAP for complete financial statements. These Condensed Consolidated Financial Statements should be read in conjunction with the financial statement disclosures in our annual report on Form 10-K for the year ended December 31, 2018 filed with the SEC on March 18, 2019.

The Company uses the same accounting policies in preparing quarterly and annual financial statements. Unless otherwise noted, amounts presented within the Notes to Condensed Consolidated Financial Statements refer to the Company’s continuing operations. Notes 2 and 12 provide information about the Company’s adoption of new accounting standards for leases.

Use of Estimates

The preparation of 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, management evaluates its estimates, including those related to warranty obligations, sales commission, accounts receivable and sales allowances, valuation of inventories, fair value of goodwill, useful lives of property and equipment, incremental borrowing rates related to the Company’s leases, assumptions regarding variables used in calculating the fair value of the Company’s equity awards, expected achievement of performance based vesting criteria, management performance bonuses, fair value of investments, the standalone selling price of the Company’s products and services, the 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. Management bases 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 global 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 and maintain regulatory approvals, government regulations and oversight, patent and other types of litigation, ability to protect proprietary technology from counterfeit versions of the Company's products, strategic relationships and dependence on key individuals.

Recently Adopted Accounting Pronouncements Adopted

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-02, "Leases," (also known as ASC Topic 842) which requires, among other items, a lessee to recognize most leases as assets and liabilities on the balance sheet. Qualitative and quantitative disclosures were enhanced to better understand the amount, timing and uncertainty of cash flows arising from leases. In July 2018, the FASB issued ASU 2018-11, "Targeted Improvements," which gives the option to apply the transition provisions of ASU 2016-02 at its adoption date instead of at the earliest comparative period presented in its financial statements. In addition, ASU 2018-11 provides a practical expedient that permits lessors to not separate non-lease components from the associated lease component if certain conditions are met. Also in July 2018, the FASB issued ASU 2018-10, "Codification Improvements to ASC Topic 842, Leases," which clarifies certain aspects of ASU 2016-02.

The Company adopted ASU 2016-02, as of January 1, 2019, using the modified retrospective method, to all leases existing at the date of initial application. The comparative period information has not been restated and continues to be reported under the accounting standards in effect for the period presented. The new standard provides a number of optional practical expedients in transition. The Company elected the package of practical expedients permitted under the transition guidance within the new standard, which allowed the Company to carry forward the Company's historical conclusions about lease identification, lease classification and initial direct costs. The Company also elected the practical expedient related to land easements, allowing the Company to carry forward the Company's accounting treatment for land easements on existing agreements. The Company did not elect the practical expedient to use hindsight in determining the lease term.

The adoption of the new standard resulted in the recording of additional lease assets and lease liabilities of \$10.3 million and \$10.4 million, respectively, as of January 1, 2019, based on the present value of the remaining minimum rental payments under current leasing standards for existing operating leases. The difference between the additional lease assets and lease liabilities results from rent-free periods which were previously recorded as deferred rent. The Company's accounting for finance leases remained substantially unchanged. The standard had no material impact on the Company's condensed consolidated net earnings, results of operations, comprehensive loss, statements of changes in equity, and cash flows.

See Notes 2 and 12 for additional accounting policy and transition disclosures regarding ASC Topic 842.

In August 2018, the FASB issued ASU No. 2018-15, "Intangibles (Topic 350): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract", which aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. This standard also requires customers to amortize the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement inclusive of expected contract renewals. The Company adopted this standard effective April 1, 2019, on a prospective basis for applicable implementation costs. The adoption of this guidance prospectively resulted in the capitalization of software development costs of \$0.4 and \$0.9 million during the three and six months ending September 30, 2019. These costs relate to implementation of a new Enterprise Resource Planning and Customer Relationship Management systems and are included in "other current assets and prepaid expenses" on the balance sheet.

Note 2. Effect of Adoption of the New Lease Standard (ASC Topic 842) on Condensed Consolidated Financial Statements

The Company adopted ASC Topic 842 on January 1, 2019, applying the modified retrospective method to all leases existing at the date of initial application. The comparative information has not been adjusted and continues to be reported under the accounting standards in effect for the prior period.

The following table summarizes the effects of adopting Topic 842 on the Company's consolidated balance sheet as of January 1, 2019 (in thousands):

| | As reported under Topic 842 | Adjustments | Balances under Prior GAAP |
|---|--------------------------------|-------------|------------------------------|
| Operating lease right-of-use assets | \$ 10,049 | \$ (10,049) | \$ — |
| Operating lease liabilities | (2,430) | 2,430 | — |
| Other long-term liabilities* | — | 140 | 140 |
| Operating lease liabilities, net of current portion | (7,759) | 7,759 | — |

*Deferred rent included in other long-term liabilities

Note 3. Cash, Cash Equivalents and Marketable Investments

The Company invests its cash primarily in money market funds, U.S. Treasury bills 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 the Company's foreign subsidiaries maintain a limited amount of cash in their local banks to cover 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 are 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.

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 September 30, 2019 and December 31, 2018:

| September 30, 2019 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Market Value |
|---|-------------------|------------------------------|-------------------------------|----------------------|
| Cash and cash equivalents | \$ 22,879 | \$ — | \$ — | \$ 22,879 |
| Marketable investments: | | | | |
| U.S. government notes | 3,904 | 1 | — | 3,905 |
| Commercial paper | 2,141 | — | — | 2,141 |
| Corporate debt securities | 402 | — | — | 402 |
| Total marketable investments | 6,447 | 1 | — | 6,448 |
| Total cash, cash equivalents and marketable investments | \$ 29,326 | \$ 1 | \$ — | \$ 29,327 |

| December 31, 2018 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Market Value |
|---|---------------------------|---------------------------------------|--|------------------------------|
| Cash and cash equivalents | \$ 26,052 | \$ — | \$ — | \$ 26,052 |
| Marketable investments: | | | | |
| U.S. government notes | 1,397 | — | — | 1,397 |
| U.S. government agencies | 2,677 | — | — | 2,677 |
| Municipal securities | 200 | — | — | 200 |
| Commercial paper | 2,433 | — | — | 2,433 |
| Corporate debt securities | 2,825 | — | (9) | 2,816 |
| Total marketable investments | <u>9,532</u> | <u>—</u> | <u>(9)</u> | <u>9,523</u> |
| Total cash, cash equivalents and marketable investments | <u>\$ 35,584</u> | <u>\$ —</u> | <u>\$ (9)</u> | <u>\$ 35,575</u> |

As of September 30, 2019 and December 31, 2018, the gross unrealized gains and losses were \$1,000 and \$(9,000), 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 September 30, 2019 (in thousands):

| | Amount |
|------------------------------|-----------------|
| Due in less than one year | \$ 6,448 |
| Due in 1 to 3 years | — |
| Total marketable investments | <u>\$ 6,448</u> |

Note 4. Fair Value of Financial Instruments

Fair value is an exit price representing the amount that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The fair value hierarchy contains three levels of inputs that may be used to measure fair value, in accordance with ASC 820, as follows:

- Level 1: inputs, which include quoted prices in active markets for identical assets or liabilities;
- Level 2: inputs, which include observable inputs other than Level 1 inputs, such as quoted prices for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability. For available-for-sale securities, the Company reviews trading activity and pricing as of the measurement date. When sufficient quoted pricing for identical securities is not available, the Company uses market pricing and other observable market inputs for similar securities obtained from various third-party data providers. These inputs either represent quoted prices for similar assets in active markets or have been derived from observable market data; and
- Level 3: inputs, which include unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the underlying asset or liability. Level 3 assets and liabilities include those whose fair value measurements are determined using pricing models, discounted cash flow methodologies, or similar valuation techniques, as well as significant management judgment or estimation.

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 September 30, 2019, 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):

| September 30, 2019 | Level 1 | Level 2 | Level 3 | Total |
|--------------------------------|-----------------|------------------|----------------|------------------|
| Cash equivalents: | | | | |
| Money market funds | \$ 3,061 | \$ — | \$ — | \$ 3,061 |
| Commercial paper | — | 4,344 | — | 4,344 |
| Marketable investments: | | | | |
| Available-for-sale securities | — | 6,448 | — | 6,448 |
| Total assets at fair value | <u>\$ 3,061</u> | <u>\$ 10,792</u> | <u>\$ —</u> | <u>\$ 13,853</u> |

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As of December 31, 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 was as follows (in thousands):

| December 31, 2018 | Level 1 | Level 2 | Level 3 | Total |
|--------------------------------|-----------------|------------------|----------------|------------------|
| Cash equivalents: | | | | |
| Money market funds | \$ 3,036 | \$ — | \$ — | \$ 3,036 |
| Commercial paper | — | 1,047 | — | 1,047 |
| Marketable investments: | | | | |
| Available-for-sale securities | — | 9,523 | — | 9,523 |
| Total assets at fair value | <u>\$ 3,036</u> | <u>\$ 10,570</u> | <u>\$ —</u> | <u>\$ 13,606</u> |

Money market funds and U.S. Treasury bills are highly liquid investments and are actively traded. The pricing information on these investment instruments are readily available and can be independently validated as of the measurement date. This approach results in the classification of these securities as Level 1 of the fair value hierarchy.

Corporate debt, U.S. government-backed securities, and commercial paper are measured at fair value using Level 2 inputs. The Company reviews trading activity and pricing for these investments as of each measurement date. When sufficient quoted pricing for identical securities is not available, the Company uses market pricing and other observable market inputs for similar securities obtained from various third party data providers. These inputs represent quoted prices for similar assets in active markets or these inputs have been derived from observable market data. This approach results in the classification of these securities as Level 2 of the fair value hierarchy. The average remaining maturity of the Company's Level 2 investments as of September 30, 2019 is less than nine 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 September 30, 2019 and December 31, 2018, respectively.

Note 5. Balance Sheet Details

Inventories

As of September 30, 2019 and December 31, 2018, inventories consist of the following (in thousands):

| | September 30, 2019 | December 31, 2018 |
|-----------------|-------------------------------|------------------------------|
| Raw materials | \$ 18,637 | \$ 16,991 |
| Work in process | 2,242 | 2,306 |
| Finished goods | 13,163 | 8,717 |
| Total | <u>\$ 34,042</u> | <u>\$ 28,014</u> |

Accrued Liabilities

As of September 30, 2019 and December 31, 2018, accrued liabilities consist of the following (in thousands):

| | September 30, 2019 | December 31, 2018 |
|--------------------------------------|-------------------------------|------------------------------|
| Accrued payroll and related expenses | \$ 13,073 | \$ 9,377 |
| Sales and marketing accruals | 2,229 | 2,379 |
| Warranty liability | 4,406 | 4,666 |
| Sales tax | 3,152 | 2,935 |
| Other | 5,236 | 3,943 |
| Total | <u>\$ 28,096</u> | <u>\$ 23,300</u> |

Product Remediation Liability

During the fourth quarter of 2018, the Company recognized a liability for a product remediation plan related to one of its legacy systems. This product remediation plan, a voluntary action initiated by the Company, includes the replacement of a component in one of our legacy products. The accrued liability consists of the cost of materials and labor to replace the component in all units under the Company's standard warranty or covered under an existing Extended Warranty contract as of the fourth quarter of 2018. The Company recorded approximately \$5.0 million related to this product remediation plan, of which \$1.1 million was utilized in the fourth quarter of 2018. As of December 31, 2018, approximately \$0.7 million of the balance was related to product warranty and included in accrued liabilities, and \$3.2 million was separately recorded as Extended Warranty Liability.

In the nine months ended September 30, 2019, the Company utilized \$0.2 million related to product warranty and \$0.9 million related to extended warranty liability. As of September 30, 2019, the product remediation warranty and extended warranty liability were \$0.5 million and \$2.2 million, respectively.

Note 6. Warranty and Extended Service Contract

The Company has a direct field service organization in North America (including Canada). Internationally, the Company provides direct service support in Australia, Belgium, France, Germany, Hong Kong, Japan, Spain and Switzerland, as well as through third-party service providers in the United Kingdom. In 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 an extended service contract basis or on a time and materials basis. The Company provides for the estimated cost to repair or replace products under standard warranty at the time of sale. Costs incurred in connection with extended service contracts are recognized at the time when costs are incurred, except the one-time extended service contracts charge of \$3.2 million in December 31, 2018, related to the cost to replace a component in one of the Company's legacy products.

The following table provides the changes in the product standard warranty accrual for the three and nine months ended September 30, 2019 and 2018 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|
| | 2019 | 2018 | 2019 | 2018 |
| Beginning Balance | \$ 4,832 | \$ 3,561 | \$ 4,668 | \$ 3,508 |
| Add: Accruals for warranties issued during the period | 1,504 | 1,589 | 5,656 | 6,164 |
| Less: Settlements made during the period | (1,930) | (1,510) | (5,918) | (6,032) |
| Ending Balance | \$ 4,406 | \$ 3,640 | \$ 4,406 | \$ 3,640 |

Note 7. Deferred Revenue

The Company records deferred revenue when revenue is to be recognized subsequent to invoicing. For extended service contracts, the Company generally invoices customers at the beginning of the extended service contract term. The Company's extended service contracts typically have one, two or three year terms. Deferred revenue also includes payments for installation, training and extended marketing support service. As of September 30, 2019, approximately 75% of the deferred revenue balance of \$13.5 million will be recognized over the next 12 months.

The following table provides changes in the deferred service contract revenue balance for the three and nine months ended September 30, 2019 and 2018 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2019 | 2018 | 2019 | 2018 |
| Beginning Balance | \$ 13,859 | \$ 11,807 | \$ 11,855 | \$ 11,656 |
| Add: Payments received | 3,624 | 3,609 | 13,075 | 12,025 |
| Less: Revenue recognized | (4,010) | (4,097) | (11,457) | (12,362) |
| Ending Balance | \$ 13,473 | \$ 11,319 | \$ 13,473 | \$ 11,319 |

Costs for extended service contracts were \$2.3 million and \$6.5 million, respectively, for the three and nine months ended September 30, 2019, and \$1.7 million and \$5.7 million, respectively, for the three and nine months ended September 30, 2018.

Note 8. 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 13% and 9% respectively, of the Company's total revenue for the nine months ended September 30, 2019 and 2018.

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The Company has certain system sale arrangements that 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. The Company's products and services are distinct if a customer can benefit from the product or service on its own or with other resources that are readily available to the customer, and if the Company's promise to transfer the products or service to the customer is separately identifiable from other promises in the sale arrangements. The Company's system sale arrangements can include all or 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 performance obligations at a point in time. Systems, system accessories (hand pieces), training, and time and materials services are also sold on a stand-alone basis, and these 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 standalone selling price basis.

Nature of Products and Services

Systems

Systems revenue is generated from the sale of systems and from the sale of upgrades to existing systems. A system consists of a console that incorporates a universal graphic user interface, a laser or other energy based module, control system software and high voltage electronics, as well as one or more hand pieces. In certain applications, the laser or other energy-based module is contained in the hand piece, such as with the Company's *Pearl* and *Pearl Fractional* applications, rather than 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 the Company with a source of additional Systems revenue.

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 does not identify calibration and installation services for systems other than *enlighten* as performance obligations because such services are immaterial in the context of the sale arrangement. The related costs to complete calibration and installation for systems other than *enlighten* are immaterial. Calibration and installation services for *enlighten* systems are identified as separate performance obligations.

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. When collectability is not established in advance of receipt of payment from the customer, revenue is recognized upon the later of the receipt of payment or the satisfaction of the performance obligation. For systems sold through credit approved distributors, revenue is recognized at the time of shipment to the distributor.

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 third-party skincare products are purchased from the third-party manufacturer and sold 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. Sales of skincare products are typically the subject of contracts in which the skincare products represent the sole performance obligations. The Company recognizes revenue for skincare products at a point in time, at time of shipment.

Consumables (Other accessories)

The Company treats its customers' purchases of replacement cycles for *truSculpt iD* and *truSculpt flex*, as well as replacement *Titan* and *truSculpt 3D* hand pieces, as Consumable revenue, which provides the Company with a source of recurring revenue from existing customers. The *Juliet* and *Secret RF* products have single use disposable tips which must be replaced after every treatment. Sales of these consumable tips further enhance the Company's recurring revenue. 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 parts and labor for a term of one, two, or three years. Service contract revenue is recognized over time, using a time based measure of progress, as the customers benefit from the service throughout the service period. The Company also offers services on a time-and-materials basis for systems and detachable hand piece replacements. Revenue related to services performed on a time-and-materials basis is recognized when performed. These post-warranty services serve as additional sources of recurring revenue from the Company's installed product base.

Training

Sales of systems to customers include training on the use of the system to be provided within 180 days of purchase. The Company considers training a separate performance obligation as customers can immediately benefit from the training together with the customer's 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 across all system platforms. 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 recognizes revenue over the six-month term of the contracts.

Significant Judgments

The determination of whether two or more contracts entered into at or near the same time with the same customer should be combined and accounted for as one contract may require the use of significant judgment. In making this determination, the Company considers whether the contracts are negotiated as a package with a single commercial objective, have price interdependencies, or promise goods or services that represent a single performance objective.

While the Company's purchase agreements do not provide customers with a contractual right of return, the Company maintains a sales allowance to account for potential returns or refunds as a reduction in transaction price at the time of sale. The Company estimates sales returns and other variable consideration based on historical experience.

The Company determines standalone selling price ("SSP") 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/Service contracts: SSP is based on observable price when sold on a standalone basis (by customer type).
- Customer Marketing Support: SSP is estimated based on cost plus a margin.
- Set-up/Installation: SSP is based on observable price when sold on a standalone basis. Set-up or installation for all systems, excluding the *enlighten* system, is immaterial in the context of the contract. The related costs to complete set-up or installation are immaterial.

The calibration and installation service of the *enlighten* system are treated as separate performance obligations because the Company regularly sells *enlighten* systems without the calibration and installation service.

Loyalty Program

The Company launched a customer loyalty program during the third quarter of 2018 for qualified customers located in the U.S. and Canada. Under the loyalty program, customers accumulate points based on their purchasing levels. Once a loyalty program member achieves a certain tier level, the member earns a reward. A customer's account must be in good standing to receive the benefits of the rewards program. Rewards are earned on a quarterly basis and must be used in the following quarter. Customers receive a notification regarding their rewards tier by the fifth day of the following quarter. All unused rewards are forfeited. The fair value of the reward earned by loyalty program members is included in accrued liabilities and recorded as a reduction of net revenue at the time the reward is earned. As of September 30, 2019, the accrual for the loyalty program included in accrued liabilities was \$0.2 million.

Deferred Sales Commissions

Incremental costs of obtaining a contract, which consist primarily of commissions and related payroll taxes, are capitalized and amortized on a straight-line basis over the expected period of benefit. 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.

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Total capitalized costs as of September 30, 2019 were \$4.7 million and are included in other assets in the Company's condensed consolidated balance sheet. Amortization expense for these assets was \$0.8 million and \$2.2 million respectively, during the three and nine months ended September 30, 2019 and is included in sales and marketing expense in the Company's condensed consolidated statement of operations. Amortization expense was \$0.5 million and \$1.3 million, respectively, during the three and nine months ended September 30, 2018.

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

The Company's equity incentive plans are broad-based, long-term programs intended to attract and retain talented employees and align stockholder and employee interests. In June 2019, stockholders approved an amendment and restatement of the Amended and Restated 2004 Equity Incentive Plan (the "Prior Plan") as the 2019 Equity Incentive Plan (the "2019 Plan") and approved an additional 700,000 shares, available for future grants (in addition to the 9,701,192 shares provided under the Prior Plan). The 2019 Plan provides for the grant of incentive stock options, non-statutory stock options, RSAs, restricted stock units ("RSUs"), stock appreciation rights, performance stock units, performance shares, and other stock or cash awards.

The Company awarded zero and 42,236 RSUs to its non-employee directors during the three and nine months ended September 30, 2019, respectively. Executive officers, senior management and certain employees were awarded 10,185 and 375,252 performance stock units ("PSUs") by the Board of Directors ("Board") during the three and nine months ended September 30, 2019, respectively. The PSUs granted in the nine months ended September 30, 2019 vest subject to the recipients' continued service and the achievement of certain performance goals for the Company's 2019 fiscal year established by the Board and relating to the achievement of revenue targets for consumable products, revenue targets for international revenue, and specific operational milestones related to product performance and IT systems implementation projects. On September 5, 2019, the Board made a modification to all the PSU grants outstanding as of September 4, 2019, such that 15% of the PSUs will now vest upon the achievement of revenue targets for consumable products or revenue targets for international revenue rather than upon the achievement of targets related to IT systems implementation projects. The modified PSUs were valued at the Company's share price on the date of the modification. The impact due to the PSU modification was \$0.2 million.

The 10,185 PSUs awards during the three months ended September 30, 2019, relate to 15% of 67,897 shares the Company's Board awarded its new CEO, David H. Mowry, scheduled to vest over 4 years from 2019 through 2022. These PSUs are subject to certain performance-based criteria related to achieving financial metrics in the Board approved annual budgets for the years 2019 through 2022. As of September 30, 2019, the Company concluded that only the 2019 tranche meets the criteria for measurement and recognition. However the 2020-2022 tranches (2020 tranche = 25% of the target number of the PSUs; 2021 tranche = 30% of the target number of the PSUs; and 2022 tranche = 30% of the target number of the PSUs) do not meet the criteria for measurement and recognition as of September 30, 2019, and will meet the criteria for measurement and commencement of recognition when the Company's Board of Directors establishes the financial metrics for each fiscal year.

The Board also awarded executive officers, senior management and certain employees 147,317 and 414,423 RSUs during the three and nine months ended September 30, 2019, respectively. 25% of the RSUs granted vest on each of the first four anniversaries of the vest date subject to the recipients' continued service.

As of September 30, 2019, there was approximately \$15.8 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 1.65 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.

Activities under the 2004 and 2019 Equity Incentive Plans are summarized as follows:

| | Shares Available for Grant | Options Outstanding | |
|------------------------------------|----------------------------|-------------------------------------|---------------------------------|
| | | Number of Stock Options Outstanding | Weighted-Average Exercise Price |
| Balance, December 31, 2018 | 1,141,305 | 507,705 | \$ 20.52 |
| Additional shares reserved | 700,000 | — | — |
| Stock awards granted* | (1,486,688) | — | — |
| Options exercised | — | (81,032) | 9.47 |
| Options canceled | 42,873 | (42,873) | 20.18 |
| Stock awards canceled* | 313,623 | — | — |
| Balance, September 30, 2019 | <u>711,113</u> | <u>383,800</u> | <u>\$ 22.89</u> |

*The Company had a "fungible share" provision in the Prior Plan whereby for each full-value award (RSU/PSU) issued or canceled under the Prior Plan required the subtraction or add back of 2.12 shares from or to the Shares Available for Grant, respectively. The Company's stockholders approved the removal of the "fungible share" provision for awards granted on or after June 14, 2019 upon adoption of the Amended and Restated Plan at the Company's 2019 Annual Meeting of Stockholders held on June 14, 2019.

Non-Employee Stock-Based Compensation

The Company granted 9,303 RSUs and 11,920 PSUs to non-employees during the nine months ended September 30, 2019. The RSUs granted vest over four years at 25% on each anniversary of the grant date. The PSUs vest over a year subject to the same performance criteria as the PSUs granted to employees. The PSUs granted in the three and nine months ended September 30, 2019 vest subject to the recipients continued service.

Stock-based Compensation Expense

Stock-based compensation expense by department recognized during the three and nine months ended September 30, 2019 and 2018 were as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------------|------------------------------------|-----------------|
| | 2019 | 2018 | 2019* | 2018 |
| Cost of revenue | \$ 430 | \$ 196 | \$ 1,103 | \$ 576 |
| Sales and marketing | 1,365 | 540 | 3,080 | 1,744 |
| Research and development | 443 | 164 | 1,076 | 617 |
| General and administrative | 940 | 731 | 1,745 | 2,587 |
| Total stock-based compensation expense | <u>\$ 3,178</u> | <u>\$ 1,631</u> | <u>\$ 7,004</u> | <u>\$ 5,524</u> |

*Included in the nine-month ended September 30, 2019 stock-based compensation expense is the charge in connection with the accelerated vesting of 4,667 shares of the Company's former CEO, in accordance with his separation agreement dated January 4, 2019.

Note 10. Net Loss Per Share

Basic net 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, RSUs, PSUs and employee stock purchase plan contributions), which is calculated based on the average share price for each fiscal period using the treasury stock method.

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 September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------------|------------------------------------|-------------------|
| | 2019 | 2018 | 2019 | 2018 |
| <i>Numerator</i> | | | | |
| Net loss (in thousands) | <u>\$ (2,628)</u> | <u>\$ (873)</u> | <u>\$ (10,260)</u> | <u>\$ (4,477)</u> |
| <i>Denominator</i> | | | | |
| Weighted average shares of common stock outstanding used in computing net loss per share, basic | 14,182 | 13,851 | 14,095 | 13,717 |
| Dilutive effect of incremental shares and share equivalents | — | — | — | — |
| Weighted average shares of common stock outstanding used in computing net loss per share, diluted | <u>14,182</u> | <u>13,851</u> | <u>14,095</u> | <u>13,717</u> |
| <i>Net loss per share:</i> | | | | |
| Net loss per share, basic | <u>\$ (0.19)</u> | <u>\$ (0.06)</u> | <u>\$ (0.73)</u> | <u>\$ (0.33)</u> |
| Net loss per share, diluted | <u>\$ (0.19)</u> | <u>\$ (0.06)</u> | <u>\$ (0.73)</u> | <u>\$ (0.33)</u> |

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

| | Three Months Ended | | Nine Months Ended | |
|-------------------------------------|---------------------------|--------------|--------------------------|--------------|
| | September 30, | | September 30, | |
| | 2019 | 2018 | 2019 | 2018 |
| Options to purchase common stock | 398 | 607 | 443 | 707 |
| Restricted stock units | 648 | 411 | 523 | 419 |
| Performance stock units | 221 | 24 | 166 | 19 |
| Employee stock purchase plan shares | 94 | 47 | 94 | 82 |
| Total | <u>1,361</u> | <u>1,089</u> | <u>1,226</u> | <u>1,227</u> |

Note 11. Income Taxes

For the three and nine months ended September 30, 2019, the Company's income tax expense and benefit were \$73,000 and \$55,000, respectively, compared to tax benefits of \$174,000 and \$3,505,000, respectively, for the same periods in 2018.

The Company's income tax benefit for the nine month ended September 30, 2019 is due primarily to the release of reserve for uncertain tax position in Germany of \$0.3 million, partially offset by income taxes in foreign jurisdictions. Based on all available objectively verifiable evidence during the three and nine months ended September 30, 2019, the Company believes it is more likely than not that the tax benefits of the U.S. losses incurred will not be realized. Accordingly, the Company will continue to maintain a full valuation allowance on the U.S. deferred tax assets. There was no valuation allowance during the three months ended September 30, 2018 other than the California jurisdiction.

Note 12. Leases

The Company is a party to certain operating and finance leases for vehicles, office space and storages. The Company's material operating leases consist of office space, as well as storage facilities. The Company's leases generally have remaining terms of 1 to 10 years, some of which include options to renew the leases for up to 5 years. The Company leases space for operations in the United States, Japan, Belgium, France and Spain. In addition to the above facility leases, the Company also routinely leases automobiles for certain sales and field service employees under operating leases.

The Company determines if a contract contains a lease at inception. Operating lease assets and liabilities are recognized at the lease commencement date. Operating lease liabilities represent the present value of lease payments not yet paid. Operating lease assets represent the right to use an underlying asset and are based upon the operating lease liabilities adjusted for prepayments or accrued lease payments, initial direct costs, lease incentives, and impairment of operating lease assets. To determine the present value of lease payments not yet paid, the Company estimates the incremental secured borrowing rates corresponding to the maturities of the leases. The Company based the rate estimates on prevailing financial market conditions, credit analysis, and management judgment.

The Company recognizes expense for these leases on a straight-line basis over the lease term. Additionally, tenant incentives used to fund leasehold improvements are recognized when earned and reduce our right-of-use asset related to the lease. These are amortized through the right-of-use asset as reductions of expense over the lease term.

Below is supplemental balance sheet information related to leases (in thousands):

| Assets | Classification | September 30, 2019 |
|----------------------------|-------------------------------|-------------------------------|
| Right-of-use assets | Operating lease assets | \$ 8,332 |
| Finance lease | Property and equipment, net * | 1,152 |
| Total leased assets | | \$ 9,484 |

*Finance lease assets included in Property and equipment, net.

| Liabilities | Classification | September 30, 2019 |
|--|---|-------------------------------|
| Operating lease liabilities | | |
| Operating lease liabilities, current | Operating lease liabilities | \$ 634 |
| Operating lease liabilities, non-current | Operating lease liabilities, net of current portion | 7,888 |
| Total operating lease liabilities | | \$ 8,522 |
| Finance lease liabilities | | |
| Finance lease liabilities, current | Accrued liabilities | \$ 570 |
| Finance lease liabilities, non-current | Other long-term liabilities | 690 |
| Total finance lease liabilities | | \$ 1,260 |

Lease costs during the three months ended September 30, 2019:

| | | |
|----------------------|----------------------------|--------|
| Finance lease cost | Amortization expense | \$ 175 |
| Finance lease cost | Interest for finance lease | 25 |
| Operating lease cost | Operating lease expense | 727 |

Lease costs during the nine months ended September 30, 2019:

| | | |
|----------------------|----------------------------|--------|
| Finance lease cost | Amortization expense | \$ 546 |
| Finance lease cost | Interest for finance lease | 65 |
| Operating lease cost | Operating lease expense | 2,168 |

Cash paid for amounts included in the measurement of lease liabilities during the three months ended September 30, 2019 were as follows:

| | | |
|---------------------|-----------------|-------|
| Operating cash flow | Finance lease | \$ 25 |
| Financing cash flow | Finance lease | 175 |
| Operating cash flow | Operating lease | 708 |

Cash paid for amounts included in the measurement of lease liabilities during the nine months ended September 30, 2019 were as follows:

| | | |
|---------------------|-----------------|-------|
| Operating cash flow | Finance lease | \$ 65 |
| Financing cash flow | Finance lease | 590 |
| Operating cash flow | Operating lease | 2,112 |

Maturities of lease liabilities

Maturities of lease liabilities were as follows as of September 30, 2019 (in thousands):

| | Operating leases |
|---|-------------------------|
| Remainder of 2019 | \$ 722 |
| 2020 | 2,868 |
| 2021 | 2,613 |
| 2022 | 2,607 |
| 2023 and thereafter | 351 |
| Total lease payments | 9,161 |
| Less: imputed interest | 639 |
| Present value of lease liabilities | \$ 8,522 |

Vehicle Leases

As of September 30, 2019, the Company was committed to minimum lease payments for vehicles leased under long-term non-cancelable finance leases as follows (in thousands):

| | Operating leases |
|---|-------------------------|
| Remainder of 2019 | \$ 185 |
| 2020 | 541 |
| 2021 | 400 |
| 2022 | 240 |
| Total lease payments | 1,366 |
| Less: imputed interest | 106 |
| Present value of lease liabilities | \$ 1,260 |

As previously disclosed in our 2018 Annual Report on Form 10-K and under the previous lease accounting, maturities of lease liabilities were as follows as of December 31, 2018:

Facility Leases

As of December 31, 2018, the Company was committed to minimum lease payments for facilities and other leased assets under long-term non-cancelable operating leases as follows (in thousands):

| | Operating leases |
|---------------------------------------|-------------------------|
| 2019 | \$ 3,011 |
| 2020 | 2,939 |
| 2021 | 2,564 |
| 2022 | 2,495 |
| 2023 and thereafter | 214 |
| Future minimum rental payments | \$ 11,223 |

Vehicle Leases – U.S.

As of December 31, 2018, the Company was committed to minimum lease payments for vehicles leased under long-term non-cancelable capital leases as follows (in thousands):

| | Operating leases |
|--------------------------------------|-------------------------|
| 2019 | \$ 576 |
| 2020 | 287 |
| 2021 | 152 |
| Future minimum lease payments | \$ 1,015 |

Weighted-average remaining lease term and discount rate, as of September 30, 2019, were as follows:

Lease Term and Discount Rate

| | |
|---|------|
| Weighted-average remaining lease term (years) | |
| Operating leases | 3.3 |
| Finance leases | 2.8 |
| Weighted-average discount rate | |
| Operating leases | 4.4% |
| Finance leases | 5.6% |

Note 13. Contingencies

The Company is named from time to time as a party to other legal proceedings, product liability, commercial disputes, employee disputes, and contractual lawsuits in the ordinary course of business. A liability and related charge are recorded to earnings in the Company's consolidated financial statements for legal contingencies when the loss is considered probable and the amount can be reasonably estimated. The assessment is re-evaluated each accounting period and is based on all available information, including discussion with outside legal counsel. If a reasonable estimate of a known or probable loss cannot be made, but a range of probable losses can be estimated, the low-end of the range of losses is recognized if no amount within the range is a better estimate than any other. If a material loss is reasonably possible, but not probable and can be reasonably estimated, the estimated loss or range of loss is disclosed in the notes to the consolidated financial statements. The Company expenses legal fees as incurred.

As of September 30, 2019 and December 31, 2018, the Company had zero and \$171,000 accrued, respectively, related to various pending contractual and product liability lawsuits. The Company does not believe that a material loss in excess of accrued amounts is reasonably likely.

Note 14. Debt

On May 30, 2018, the Company and Wells Fargo Bank, N.A. ("Wells Fargo") entered into a Loan and Security Agreement (the "Original Revolving Line of Credit") in the original principal amount of \$25 million. The Original Revolving Line of Credit terminates on May 30, 2021.

On or about November 2, 2018, the Company entered into a First Amendment and Waiver to the Loan and Security Agreement with Wells Fargo (the "First Amended Revolving Line of Credit"). The First Amended Revolving Line of Credit provided for an original principal amount of \$15 million, with the ability to request an additional \$10 million, and a waiver of any existing defaults under the Original Revolving Line of Credit as long as the Company is in compliance with the terms of the First Amended Revolving Line of Credit.

On or about, March 11, 2019, the Company entered into a Second Amendment and Waiver to the Loan and Security Agreement with Wells Fargo (the "Second Amended Revolving Line of Credit"). The Second Amended Revolving Line of Credit requires the Company to maintain a minimum cash balance of \$15 million at Wells Fargo, but removes all other covenants so long as no money is drawn on the line of credit. The Company may draw down on the line of credit at the time it reaches and maintains trailing twelve months adjusted EBITDA of not less than \$10 million, and a leverage ratio not to exceed 2.5 to 1.0.

As of September 30, 2019, the Company had not drawn on the Original Revolving Line of Credit and the Company is in compliance with all financial covenants of the Original Revolving Line of Credit, as amended by the First and Second Amendment to the Revolving Line of Credit.

Note 15. Segment Reporting

Segment reporting is based on the "management approach," following the method that management organizes the company's reportable segments for which separate financial information is made available to, and evaluated regularly by, the chief operating decision maker in allocating resources and in assessing performance. The Company's chief operating decision maker ("CODM") is its Chief Executive Officer ("CEO"), who makes decisions on allocating resources and in assessing performance. The CEO reviews the Company's consolidated results as one operating segment. In making operating decisions, the CEO primarily considers consolidated financial information, accompanied by disaggregated information about revenues by geography and product. All of the Company's principal operations and decision-making functions are located in the U.S. The Company's CEO views its operations, manages its business, and uses one measurement of profitability for the one operating segment - which sells aesthetic medical equipment and services, and distributes skincare products, to qualified medical practitioners. Substantially all of the Company's long-lived assets are located in the U.S.

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The following table presents a summary of revenue by geography for the three months ended September 30, 2019 and 2018:

| | Three Months Ended September 30, | |
|---|----------------------------------|------------------|
| | 2019 | 2018 |
| Revenue mix by geography: | | |
| United States | \$ 26,425 | \$ 24,329 |
| Japan | 7,511 | 5,021 |
| Asia, excluding Japan | 3,754 | 4,348 |
| Europe | 1,907 | 2,356 |
| Rest of the world | 6,520 | 4,519 |
| Total consolidated revenue | <u>\$ 46,117</u> | <u>\$ 40,573</u> |
| Revenue mix by product category: | | |
| Products | \$ 34,958 | \$ 33,197 |
| Consumables | 2,510 | 1,055 |
| Skincare | 2,847 | 1,423 |
| Total product revenue | <u>\$ 40,315</u> | <u>\$ 35,675</u> |
| Service | 5,802 | 4,898 |
| Total consolidated revenue | <u>\$ 46,117</u> | <u>\$ 40,573</u> |

The following table presents a summary of revenue by geography for the nine months ended September 30, 2019 and 2018:

| | Nine Months Ended September 30, | |
|---|---------------------------------|-------------------|
| | 2019 | 2018 |
| Revenue mix by geography: | | |
| United States | \$ 74,972 | \$ 73,597 |
| Japan | 18,142 | 12,522 |
| Asia, excluding Japan | 11,396 | 11,422 |
| Europe | 7,147 | 6,729 |
| Rest of the world | 18,260 | 12,981 |
| Total consolidated revenue | <u>\$ 129,917</u> | <u>\$ 117,251</u> |
| Revenue mix by product category: | | |
| Products | \$ 99,706 | \$ 95,727 |
| Consumables | 7,109 | 2,881 |
| Skincare | 6,230 | 3,981 |
| Total product revenue | <u>\$ 113,045</u> | <u>\$ 102,589</u> |
| Service | 16,872 | 14,662 |
| Total consolidated revenue | <u>\$ 129,917</u> | <u>\$ 117,251</u> |

Note 16. Subsequent Events

The Company has determined based on the evaluation that no material subsequent events exist other than the following:

On November 1, 2019, Sandra A. Gardiner, the Company's Executive Vice President and Chief Financial Officer, informed the Company that she intends to resign her position with the Company to pursue another opportunity. At that time, the Company offered to enter into a resignation agreement whereby Ms. Gardiner would resign her position with the Company as of November 15, 2019, with compensation in return for certain transition assistance through the end of the Company's fiscal year, and her release of certain claims.

The Company was not able to reach agreement with Ms. Gardiner on the terms of her separation. On November 7, 2019, the Company received a Demand for Arbitration from Ms. Gardiner related to the terms of her separation from the Company. In the demand Ms. Gardiner alleges claims related to the negotiation of her separation agreement including fraudulent inducement or promissory fraud, negligent misrepresentation or omission, breach of contract, breach of the covenant of good faith and fair dealing promissory estoppel, and violations of the California Unfair Business Practices - Business & Professions Code. The Company believes it has viable defenses to each of these claims, and it intends to defend itself against these claims.

Also on November 7, 2019, the Company's Board of Directors appointed Dave Mowry, the Company's current Chief Executive Officer, to serve as Interim Chief Financial Officer of the Company until the Board appoints a successor Chief Financial Officer. The Nominating and Governance Committee of the Board of Directors of the Company is actively searching for qualified candidates to serve as the Company's Chief Financial Officer, which individual also performs the functions of the Company's principal financial officer.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis should be read in conjunction with the Company's financial condition and results of operations in conjunction with the Company's unaudited Condensed Consolidated Financial Statements and notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q and the Company's audited financial statements and notes thereto for the year ended December 31, 2018, included in its Annual Report on Form 10-K filed on March 18, 2019 with the U.S. Securities and Exchange Commission (SEC).

Unless otherwise indicated, all results presented are prepared in a manner that complies, in all material respects, with accounting principles generally accepted in the United States of America ("GAAP"). Additionally, unless otherwise indicated, all changes identified for the current-period results represent comparisons to results for the prior corresponding fiscal period.

Special note regarding forward-looking statements

This report contains forward-looking statements that involve risks and uncertainties. The Company's actual results could differ materially from those discussed in the forward-looking statements. The statements contained in this report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended, ("the Exchange Act"). Forward looking statements are often identified by the use of words such as, but not limited to, "anticipate," "believe," "can," "continue," "could," "estimate," "expect," "intend," "may," "plan," "project," "seek," "should," "strategy," "target," "will," "would" and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of the Company's management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below and those discussed in the section titled "Risk Factors" included under Part II, Item 1A below.

Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, the Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. The statements are subject to change based on various factors, including but not limited to the risks and uncertainties summarized below:

- changes in the Company's common stock price;
- the ability of the Company's sales force to effectively market and promote the Company's products, and the extent to which those products gain market acceptance;
- the existence and timing of any product approvals or changes;
- the inability to meet the Company's debt repayment obligations, if any, under the Loan and Security Agreement with Wells Fargo Bank, N.A., as amended by the First Amendment and Waiver to the Loan and Security Agreement and the Second Amendment and Waiver to the Loan and Security Agreement, due to insufficient cash;
- the possibility that cybersecurity breaches, data breaches, and other disruptions could compromise our information or result in the unauthorized disclosure of confidential information;
- the existence and timing of any product approvals or changes;
- the rate and size of expenditures incurred on the Company's clinical, manufacturing, sales, marketing and product development efforts;
- the Company's ability to obtain and retain personnel;
- the availability of key components, materials and contract services, which depends on the Company's ability to forecast sales, among other things;
- investigations of the Company's business and business-related activities by regulatory or other governmental authorities;
- variations in timing and quantity of product orders;
- temporary manufacturing interruptions or disruptions;
- the timing and success of new product and new market introductions, as well as delays in obtaining domestic or foreign regulatory approvals for such introductions;
- increased competition, patent expirations or new technologies or treatments;
- impact of the FDA communication letter regarding "vaginal rejuvenation" procedures using energy-based devices on sales of the Company's products;
- product recalls or safety alerts;
- litigation, including product liability, patent, employment, securities class action, stockholder derivative, general commercial and other lawsuits;
- volatility in the global market and worldwide economic conditions;
- changes in tax laws, including changes domestically and internationally, or exposure to additional income tax liabilities;
- the impact of the new EU privacy regulations, the General Data Protection Regulation on the Company's resources;
- the financial health of the Company's customers and their ability to purchase the Company's products in the current economic environment; and
- other unusual or non-operating expenses, such as expenses related to mergers or acquisitions, may cause operating result variations.

Introduction

The Management's Discussion and Analysis, or MD&A, is organized as follows:

- **Executive Summary.** This section provides a general description and history of the Company's business, a brief discussion of the product lines and the opportunities, trends, challenges and risks the Company focuses on in the operation of our business.
- **Critical Accounting Policies and Estimates.** This section describes the key accounting policies that are affected by critical accounting estimates.
- **Results of Operations.** This section provides the Company's analysis and outlook for the significant line items on the Company's Condensed Consolidated Statements of Operations.
- **Liquidity and Capital Resources.** This section provides an analysis of the Company's liquidity and cash flows, as well as a discussion of the Company's commitments that existed as of September 30, 2019.

Executive Summary

Company Description

The Company is a leading medical device company specializing in the research, development, manufacture, marketing and servicing of light and other energy based aesthetics systems for practitioners worldwide. In addition to products developed internally, the Company distributes third party sourced products under our own brand names. The Company offers easy-to-use products that enable practitioners to perform safe and effective aesthetic procedures, including treatment for body contouring, skin resurfacing and revitalization, tattoo removal, removal of benign pigmented lesions, vascular conditions, hair removal, toenail fungus and women's health. The Company's platforms are designed to be easily upgraded to add additional applications and hand pieces, which provide flexibility for our customers as they expand their practices. In addition to systems and upgrade revenue, the Company generates revenue from the sale of post warranty service contracts, providing services for products that are out of warranty, hand piece refills and other per procedure related revenue on select systems, as well as distributing third-party manufactured skincare products.

The Company's ongoing research and development activities primarily focus on developing new products, as well as improving and enhancing the Company's portfolio of existing products. The Company also explores ways to expand the Company's product offerings through alternative arrangements with other companies, such as distribution arrangements. The Company introduced *Juliet*, a product for women's health, in December 2017, *Secret RF*, a fractional RF microneedling device for skin revitalization, in January 2018, *enlighten SR* in April 2018, *truSculpt iD* in July 2018, *excel V+* in February 2019 and *truSculpt flex* in September 2019.

The Company's corporate headquarters and U.S. operations are located in Brisbane, California, where the Company conducts manufacturing, warehousing, research and development, regulatory, sales and marketing, service, and administrative activities. The Company markets, sells and services the Company's products through direct sales and service employees in North America (including Canada), Australia, Belgium, France, Germany, Hong Kong, Japan, Spain, Switzerland and the United Kingdom. Sales and Services outside of these direct markets are made through a network of distributors in over 40 countries.

Products and Services

The Company derives revenue from the sale of Products and Services. Product revenue includes revenue from the sale of systems, hand pieces and upgrade of systems (collectively "Systems" revenue), replacement hand pieces, *truSculpt iD* and *truSculpt flex* cycle refills, as well as single use disposable tips applicable to *Juliet* and *Secret RF* ("Consumables" revenue), and the sale of skincare products ("Skincare" revenue). 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's primary system platforms include: *excel*, *enlighten*, *Juliet*, *Secret RF*, *truSculpt* and *xeo*.

Skincare revenue relates to the distribution of ZO's skincare products in Japan.

Service includes prepaid service contracts, training services, *enlighten* installation, direct billings for detachable hand piece replacements and revenue for parts, customer marketing support and labor on out-of-warranty products.

Significant Business Trends

The Company believes that its ability to grow revenue will be primarily dependent on the following:

- continuing to expand the Company's product offerings, both through internal development and sourcing from other vendors;
- ongoing investment in the Company's global sales and marketing infrastructure;
- use of clinical results to support new aesthetic products and applications;
- enhanced luminary development and reference selling efforts (to develop a location where Company's products can be displayed and used to assist in selling efforts);
- customer demand for the Company's products;
- marketing to physicians in the core dermatology and plastic surgeon specialties, as well as outside those specialties; and
- generating recurring revenue from the Company's growing installed base of customers through the sale of systems with a Consumable revenue component.

For a detailed discussion of the significant business trends impacting the Company's business, please see the section titled "Results of Operations" below.

Factors that May Impact Future Performance

The Company's industry is impacted by numerous competitive, regulatory and other significant factors. The Company's industry is highly competitive and the Company's future performance depends on the Company's ability to compete successfully. Additionally, the Company's future performance is dependent upon the ability to continue to expand the Company's product offerings with innovative technologies, obtain regulatory clearances for the Company's products, protect the proprietary technology of the products and manufacturing processes, manufacture the products cost-effectively, and successfully market and distribute the products in a profitable manner. If the Company fails to execute on the aforementioned initiatives, the Company's business would be adversely affected.

The Company, and other medical aesthetic companies, are facing increased scrutiny by the Food and Drug Administration (the "FDA") with respect to products for vaginal health. On July 30, 2018, the FDA issued a public statement and sent letters to a number of companies in the medical aesthetics industry expressing concerns regarding "vaginal rejuvenation" procedures using energy-based devices. Although the Company did not receive such a letter at that time, we carefully considered the FDA's broader concerns articulated in the letter and elected to implement certain commercial and promotional initiatives that addressed the FDA's stated concerns, including ceasing to promote the Juliet device for "vaginal rejuvenation" procedures until we and the manufacturer assessed the implications of recent FDA considerations for devices in this category. Subsequently, on or about September 3, 2019, the Company received correspondence from the FDA related to its distributed product, the Juliet laser, expressing similar concerns to the letter issued in July, 2019. The Company responded to the FDA's correspondence outlining measures already taken that we believe address the FDA's concerns. The Company expects to continue to market Juliet consistent with its currently cleared indications: coagulation, vaporization, ablation or cutting of soft tissue (skin) in Dermatology, Plastic Surgery, Oral Surgery, ENT, Gynecology, General Surgery, Podiatry and Ophthalmology (skin around the eyes), as well as skin resurfacing on the face and body. Lost sales of the *Juliet* device and its hand pieces, has and will likely continue, to impact our revenue. The Company believes, however, that a higher level of scrutiny from regulatory authorities ultimately will benefit us as well as our customers and patients.

The Company believes it has a robust, multi-functional process that reviews its promotional claims and materials to ensure they are truthful not misleading, fair and balanced, and supported by sound scientific evidence. A detailed discussion of these and other factors that could impact the Company's future performance are provided in (1) the Company's Annual Report on Form 10-K for the year ended December 31, 2018- Part I, Item 1A "Risk Factors," (2) the Company's reports and registration statements filed and furnished from time to time with the SEC, and (3) other announcements the Company makes from time to time.

The Company recently hired a new Chief Executive Officer, who was also elected to serve on the Company's Board of Directors. His prior experience is primarily with medical device companies, but not within the aesthetics industry specifically. In addition, recently hired executives may view the business differently than prior members of management, and over time may make changes to the existing personnel and their responsibilities, our strategic focus, operations or business plans. The Company can give no assurances that it will be able to properly manage any such shift in focus, or that any changes to its business, would ultimately prove successful. In addition, leadership transitions and management changes can be inherently difficult to manage and may cause uncertainty or a disruption to the Company's business or may increase the likelihood of turnover in key officers and employees. The Company's success depends in part on having a successful leadership team. If the Company cannot effectively manage the leadership transitions and management changes, it could make it more difficult to successfully operate its business and pursue its business goals.

On November 1, 2019, Sandra A. Gardiner, the Company's Executive Vice President and Chief Financial Officer resigned. Since then, the Company's current Chief Executive Officer, David H. Mowry has been acting as Chief Executive Officer and Interim Chief Financial Officer. The Board is conducting a search for a new Chief Financial Officer. The Board's search for a Chief Financial Officer, and any related speculation and uncertainty regarding our future business strategy and direction in connection with the search and the appointment of a Chief Financial Officer, may cause or result in: 1) Disruption of our business or distraction of our employees and management; 2) Difficulty recruiting, hiring, motivating and retaining talented and skilled personnel, including a permanent Chief Financial Officer; 3) Departures of other members of management; 4) Increased stock price volatility; and 4) Difficulty in establishing, maintaining or negotiating business or strategic relationships or transactions.

If the Company is unable to mitigate these or other potential risks related to the appointment and transition of a Chief Financial Officer, it may disrupt the Company's business or adversely impact its revenue, operating results, and financial condition. Further, there can be no assurance that the Company will be able to attract a qualified permanent Chief Financial Officer or that the Company can hire a Chief Financial Officer on acceptable terms.

Brexit

On June 23, 2016, the United Kingdom held a referendum in which voters approved an exit from the European Union, commonly referred to as "Brexit." On March 29, 2017, the UK government gave formal notice of its intention to leave the EU and began the process of negotiating the future terms of the UK's relationship with the EU. Brexit could adversely affect UK, regional (including European) and worldwide economic and market conditions and could contribute to instability in global financial and foreign exchange markets, including volatility in the value of the British Pound and Euro. For the three months ended September 30, 2019 and 2018, net sales generated from the Company's European operations constituted approximately 4% and 6%, respectively, of total net sales. For the nine months ended September 30, 2019 and 2018, net sales generated from our European operations constituted approximately 6% and 6%, respectively.

Negotiations between the UK and the EU continue about provisions of the withdrawal agreement. Unless the deadline is further extended, the UK will leave the EU on January 31, 2020. Although the long-term effects of Brexit will depend on any agreements the UK makes to retain access to the EU markets, Brexit has created additional uncertainties that may ultimately result in new regulatory costs and challenges for medical device companies and increased restrictions on imports and exports throughout Europe. This could adversely affect the Company's ability to conduct and expand its operations in Europe and may have an adverse effect on the Company's overall business, financial condition and results of operations. For additional information on how Brexit could affect its business, see "Part I, Item 1A Risk Factors - Economic and other risks associated with international sales and operations could adversely affect the Company's business" of our 2018 Form 10-K.

Critical Accounting Policies, Significant Judgments and Use of Estimates.

The preparation of the Company's unaudited Condensed Consolidated Financial Statements and related disclosures in conformity with GAAP requires us to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses. These estimates, judgments and assumptions are based on historical experience and on various other factors that we believe are reasonable under the circumstances. The Company periodically reviews its estimates and make adjustments when facts and circumstances dictate. To the extent that there are material differences between these estimates and actual results, the Company's financial condition or results of operations will be affected.

The Company adopted Accounting Standards Update ("ASU") 2016-02, "Leases", (also known as ASC Topic 842) in the first quarter of fiscal year 2019 using the modified retrospective method, to all leases existing at the date of initial application. The comparative information has not been restated and continues to be reported under the accounting standards in effect for the period presented. The adoption of the new standard resulted in the recording of additional net lease assets and lease liabilities of \$10.3 million and \$10.4 million, respectively, as of January 1, 2019, based on the present value of the remaining minimum rental payments under current leasing standards for existing operating leases. The difference between the additional lease assets and lease liabilities, was recorded as deferred rent. The standard had no material impact on the Company's condensed consolidated statements of operations, comprehensive loss, statements of changes in equity, and cash flows. Refer to notes 2 and 12 to the unaudited Condensed Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for additional accounting policy and transition disclosures.

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The Company also adopted ASU No. 2018-15 during the second quarter of fiscal year 2019. The adoption resulted in the capitalization of software development costs of \$0.5 and \$0.9 million during the three and nine months ending September 30, 2019, related to implementation of a new Enterprise Resource Planning and Customer Relationship Management systems. The amount is included in other current assets and prepaid expenses on the balance sheet.

Critical accounting estimates, as defined by the SEC, are those that are most important to the portrayal of our financial condition and results of operations and require our management's most difficult and subjective judgments and estimates of matters that are inherently uncertain. The accounting policies and estimates that the Company considers to be critical, subjective, and requiring judgment in their application are summarized in "Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2018 filed with the SEC on March 18, 2019. With the exception of the change for the accounting of leases as a result of the adoption of ASU 2016-02 and the adoption of ASU No. 2018-15, there have been no new or material changes to the significant accounting policies discussed in the Company's Annual Report on Form 10-K that are of significance, or potential significance, to the Company.

Results of Operations

The following table sets forth selected consolidated financial data for the periods indicated, expressed as a percentage of total revenue, net. Percentages in this table and throughout our discussion and analysis of financial condition and results of operations may reflect rounding adjustments.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------------|-------------------------------------|------|------------------------------------|------|
| | 2019 | 2018 | 2019 | 2018 |
| Net revenue | 100% | 100% | 100% | 100% |
| Cost of revenue | 43% | 46% | 47% | 47% |
| Gross margin | 57% | 54% | 53% | 53% |
| Operating expenses: | | | | |
| Sales and marketing | 39% | 36% | 39% | 37% |
| Research and development | 8% | 8% | 8% | 9% |
| General and administrative | 16% | 13% | 14% | 13% |
| Total operating expenses | 63% | 57% | 61% | 59% |
| Loss from operations | (6)% | (3)% | (8)% | (7)% |
| Interest and other income, net | —% | —% | —% | —% |
| Loss before income taxes | (6)% | (3)% | (8)% | (7)% |
| Provision (benefit) for income taxes | —% | —% | —% | (3)% |
| Net loss | (6)% | (3)% | (8)% | (4)% |

Revenue

The timing of the Company's revenue is significantly affected by the mix of system products, installation, training, consumables and extended contract services. The revenue generated in any given period is also impacted by whether the revenue is recognized over time or at a point in time, upon completion of delivery. For an additional description on revenue, see Note 1 in the notes to consolidated financial statements on the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018 and Note 8 to the unaudited Condensed Consolidated Financial Statements included in Item I, Part 1 of this Quarterly Report on Form 10-Q.

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 13% and 9% of the Company's total revenue for the nine months ended September 30, 2019 and September 30, 2018, respectively. Revenue recognized over time relates to revenue from the Company's extended service contracts and marketing services. Revenue recognized upon delivery is primarily generated by the sales of systems, consumables and skincare.

Total Net Revenue

| (Dollars in thousands) | Three Months Ended September 30, | | | Nine months Ended September 30, | | |
|---|----------------------------------|------------|------------------|---------------------------------|------------|-------------------|
| | 2019 | % Change | 2018 | 2019 | % Change | 2018 |
| Revenue mix by geography: | | | | | | |
| United States | \$ 26,425 | 9% | \$ 24,329 | \$ 74,972 | 2% | \$ 73,597 |
| International | 19,692 | 21% | 16,244 | 54,945 | 26% | 43,654 |
| Consolidated total revenue | <u>\$ 46,117</u> | <u>14%</u> | <u>\$ 40,573</u> | <u>\$ 129,917</u> | <u>11%</u> | <u>\$ 117,251</u> |
| <i>United States as a percentage of total revenue</i> | 57% | | 60% | 58% | | 63% |
| <i>International as a percentage of total revenue</i> | 43% | | 40% | 42% | | 37% |

| (Dollars in thousands) | Three Months Ended September 30, | | | Nine months Ended September 30, | | |
|---|----------------------------------|------------|------------------|---------------------------------|------------|-------------------|
| | 2019 | % Change | 2018 | 2019 | % Change | 2018 |
| Revenue mix by product category: | | | | | | |
| Systems - North America | \$ 24,121 | 7% | \$ 22,628 | \$ 68,192 | 1% | \$ 67,458 |
| Systems - Rest of World | 10,837 | 3% | 10,569 | 31,514 | 11% | 28,269 |
| <i>Total Systems</i> | 34,958 | 5% | 33,197 | 99,706 | 4% | 95,727 |
| Consumables | 2,510 | 138% | 1,055 | 7,109 | 147% | 2,881 |
| Skincare | 2,847 | 100% | 1,423 | 6,230 | 56% | 3,981 |
| <i>Total Products</i> | 40,315 | 13% | 35,675 | 113,045 | 10% | 102,589 |
| Service | 5,802 | 18% | 4,898 | 16,872 | 15% | 14,662 |
| <i>Total Net Revenue</i> | <u>\$ 46,117</u> | <u>14%</u> | <u>\$ 40,573</u> | <u>\$ 129,917</u> | <u>11%</u> | <u>\$ 117,251</u> |

The Company's revenue increased by 14% and 11% in the three and nine month periods ended September 30, 2019, respectively, compared to the same periods in 2018, due primarily to strong growth in the Company's international business, an increase in consumables sales, and demand for the Company's recently launched systems, *excel V+* and *truSculpt flex*, offset by softness in the overall women's health market, and competitive trends affecting certain legacy system pricing.

Revenue by Geography:

The Company's U.S. revenue increased 9% and 2% in the three and nine month periods ended September 30, 2019, respectively, compared to the same periods in 2018. This increase in both the three and nine month periods was due primarily to continued demand of the *truSculpt* portfolio, including the recently launched *truSculpt flex*, as well as the Company's *excel V+* system.

The Company's international revenue increased by \$3.4 million, or 21%, and \$11.3 million, or 26% in the three and nine months ended September 30, 2019, compared to the same periods in 2018, driven primarily by increases in service, skincare products and consumables.

Revenue by Product Type:
Systems Revenue

Systems revenue in North America increased by \$1.5 million, or 7%, and \$0.7 million, or 1%, in the three and nine months and ended September 30, 2019, respectively, compared to the same periods in 2018, due primarily to the recently launched *excel V+* and *truSculpt flex* systems. The Rest of the World systems revenue increased 3% and 11% for the three and nine months ended September 30, 2019, compared to the same periods in 2018. The increase in Rest of the World revenue was primarily a result of an increase in the Company's direct business in Asia Pacific and Europe, as well as an increase in the Company's distributor business in the Middle East.

Consumables Revenue

Consumables revenue increased \$1.5 million, or 138%, and \$4.2 million, or 147%, for the three and nine months ended September 30, 2019, respectively, compared to the same periods in 2018. The increase in consumables revenue for the three months ended September 30, 2019 was primarily due to the increasing installed base of *truSculpt iD*, introduced in July 2018. The increase in consumables revenue for the nine months ended September 30, 2019 was primarily due to *truSculpt iD*, followed by *Secret RF*, each of which have a consumable element.

Skincare Revenue

The Company's revenue from Skincare products in Japan increased \$1.4 million, or 100%, and \$2.2 million, or 56%, for the three and nine months ended September 30, 2019, respectively, compared to the same periods in 2018. This increase was due primarily to increased marketing and promotional activities, and a temporary increase in consumer demand due to changes in the Japanese consumption tax rate from 8% to 10% effective October 1, 2019.

Service Revenue

The Company's Service revenue increased \$0.9 million, or 18%, and \$2.2 million, or 15%, for the three and nine months ended September 30, 2019, respectively, compared to the same periods in 2018. This increase was due primarily to increased sales of service contracts, and support and maintenance services provided on a time and materials basis to the Company's network of international distributors.

Gross Profit

| (Dollars in thousands) | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|--------------------------------------|----------------------------------|----------|-----------|---------------------------------|----------|-----------|
| | 2019 | % Change | 2018 | 2019 | % Change | 2018 |
| Gross profit | \$ 26,233 | 20% | \$ 21,885 | \$ 69,373 | 13% | \$ 61,596 |
| As a percentage of total net revenue | 57% | | 54% | 53% | | 53% |

The Company's cost of revenue consists primarily of material, personnel expenses, product warranty costs, and manufacturing overhead expenses. The Company also continues to make investments in its international direct service support, as well as operational improvement activities, which is positively impacting the Company's international revenue.

Gross margins for the three months ended September 30, 2019 increased by 3%, compared to same period in 2018. The increase in gross margins in the three months ended September 30, 2019 was largely driven by demand for the Company's new products with higher gross margins, as well as strong growth in consumables and skincare products. Gross margin was 53% for each of the nine month periods ended September 30, 2019 and 2018.

Sales and Marketing

| (Dollars in thousands) | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|--------------------------------------|----------------------------------|----------|-----------|---------------------------------|----------|-----------|
| | 2019 | % Change | 2018 | 2019 | % Change | 2018 |
| Sales and marketing | \$ 17,691 | 22% | \$ 14,479 | \$ 50,786 | 18% | \$ 43,102 |
| As a percentage of total net revenue | 39% | | 36% | 39% | | 37% |

Sales and marketing expenses consist primarily of personnel expenses, expenses associated with customer-attended workshops and trade shows, post-marketing studies, advertising and training.

The \$3.2 million or 22% increase in sales and marketing expenses for the three months ended September 30, 2019 compared to same period in 2018, was due primarily to:

- \$1.4 million net increase in personnel related expenses, driven primarily by increased headcount and commissions related to higher revenues;
- \$1.0 million increased stock-based compensation as a result of increased headcount;
- \$0.6 million increase in professional fees and consulting services related to the ongoing implementation efforts of a new Customer Relationship Management system; and
- \$0.2 million higher promotional and product demonstration expenses, primarily in North America.

The \$7.7 million or 18% increase in sales and marketing expenses for the nine months ended September 30, 2019 compared to same period in 2018, was due primarily to:

- \$4.1 million net increase in personnel related expenses, driven primarily by increased headcount and commissions related to higher revenues;
- \$1.3 million increased stock-based compensation as a result of increased headcount;
- \$1.3 million increase in professional fees and consulting services related to the ongoing implementation efforts of a new Customer Relationship Management system; and
- \$1.0 million higher promotional and product demonstration expenses, primarily in North America.

Research and Development (“R&D”)

| (Dollars in thousands) | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|--------------------------------------|----------------------------------|----------|----------|---------------------------------|----------|-----------|
| | 2019 | % Change | 2018 | 2019 | % Change | 2018 |
| Research and development | \$ 3,643 | 12% | \$ 3,244 | \$ 10,622 | (3)% | \$ 10,895 |
| As a percentage of total net revenue | 8% | | 8% | 8% | | 9% |

R&D expenses consist primarily of personnel expenses, clinical research, regulatory and material costs. R&D expenses increased by \$0.4 million, or 12%, and decreased by \$0.2 million or 3%, in the three and nine months ended September 30, 2019, respectively, compared to the same period in 2018. The increase in expense in the three months ended September 30, 2019 was due primarily to an increase in stock-based compensation. This decrease in expense was due primarily to decrease in material cost related to ongoing research and development efforts.

General and Administrative (“G&A”)

| (Dollars in thousands) | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|--------------------------------------|----------------------------------|----------|----------|---------------------------------|----------|-----------|
| | 2019 | % Change | 2018 | 2019 | % Change | 2018 |
| General and administrative | \$ 7,308 | 42% | \$ 5,160 | \$ 18,100 | 17% | \$ 15,501 |
| As a percentage of total net revenue | 16% | | 13% | 14% | | 13% |

G&A expenses consist primarily of personnel expenses, legal, accounting, audit and tax consulting fees, as well as other general and administrative expenses. G&A expenses increased by \$2.2 million, or 42%, in the three months ended September 30, 2019 as compared to the same period in 2018. G&A represented 16% of revenue in the three months ended September 30, 2019 as compared to 13% of revenue in the three months ended September 30, 2018. The increase in expenses was due primarily to \$1.0 million of personnel related expenses, inclusive of \$0.3 million increase stock-based compensation, \$0.9 million increase in professional fees, consulting services and legal fees related to the ongoing implementation efforts of a new Enterprise Resource Planning system and \$0.5 million related to credit card fees and allowances for doubtful accounts due to higher revenue levels from a year ago.

G&A expenses increased by \$2.6 million, or 17%, in the nine months ended September 30, 2019 as compared to the same period in 2018. G&A represented 14% of revenue in the nine months ended September 30, 2019 as compared to 13% of revenue in the nine months ended September 30, 2018. The increase in expenses was due primarily to \$1.4 million of increased professional fees and consulting services related to the ongoing implementation efforts of a new Enterprise Resource Planning and Customer Relationship Management systems, \$0.8 million increased personnel related costs primarily related to executive separation and recruitment and \$0.4 million increased credit card fees due to higher revenue levels from a year ago.

Interest and Other Income (Expense), Net

Interest and other income (expense), net, consists of the following:

| (Dollars in thousands) | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|--|----------------------------------|-----------|---------|---------------------------------|-----------|---------|
| | 2019 | \$ Change | 2018 | 2019 | \$ Change | 2018 |
| Interest and other expense, net | \$ (146) | \$ (97) | \$ (49) | \$ (180) | \$ (100) | \$ (80) |
| As a percentage of total net revenue | —% | | —% | —% | | —% |

Interest and other expense, net, increased \$97,000 to \$146,000 and \$100,000 to \$180,000 in the three and nine months ended September 30, 2019, respectively. The increase in net expense in both periods was primarily due to increase in foreign exchange losses offset by interest income from the Company’s marketable investments from a year ago, and an increase in estimated interest expense for advance payment related to service contracts.

Provision for Income Taxes

| (Dollars in thousands) | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|----------------------------------|------------|------------|---------------------------------|------------|------------|
| | 2019 | \$ Change | 2018 | 2019 | \$ Change | 2018 |
| Loss before income taxes | \$ (2,555) | \$ (1,508) | \$ (1,047) | \$ (10,315) | \$ (2,333) | \$ (7,982) |
| Provision (benefit) for income taxes | 73 | 247 | (174) | (55) | 3,450 | (3,505) |

For the three and nine months ended September 30, 2019, the Company’s income tax expense and benefit were \$73,000 and \$55,000, respectively, compared to tax benefits of \$174,000 and \$3,505,000 in the same periods in 2018. In the three and nine months ended September 30, 2019, the Company calculated the income tax provision for interim reporting periods by applying an estimate of the annual effective tax rate for the full year to ordinary income or loss for the reporting period. The Company’s income tax benefit in the nine month ended September 30, 2019 was primarily related to the release of a reserve for uncertain tax positions in Germany during the second quarter end June 30, 2019. The release of the reserve resulted in a tax benefit of \$0.3 million for the nine months ended September 30, 2019.

As of September 30, 2019 and December 31, 2018, the Company maintains a 100% valuation allowance against its U.S. deferred tax assets. There was no valuation allowance during the nine months ended September 30, 2018 other than the California jurisdiction.

Liquidity and Capital Resources

The Company's principal source of liquidity is cash from maturity and sales of marketable investments and cash generated from the issuance of common stock through exercise of stock options and the Company's Employee Stock Purchasing Plan ("ESPP"). The Company actively manages its cash and investments to ensure the maintenance of funds sufficient to meet its operational needs. The majority of the Company's cash and investments are held in banks. Our foreign subsidiaries maintain a limited amount of cash in their local banks to cover their short-term operating expenses.

As of September 30, 2019 and December 31, 2018, the Company had \$36.7 million and \$39.6 million of working capital, respectively. Cash and cash equivalents, plus marketable investments decreased by \$6.2 million to \$29.3 million as of September 30, 2019, from \$35.6 million as of December 31, 2018, primarily due to settling accounts payable and accrued liabilities, as well as increased investments in sales, service and other management headcount to facilitate revenue growth.

Cash, Cash Equivalents and Marketable Investments

The following table summarizes our cash, cash equivalents and marketable investments:

| (Dollars in thousands) | September 30, 2019 | December 31, 2018 | Change |
|----------------------------------|-----------------------|----------------------|-------------------|
| Cash and cash equivalents | \$ 22,879 | \$ 26,052 | \$ (3,173) |
| Marketable investments | 6,448 | 9,523 | (3,075) |
| Total | <u>\$ 29,327</u> | <u>\$ 35,575</u> | <u>\$ (6,248)</u> |

Cash Flows

| (Dollars in thousands) | Nine Months Ended September 30, | |
|--|---------------------------------|-----------------|
| | 2019 | 2018 |
| Net cash flow provided by (used in): | | |
| Operating activities | \$ (6,194) | \$ (8,119) |
| Investing activities | 2,667 | 15,531 |
| Financing activities | 354 | 270 |
| Net increase (decrease) in cash and cash equivalents | <u>\$ (3,173)</u> | <u>\$ 7,682</u> |

Cash Flows from Operating Activities

Net cash used in operating activities in the nine months ended September 30, 2019 was approximately \$6.2 million, primarily due to:

- \$10.3 million net loss as adjusted for by non-cash related items consisting primarily of stock-based compensation expense of \$7.0 million, and \$3.3 million of depreciation and amortization expenses;
- \$6.0 million used to increase inventories;
- \$4.9 million increase in accrued liabilities due primarily to accrued payroll and related expenses;
- \$4.2 million increase in accounts receivables;
- \$4.0 million increase in pre-paid expenses and other long term assets;
- \$2.9 million generated from an increase in accounts payable, due primarily to increased material purchases;
- \$0.9 million used to settle extended warranty liabilities;
- \$0.9 million generated from an increase in deferred revenue; and
- \$0.4 million decrease in other long-term liabilities, including a tax liability of \$0.3 million.

Net cash used in operating activities in the nine months ended September 30, 2018 was approximately \$8.1 million, primarily due to:

- \$4.4 million net loss as adjusted for non-cash related items consisting primarily of stock-based compensation expense of \$5.5 million, income tax benefit of \$3.6 million, \$0.9 million provision for doubtful accounts receivable, and \$2.1 million depreciation and amortization expenses;
- \$6.3 million generated from an increase in accounts payable due primarily to increased inventory related purchases;
- \$4.2 million cash used to settle accrued liabilities;
- \$3.1 million cash used to increase pre-paid expenses and other long term assets;
- \$5.5 million used as a result of increased account receivables; and
- \$2.5 million used to increase inventories.

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Cash Flows from Investing Activities

Net cash provided by investing activities was \$2.7 million in the nine months ended September 30, 2019, primarily due to:

- \$11.5 million in net proceeds from the maturities of marketable investments; partially offset by
- \$8.3 million of cash used to purchase marketable investments; and
- \$0.5 million of cash used to purchase property, equipment and software.

Net cash provided by investing activities was \$15.5 million in the nine months ended September 30, 2018, which was attributable primarily to:

- \$21.1 million in net proceeds from the sales and maturities of marketable investments; partially offset by
- \$4.4 million of cash used to purchase marketable investments; and
- \$1.2 million of cash used to purchase property, equipment and software.

Cash Flows from Financing Activities

Net cash provided by financing activities was \$0.4 million in the nine months ended September 30, 2019, primarily due to:

- \$1.6 million net proceeds from the issuance of common stock due to employees exercising their stock options and purchasing stock through the ESPP; offset by
- \$0.7 million of cash used for taxes related to net share settlement of equity awards; and
- \$0.5 million of cash used to pay finance lease obligations.

Net cash provided by financing activities was \$270,000 in the nine months ended September 30, 2018, which was primarily due to:

- \$3.6 million proceeds from exercise of stock options and employee stock purchase plan, offset by
- \$3.0 million of cash used for taxes paid related to net share settlement of equity awards; and
- \$0.4 million of cash used to pay capital lease obligations.

Adequacy of Cash Resources to Meet Future Needs

The Company had cash, cash equivalents, and marketable investments of \$29.3 million as of September 30, 2019. For the nine months ended September 30, 2019, the Company's principal source of liquidity is cash from maturity and sales of marketable investments and cash generated from the issuance of common stock through exercise of stock options and the ESPP. The Company believes that the existing cash resources are sufficient to meet the Company's anticipated cash needs for working capital and capital expenditures for at least the next several years, but there can be no assurances.

Loan and Security Agreement

On May 30, 2018, the Company and Wells Fargo Bank, N.A. ("Wells Fargo") entered into a Loan and Security Agreement (the "Original Revolving Line of Credit") in the original principal amount of \$25 million. The Original Revolving Line of Credit terminates on May 30, 2021.

The Original Revolving Line of Credit contained financial and other covenants as well as the maintenance of a leverage ratio not to exceed 2.5 to 1.0 and a trailing twelve months ("TTM") adjusted EBITDA of not less than \$10 million. A violation of any of the covenants could result in a default under the Original Revolving Line of Credit that would permit the lenders to restrict the Company's ability to further access the revolving line of credit for loans and letters of credit and require the immediate repayment of any outstanding loans under the Loan and Security Agreement.

During the third quarter of 2018, the Company received notice that it was in violation of certain financial covenants in the Original Revolving Line of Credit and entered into discussions with Wells Fargo to amend and revise certain terms of the Original Revolving Line of Credit.

On or about November 2, 2018, the Company entered into a First Amendment and Waiver to the Loan and Security Agreement with Wells Fargo (the "First Amended Revolving Line of Credit"). The First Amended Revolving Line of Credit provided for a principal amount of \$15 million, with the ability to request an additional \$10 million, and a waiver of any existing defaults under the Original Revolving Line of Credit as long as the Company is in compliance with the terms of the First Amended Revolving Line of Credit.

On or about March 11, 2019, the Company entered into a Second Amendment and Waiver to the Loan and Security Agreement with Wells Fargo (the "Second Amended Revolving Line of Credit"). The Second Amended Revolving Line of Credit requires the Company to maintain a minimum cash balance of \$15 million at Wells Fargo, but removes all other covenants so long as no money is drawn on the line of credit. The Company may draw down on the line of credit at the time it reaches and maintains TTM adjusted EBITDA of not less than \$10 million, and a leverage ratio not to exceed 2.5 to 1.0.

A violation of any of the covenants could result in a default under the Second Amended Revolving Line of Credit that would permit the lenders to restrict the Company's ability to further access the revolving line of credit for loans and letters of credit and require the immediate repayment of any outstanding loans under the Second Amended Revolving Line of Credit.

As of September 30, 2019, the Company had not drawn on the Original Revolving Line of Credit and the Company is in compliance with all financial covenants of the Original Revolving Line of Credit, as amended by the First Amended Revolving Line of Credit and the Second Amended Revolving Line of Credit.

Commitments and Contingencies

As of the date of this report, other than changes related to adoption of the new lease accounting standard effective January 1, 2019, and as described in Notes 2 and 12 to the Condensed Consolidated Financial Statements, there were no material changes to the Company's contractual obligations and commitments outside the ordinary course of business since March 18, 2019, as reported in the Company's Annual Report on Form 10-K for the year ended December 31, 2018, as filed with the SEC on March 18, 2019.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

A summary of the key market risks facing the Company is disclosed below. For a detailed discussion, please see the Company's Annual Report on Form 10-K for the year ended December 31, 2018, filed with the SEC on March 18, 2019.

Interest Rate Fluctuations

The primary objective of the Company's investment activities is to preserve principal while at the same time maximizing the income the Company receives from investments without significantly increasing risk. To achieve this objective, the Company maintains its portfolio of cash equivalents and short- and long-term investments in a variety of high quality securities, including U.S. treasuries, U.S. government agencies, corporate debt, cash deposits, money market funds, commercial paper, non-U.S. government agency securities, and municipal bonds. The securities are classified as available-for-sale and consequently are recorded at fair value with unrealized gains or losses reported as a separate component of accumulated other comprehensive loss. The weighted average maturity of the Company's portfolio as of September 30, 2019 was approximately 0.3 years. If interest rates rise, the market value of our investments may decline, which could result in a realized loss if the Company is forced to sell an investment before its scheduled maturity. A hypothetical increase in interest rate by one percentage point would have resulted in no impact on the Company's total investment portfolio.

The uncertain financial markets could result in a tightening in the credit markets, a reduced level of liquidity in many financial markets, and extreme volatility in fixed income and credit markets. The credit ratings of the securities the Company has invested in could further deteriorate and may have an adverse impact on the carrying value of these investments.

As of September 30, 2019, the Company had not drawn on the Revolving Line of Credit. Overall interest rate sensitivity is primarily influenced by any amount borrowed on the line of credit and the prevailing interest rate on the line of credit facility. The effective interest rate on the line of credit facility is based on a floating per annum rate equal to the LIBOR rate. The LIBOR rate was 2.02% as of September 30, 2019, and accordingly the Company may incur additional expenses if the Company has an outstanding balance on the line of credit and the LIBOR rate increases in future periods.

Inflation

The Company does not believe that inflation has had a material effect on the Company's business, financial condition, or results of operations. If the Company's costs were to become subject to significant inflationary pressures, the Company may not be able to fully offset such higher costs through price increases. The Company's inability or failure to do so could harm the Company's business, financial condition, and results of operations.

Foreign Exchange Fluctuations

The Company generates revenue in Japanese Yen, Euros, Australian Dollars, Canadian Dollars, British Pounds and Swiss Francs. Additionally, a portion of the Company's operating expenses and assets and liabilities are denominated in each of these currencies. Therefore, fluctuations in these currencies against the U.S. dollar could materially and adversely affect the Company's results of operations upon translation of the Company's revenue denominated in these currencies, as well as the remeasurement of the Company's international subsidiaries' financial statements into U.S. dollars.

The Company has historically not engaged in hedging activities relating to the Company's foreign currency denominated transactions, given the Company has a natural hedge resulting from the Company's foreign cash receipts being utilized to fund the respective local currency expenses.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

An evaluation as of the three months September 30, 2019 was carried out under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the Company's "disclosure controls and procedures." Rule 13a-15(e) under the Exchange Act defines "disclosure controls and procedures" as controls and other procedures of a company that are designed to ensure that the information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the company's management, including its CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure. Based upon that evaluation, the Company's CEO and CFO concluded that the Company's disclosure controls and procedures were effective at September 30, 2019. Attached as exhibits to this Quarterly Report are certifications of the Company's CEO and CFO, which are required in accordance with Rule 13a-14 of the Exchange Act. This Controls and Procedures section includes the information concerning the controls evaluation referred to in the certifications, and it should be read in conjunction with the certifications for a more complete understanding of the topics presented.

Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the three months ended September 30, 2019 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on the Effectiveness of Controls

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Accordingly, the Company's disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of the Company's disclosure control system are met. As set forth above, the Company's CEO and CFO have concluded, based on their evaluation as of the end of the period covered by this report, that the Company's disclosure controls and procedures were effective to provide reasonable assurance that the objectives of the Company's disclosure control system were met.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, the Company may be involved in legal and administrative proceedings and claims of various types. For a description of the Company's material pending legal and regulatory proceedings and settlements refer to Note 11 to the Company's consolidated financial statements entitled "Commitments and Contingencies," in the Annual Report on Form 10-K for the year ended December 31, 2018, filed with the SEC on March 18, 2019.

ITEM 1A. RISK FACTORS

There are no material changes from the Risk Factors previously disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018, filed with the SEC on March 18, 2019.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit No. Description

3.2 [Amended and Restated Certificate of Incorporation of the Registrant \(Delaware\)](#).

(1)

3.4 [Bylaws of the Registrant](#).

(1)

4.1 [Specimen Common Stock certificate of the Registrant](#).

(2)

10.14 [Cutera, Inc. 2004 Amended and Restated Equity Incentive Plan](#).

(3)

31.1 [Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002](#).

31.2 [Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002](#).

32.1 [Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002](#).

101.ins Instance Document

101.sch XBRL Taxonomy Extension Schema Document

101.cal XBRL Taxonomy Extension Calculation Linkbase Document

101.def XBRL Taxonomy Extension Definition Linkbase Document

101.lab XBRL Taxonomy Extension Label Linkbase Document

101.pre XBRL Taxonomy Extension Presentation Linkbase Document

(1) Incorporated by reference from the Company's Registration Statement on Form S-1 (Registration No. 333-111928) which was declared effective on March 30, 2004.

(2) Incorporated by reference from the Company's Annual Report on Form 10-K filed with the SEC on March 25, 2005.

(3) Incorporated by reference from the Company's Definitive Proxy Statement on Form 14A filed with the SEC on April 30, 2018.

(4) Incorporated by reference from Current Report on Form 8-K filed May 9, 2018.

(5) Incorporated by reference from Current Report on Form 8-K filed September 5, 2018.

(6) Incorporated by reference from the Company's Definitive Proxy Statement on Form 14A filed with the SEC on April 30, 2019 and June 11, 2019.

SIGNATURE

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, in the city of Brisbane, State of California, on the 12th day of November, 2019.

CUTERA, INC.

/S/ DAVID H MOWRY

David H. Mowry

**Chief Executive Officer and Interim Chief Financial Officer
(Principal Financial and Accounting Officer)**

**Certification of Chief Executive Officer and Interim Chief Financial
Officer
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, David H. Mowry, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cutera, Inc.:
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 12, 2019

/s/ David H. Mowry

David H. Mowry
**Chief Executive Officer and Interim Chief Financial Officer (Principal
Executive Officer)**

**Certification of Chief Executive Officer and Interim Chief Financial
Officer
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, David H. Mowry, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Cutera, Inc.:
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditor and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 12, 2019

/S/ DAVID H. MOWRY

David H. Mowry
Chief Executive Officer and Interim Chief Financial Officer
(Principal Financial and Accounting Officer)

**CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, David H. Mowry, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that

- i. the accompanying Quarterly Report on Form 10-Q of the Company for the quarterly period ended September 30, 2019 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- ii. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 12, 2019

/S/ David H. Mowry

David H. Mowry
Chief Executive Officer and Interim Chief Financial Officer
(Principal Executive Officer)

I, David H. Mowry, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that

- i. the accompanying Quarterly Report on Form 10-Q of the Company for the quarterly period ended September 30, 2019 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- ii. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 12, 2019

/S/ DAVID H. MOWRY

David H. Mowry
Chief Executive Officer and Interim Chief Financial Officer
(Principal Financial and Accounting Officer)

This certification accompanies this Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended.