

CUTERA INC
Form 10-Q
May 09, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2018

OR

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

For the transition period _____ to_____.

Commission file number: 000-50644

Cutera, Inc.

(Exact name of registrant as specified in its charter)

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

3240 Bayshore Blvd., Brisbane, California 94005

(Address of principal executive offices)

(415) 657-5500

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 April 30, 2018, was 13,634,482

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CUTERA, INC.

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****CUTERA, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share and per share data)

(unaudited)

| | March 31, 2018 | December 31, 2017 |
|---|-------------------------------|----------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 10,910 | \$ 14,184 |
| Marketable investments | 13,062 | 21,728 |
| Accounts receivable, net | 19,862 | 20,777 |
| Inventories | 30,979 | 28,782 |
| Other current assets and prepaid expenses | 2,601 | 2,903 |
| Total current assets | 77,414 | 88,374 |
| Property and equipment, net | 2,214 | 2,096 |
| Deferred tax asset | 21,792 | 19,055 |
| Goodwill | 1,339 | 1,339 |
| Other long-term assets | 5,367 | 374 |
| Total assets | \$ 108,126 | \$ 111,238 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 8,206 | \$ 7,002 |
| Accrued liabilities | 20,083 | 26,848 |
| Deferred revenue | 8,847 | 9,461 |
| Total current liabilities | 37,136 | 43,311 |
| Deferred revenue, net of current portion | 2,168 | 2,195 |
| Income tax liability | 384 | 379 |

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| | | |
|--|-----------|-----------|
| Other long-term liabilities | 583 | 460 |
| Total liabilities | 40,271 | 46,345 |
| Commitments and Contingencies (Note 12) | | |
| Stockholders' equity: | | |
| Convertible preferred stock, \$0.001 par value; authorized: 5,000,000 shares; none issued and outstanding | — | — |
| Common stock, \$0.001 par value; authorized: 50,000,000 shares; issued and outstanding: 13,634,154 and 13,477,973 shares at March 31, 2018 and December 31, 2017, respectively | 14 | 13 |
| Additional paid-in capital | 62,057 | 62,025 |
| Retained earnings | 5,888 | 2,947 |
| Accumulated other comprehensive loss | (104) | (92) |
| Total stockholders' equity | 67,855 | 64,893 |
| Total liabilities and stockholders' equity | \$108,126 | \$111,238 |

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

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

| | Three Months Ended March 31, 2018 2017 | |
|---|--|------------|
| Net revenue: | | |
| Products | \$29,264 | \$24,475 |
| Service | 4,861 | 4,824 |
| Total net revenue | 34,125 | 29,299 |
| Cost of revenue: | | |
| Products | 13,922 | 11,144 |
| Service | 2,869 | 2,634 |
| Total cost of revenue | 16,791 | 13,778 |
| Gross profit | 17,334 | 15,521 |
| Operating expenses: | | |
| Sales and marketing | 13,088 | 10,773 |
| Research and development | 3,556 | 2,945 |
| General and administrative | 5,439 | 3,216 |
| Total operating expenses | 22,083 | 16,934 |
| Loss from operations | (4,749) | (1,413) |
| Interest and other income, net | 98 | 273 |
| Loss before income taxes | (4,651) | (1,140) |
| Benefit for income taxes | (2,619) | (118) |
| Net loss | \$(2,032) | \$(1,022) |
| Net loss per share: | | |
| Basic and Diluted | \$(0.15) | \$(0.07) |
| Weighted-average number of shares used in per share calculations: | | |
| Basic and Diluted | 13,587 | 13,840 |

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

Table of Contents**CUTERA, INC.****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS****(in thousands)****(unaudited)**

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2018 | 2017 |
| Net loss | \$(2,032) | \$(1,022) |
| Other comprehensive loss: | | |
| Available-for-sale investments | | |
| Net change in unrealized gain (loss) on available-for-sale investments | (21) | 3) |
| Less: Reclassification adjustment for (gains) losses on investments recognized during the period | 9 | (4) |
| Net change in unrealized loss on available-for-sale investments | (12) | (1) |
| Tax loss (benefit) | — | — |
| Other comprehensive loss, net of tax | (12) | (1) |
| Comprehensive loss | \$(2,044) | \$(1,023) |

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

Table of Contents**CUTERA, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2018 | 2017 |
| Cash flows from operating activities: | | |
| Net loss | \$(2,032) | \$(1,022) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Stock-based compensation | 1,688 | 1,395 |
| Depreciation of tangible assets | 254 | 248 |
| Amortization of contract acquisition costs | 373 | — |
| Change in deferred tax asset | (2,737) | (17) |
| Other | 25 | (34) |
| Changes in assets and liabilities: | | |
| Accounts receivable | 915 | (1,305) |
| Inventories | (2,197) | (695) |
| Other current assets and prepaid expenses | 1,753 | (158) |
| Other long-term assets | (2,150) | (9) |
| Accounts payable | 1,204 | 491 |
| Accrued liabilities | (6,727) | (2,657) |
| Deferred revenue | (456) | (23) |
| Other long-term liabilities | 40 | 1 |
| Net cash used in operating activities | (10,047) | (3,785) |
| Cash flows from investing activities: | | |
| Acquisition of property, equipment and software | (104) | (69) |
| Disposal of property and equipment | — | 25 |
| Proceeds from sales of marketable investments | 13,044 | 5,255 |
| Proceeds from maturities of marketable investments | — | 14,035 |
| Purchase of marketable investments | (4,390) | (15,972) |
| Net cash provided by investing activities | 8,550 | 3,274 |
| Cash flows from financing activities: | | |
| Repurchase of common stock | — | (2,700) |
| Proceeds from exercise of stock options and employee stock purchase plan | 633 | 1,751 |
| Taxes paid related to net share settlement of equity awards | (2,288) | (784) |
| Payments on capital lease obligations | (122) | (88) |

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| | | |
|---|----------|----------|
| Net cash used in financing activities | (1,777) | (1,821) |
| Net decrease in cash and cash equivalents | (3,274) | (2,332) |
| Cash and cash equivalents at beginning of period | 14,184 | 13,775 |
| Cash and cash equivalents at end of period | \$10,910 | \$11,443 |
| Supplemental disclosure of non-cash items: | | |
| Repurchase of common stock acquired but not settled | — | \$207 |
| Assets acquired under capital lease | \$284 | \$80 |

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

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CUTERA, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Description of Operations and Principles of Consolidation

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

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

Unaudited Interim Financial Information

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

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

Use of Estimates

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

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

Risks and Uncertainties

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

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Comparability

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

Adopted Accounting Pronouncements

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

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

In *August 2016*, the FASB issued ASU *2016-15*, Statement of Cash Flows (Topic *230*), which intends to reduce diversity in practice in how certain cash receipts and cash payments are classified in the statement of cash flows. This guidance is effective for the Company in the *first* quarter of *2018*. The Company adopted the standard in the *first* quarter of fiscal year *2018*. The adoption did *not* have any material impact on the Company’s consolidated financial statements.

In *November 2016*, the FASB issued ASU *2016-18*, Statement of Cash Flows (Topic *320*), which amended the guidance on the classification and presentation of restricted cash in the statement of cash flow. The amendment requires entities to include restricted cash and restricted cash equivalents in its cash and cash equivalents in the statement of cash flow. The amendment is effective for the Company in the *first* quarter of *2018* and is required to be adopted retrospectively. The Company adopted the standard in the *first* quarter of fiscal year *2018*. The adoption did *not* have any material impact on the Company’s consolidated financial statements.

Other Accounting Pronouncements

In *February 2016*, the FASB issued ASU No. 2016-02, Leases (Topic 842), which amends the existing accounting standards for leases. The new standard requires lessees to record a right-of-use asset and a corresponding lease liability on the balance sheet (with the exception of short-term leases). The new standard also requires expanded disclosures regarding leasing arrangements. The new standard becomes effective for the Company in the *first* quarter of fiscal year 2019 and early adoption is permitted. The new standard is required to be adopted using the modified retrospective approach and requires application of the new standard at the beginning of the earliest comparative period presented. The Company finances its fleet of vehicles used by its field sales and service employees and has facility leases. Several of the Company's customers finance purchases of its system products through *third* party lease companies and *not* directly with the Company. The Company does *not* believe that the new standard will change customer buying patterns or behaviors for its products. The Company will adopt the new standard effective *January 1, 2019*. The Company expects that upon adoption, right-of-use assets and lease liabilities will be recognized in the balance sheet in amounts that will be material.

Note 2. Revenue recognition

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

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Upon adoption of the Topic 606, the Company recorded an increase to retained earnings of \$5.0 million for contracts still in force as of *January 1, 2018* for the following items in the *first* quarter of 2018:

\$237,000 reduction in deferred revenue balances for the differences in the amount of revenue recognition for the Company's revenue streams as a result of allocation of revenue based on standalone selling prices to the Company's various performance obligations.

\$151,000 increase in deferred revenue balances, related to the accretion of financing costs for multi-year post-warranty service contracts for customers who pay more than one year in advance of receiving the service. The Company estimated interest expense for such advance payments under the new revenue standard.

\$210,000 for variable consideration on sale transactions.

\$4.7 million for the capitalization of the incremental contract acquisition costs, such as sales commissions paid in connection with system sales. These contract acquisition costs were capitalized and amortized over the period of anticipated support renewals. Under the prior guidance, the Company expensed such costs when incurred.

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

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

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The following table summarizes the effects of adopting Topic 606 on the Company's condensed consolidated balance sheet as of *March 31, 2018*:

| | As reported under | Adjustments | Balances under |
|------------------------|-------------------------|-------------|-------------------|
| | Topic 606 | | Prior GAAP |
| | (In thousands) | | |
| Other long-term assets | 5,367 | 4,862 | 505 |
| Accrued Liabilities | 20,083 | (111) | 20,194 |
| Deferred revenue | 11,015 | (194) | 10,821 |
| Retained earnings | 5,888 | 5,167 | 721 |

The following table summarizes the effects of adopting Topic 606 on Company's condensed consolidated income statement for the *three* months ended *March 31, 2018*:

| | As reported under | Adjustments | Balances under |
|---------------------------------|--|-------------|-------------------|
| | Topic 606 | | Prior GAAP |
| | (In thousands, except per share amounts) | | |
| Products revenue | \$29,264 | \$ 10 | \$29,254 |
| Service revenue | 4,861 | 64 | 4,797 |
| Sales and marketing | 13,088 | (185) | 13,273 |
| Interest and other income, net* | 98 | (65) | 163 |

* Included in interest and other income, net is the estimated interest expense for advance payment related to contract services under the new revenue standard going forward. Adoption of the standard had no impact to total net cash from or used in operating, investing, or financing activities within the Condensed Consolidated Statements of Cash Flows.

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

Table of Contents**Note 3. Cash, Cash Equivalents and Marketable Investments**

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

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

| March 31, 2018 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Market Value |
|---|---------------------------|---------------------------------------|--|----------------------------------|
| Cash and cash equivalents: | | | | |
| Cash | \$ 10,579 | \$ — | \$ — | \$ 10,579 |
| Money market funds | 331 | — | — | 331 |
| Total cash and cash equivalents | 10,910 | — | — | 10,910 |
| Marketable investments: | | | | |
| U.S. government notes | 7,110 | — | (14) | 7,096 |
| Municipal securities | 201 | — | (1) | 200 |
| Corporate debt securities | 5,795 | 1 | (30) | 5,766 |
| Total marketable investments | 13,106 | 1 | (45) | 13,062 |
| Total cash, cash equivalents and marketable investments | \$ 24,016 | \$ 1 | \$ (45) | \$ 23,972 |

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

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As of *March 31, 2018* and *December 31, 2017*, the net unrealized losses were \$45,000 and \$34,000, respectively, and were related to interest rate changes on available-for-sale marketable investments. The Company has concluded that it is more-likely-than-not that the securities will be held until maturity or the recovery of their cost basis. No securities were in an unrealized loss position for more than 12 months.

The following table summarizes the contractual maturities of the Company's available-for-sale securities, classified as marketable investments as of *March 31, 2018* (in thousands):

| | Amount |
|------------------------------|---------------|
| Due in less than one year | \$ 11,867 |
| Due in 1 to 3 years | 1,195 |
| Total marketable investments | \$ 13,062 |

Note 4. Fair Value of Financial Instruments

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

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

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

financial instrument.

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

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

As of *March 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 were as follows (in thousands):

| March 31, 2018 | Level 1 | Level 2 | Level 3 | Total |
|-------------------------------|--------------------|----------------|--------------------|--------------|
| Cash equivalents: | | | | |
| Money market funds | \$ 331 | \$— | \$ — | \$331 |
| Marketable investments: | | | | |
| Available-for-sale securities | — | 13,062 | — | 13,062 |
| Total assets at fair value | \$ 331 | \$13,062 | \$ — | \$13,393 |

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

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

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

Note 5. Balance Sheet Details***Inventories***

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

| | March 31, 2018 | December 31, 2017 |
|-----------------|-------------------------------|----------------------------------|
| Raw materials | \$18,735 | \$ 19,160 |
| Work in process | 2,813 | 2,744 |
| Finished goods | 9,431 | 6,878 |
| Total | \$30,979 | \$ 28,782 |

Accrued Liabilities

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

| | March 31, 2018 | December 31, 2017 |
|--|-------------------------------|----------------------------------|
|--|-------------------------------|----------------------------------|

| | | |
|--------------------------------------|----------|-----------|
| Accrued payroll and related expenses | \$9,003 | \$ 12,567 |
| Sales and marketing accruals | 2,136 | 3,710 |
| Warranty liability | 3,373 | 3,508 |
| Sales tax | 1,718 | 2,920 |
| Other | 3,853 | 4,143 |
| Total | \$20,083 | \$ 26,848 |

Note 6. Warranty and Service Contracts

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

After the original warranty period, maintenance and support are offered on a service contract basis or on a time and materials basis. The Company provides for the estimated cost to repair or replace products under warranty at the time of sale. The following table provides the changes in the product warranty accrual for the *three* months ended *March 31, 2018* and *2017* (in thousands):

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2018 | 2017 |
| Beginning Balance | \$3,508 | \$2,461 |
| Add: Accruals for warranties issued during the period | 2,264 | 2,135 |
| Less: Settlements made during the period | (2,399) | (1,861) |
| Ending Balance | \$3,373 | \$2,735 |

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Note 7. Revenue

Revenue is recognized upon transfer of control of promised products or services to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for promised goods or services. The Company's performance obligations are satisfied either over time or at a point in time. Revenue from performance obligations that are transferred to customers over time accounted for approximately 14% of the Company's total revenue for the *three* months ended *March 31, 2018*.

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

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

Nature of Products and Services

Systems

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

The Company considers system and software license as *one* performance obligation. The system and the software are highly interrelated and interdependent. Both are necessary for the system to work as designed. The customer cannot benefit from the system without the license to the embedded software. 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 considers set-up or installation an immaterial promise as set-up or installation for systems other than *enlighten* system takes only a short time. The related costs to complete set-up or installation are immaterial to the Company. The *enlighten* system includes the related software license as *one* performance obligation and the calibration or installation service as a separate performance obligation since a *third* party could perform this service.

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

The Company typically receives payment for its system consoles and other accessories within 30 days of shipment. Certain international distributor arrangements allow for longer payment terms because of the volume of purchases by these distributors.

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Skincare products

The Company sells *third*-party manufactured skincare products in Japan. The Company purchases and inventories these *third*-party skincare products from the manufacturers and sells them to licensed physicians. The Company acts as the principal in this arrangement as it determines the price to charge customers for the skincare products, and controls the products before they are transferred to the customer. The Company warrants that the cosmeceuticals will be free of significant defects in workmanship and materials for 90 days from shipment. Skincare products are typically sold in a separate contract as the only performance obligations. The Company recognizes revenue for skincare products at a point in time, generally upon shipment or delivery.

Consumables (Other accessories)

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

Extended contract services

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

Training

Sales of system to customers include training on the system to be provided within 90 days of purchase. The Company considers training as a separate performance obligation as customers can benefit from readily available resources due

to the fact that the customer already has the system. If training occurred before the system was delivered, the customer would *not* have readily available resources and could *not* benefit from the training. Training is also sold separately from the system. This occurs when customers hire new employees and want the Company to train them on a system the customer already owns. The training is useful in providing an enhanced approach to using the System, so the training also has benefit. The Company recognizes revenue for training over time as the training is provided. As training is not required for customers to use the systems, the Company concludes that it has no effect on the Company's evaluation of when the risks and rewards of ownership transfer to customers.

Customer Marketing Support

In North America, the Company offers marketing and consulting phone support to its customers who purchase its *truSculpt 3D* system. This includes a unique marketing program and a customizable practice support kit to help customers inform, inspire and engage their current and prospective patients. This is a personalized program designed to help customers jump-start their practice with *truSculpt 3D*. It includes a business model and marketing training performed remotely with ongoing phone consultations for *six* months from date of purchase.

The Company considers this a separate performance obligation, and allocates and recognizes revenue over the *six*-month term of support. The Company determines the standalone selling price based on cost plus a margin.

Significant Judgments

More judgments and estimates are required under Topic *606* than were required under the previous revenue recognition guidance, Topic *605*. Due to the nature of certain contracts, the actual revenue recognition treatment required under Topic *606* for the Company's arrangements *may* be dependent on contract-specific terms and *may* vary in some instances.

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The Company's contract agreement with customers for system purchases includes the delivery of the system and a nonexclusive, nontransferable license to use such software and/or firmware in connection with customer's use of the product. The tangible product, including the embedded software, are delivered to the customer at the time of sale. In some circumstances, in conjunction with the purchase of a system or upgrade, customers purchase service contracts for *one* or more years to cover their products. For these transactions, the following multiple-element arrangement exists: a tangible product delivered to the customer at the inception of the revenue arrangement; and a service contract for delivery of services to the customer over a contractually stated period of time defined in the service contract.

Determining whether licenses and services are distinct performance obligations that should be accounted for separately, or *not* distinct and thus accounted for together, requires significant judgment. The system and the software are highly interrelated and interdependent. Both are necessary for the system to work as designed. The customer cannot benefit from *one* without the other. The Company has concluded that systems and the related software license are *one* performance obligation. The *enlighten* system includes the related software license as *one* performance obligation and the calibration/installation service as a separate performance obligation. The calibration/installation is a separate performance obligation for the *enlighten* system because a knowledgeable *third-party* could perform this service.

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

Sales of Products to customers include training on the products to be provided within *90* days of purchase. Training is considered a separate performance obligation.

Extended warranty, if included in the agreement, requires the Company to provide extended warranty services for one, *two* or *three* years. The Company considers extended warranty as a separate performance obligation.

Skincare products are typically sold in a separate contract as the only performance obligations.

Judgment is required to determine the standalone selling price ("SSP") for each distinct performance obligation. The Company rarely licenses or sells products on a standalone basis, so the Company estimates SSPs for each performance obligation as follows:

enlighten system: SSP is estimated from observable inputs, if available, and if *not* available, the Company estimates the SSP using cost plus margin.

All other systems: For systems other than *truSculpt 3D* with marketing program, and other marketing support, SSP is estimated from observable inputs, if available, and if *not* available, the Company estimates the SSP using cost plus margin. The Company estimates SSP for *truSculpt 3D* with marketing support using cost plus margin approach; for *truSculpt 3D* without marketing support, the Company estimates SSP from observable inputs, if available, and if *not* available, SSP is estimated using cost plus margin.

Training: SSP is estimated from observable inputs when sold on a standalone basis.

Extended warranty: SSP is estimated from observable inputs when sold on a standalone basis (by customer type).

Marketing program (excluding *third-party* marketing support, which is *not* considered a performance obligation.): SSP is estimated based on cost plus a margin.

Skincare products: Skincare products are the only performance obligation in the contracts. All product is delivered at the same time, therefore the Company does *not* have to allocate the transaction price for skincare products.

The Company allocates transaction price and discount to each performance obligation (i.e., system, extended warranty, training) based on the relative SSP of the performance obligation in the contract.

The Company recognizes revenue for all products (systems, accessories, etc.) at a point in time. The software license embedded in the system is a functional license giving the customer the right to use the software as it exists at the time of shipment. Therefore, revenue related to the software license is recognized at a point in time – upon shipment, and the software license does *not* change the timing of revenue recognition for the system. The Company concluded that it should recognize revenue for extended warranty over the service period on a straight-line basis. The Company also concluded that it should recognize the revenue for the marketing support (excluding *third-party* marketing) over the committed period for the service. The Company plans to use the invoice practical expedient for services provided on a time and materials basis (i.e., recognize the revenue for services as the time and materials are incurred and invoiced to the customer).

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

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

Contract balance

The Company's service contracts include an upfront payment for the *one*, *two* or *three*-year contract terms. The timing of receipt of payment and timing of performance of the services create timing differences that result in contract liabilities (deferred revenue) on the Company's condensed consolidated balance sheet. The advance payments under these contracts are recorded in deferred revenue (contract liability), and the Company recognizes the revenue on a straight-line basis over the period of the applicable contract. Contracted but unsatisfied performance obligations were approximately \$11.0 million as of March 31, 2018, of which the Company expects to recognize approximately 80% of the revenue over the next 12 months and the remainder thereafter.

Deferred Sales Commissions

The Company records a contract asset for the incremental costs of obtaining a contract with a customer, including direct sales commissions that are earned upon execution of the contract for its post-warranty service contracts that are capitalized and amortized over the estimated customer relationship period.

The Company uses the portfolio method to capitalize and recognize the amortization expense related to these capitalized costs related to initial contracts and renewals and such expense is recognized over a period associated with the revenue of the related portfolio, which is generally *two* to *three* years for the Company's product and service arrangements. The Company determined that it would apply the *one*-year practical expedient to sales commissions on systems sales and training because the revenue for these items would be recognized at a point in time (systems) or

shortly after the sale is completed (training).

Incremental costs related to initial contracts and renewals are amortized over the same period because the commissions paid on both the initial contract and renewals are commensurate with *one* another. Total capitalized costs as of *March 31, 2018* were \$4.9 million and are included in other assets in the Company's condensed consolidated balance sheet. Amortization of these assets was \$0.4 million during the *three* months ended *March 31, 2018* and is included in sales and marketing expense in the Company's condensed consolidated income statement.

Note 8. Deferred Service Contract Revenue

The Company generates Service revenue from the sale of extended service contracts and from time and material services provided to customers who are *not* under a warranty or extended service contract. Service contract revenue is recognized on a straight-line basis over the period of the applicable contract. Service revenue from time and material services is recognized as the services are provided.

The following table provides changes in the deferred service contract revenue balance for the *three* months ended *March 31, 2018* and *2017* (in thousands):

| | Three Months Ended March 31, 2018 2017 | |
|--------------------------|--|---------|
| Beginning Balance | \$10,719 | \$9,431 |
| Add: Payments received | 2,995 | 3,391 |
| Less: Revenue recognized | (3,347) | (3,267) |
| Ending Balance | \$10,367 | \$9,555 |

Costs for extended service contracts were \$1.9 million for the *three* months ended *March 31, 2018* and *2017*, respectively.

*The Company recognized \$0.8 million related to training, marketing assistance and installation for the *enlighten* system related to revenue deferred in 2017 and recognized during the first quarter of 2018.

Table of Contents**Note 9. Stockholders' Equity and Stock-based Compensation Expense**

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

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

| | Shares | Options Outstanding Number of | Weighted- Average Exercise Price |
|--------------------------------------|------------------------|-------------------------------------|---|
| | Available for Grant | Stock Options Outstanding | |
| Balance, December 31, 2017 | 1,494,866 | 839,919 | \$ 16.46 |
| Options granted | (14,500) | 14,500 | 53.90 |
| Stock awards granted ⁽¹⁾ | (310,275) | — | — |
| Options exercised | — | (66,167) | 9.57 |
| Options canceled | 32,438 | (32,438) | 15.87 |
| Stock awards canceled ⁽¹⁾ | 43,990 | — | — |
| Balance, March 31, 2018 | 1,246,519 | 755,814 | \$ 17.81 |

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

Under the 2004 Equity Incentive Plan, as amended, the Company issued 156,181 shares of common stock during the three months ended March 31, 2018, in conjunction with stock options exercised and the vesting of RSUs and PSUs.

As of *March 31, 2018*, there was approximately \$15.7 million of unrecognized compensation expense, net of projected forfeitures, for stock options and stock awards. The expense is expected to be recognized over the remaining weighted-average period of 2.51 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.

2004 Employee Stock Purchase Plan

On *January 12, 2004*, the Board of Directors adopted the *2004 Employee Stock Purchase Plan*. Under the *2004 Employee Stock Purchase Plan*, or *2004 ESPP*, eligible employees are permitted to purchase common stock at a discount through payroll deductions. The *2004 ESPP* offering and purchase periods are for approximately *six* months. The *2004 ESPP* has an evergreen provision based on which shares of common stock eligible for purchase are increased on the *first* day of each fiscal year by an amount equal to the lesser of:

- i. *600,000* shares;
- ii. *2.0%* of the outstanding shares of common stock on such date; or
- iii. an amount as determined by the Board of Directors.

Non-Employee Stock-Based Compensation

The Company granted 1,640 RSUs and 1,640 PSUs to *one* non-employee during the quarter ended *March 31, 2018*, and 7,745 stock options and 2,478 RSUs during the year ended *December 31, 2017*. The 7,745 stock options vests over 4 years at 25% on the *first* anniversary of the grant date and *1/48th* each month thereafter.

The 4,118 RSUs vests over 4 years at 25% each anniversary of the grant date, while the 1,640 PSUs vesting is subject to the recipient's continued service and achievement of pre-established goals. These RSUs/PSUs and stock options were granted in exchange for consulting services to be rendered and are measured and recognized as they are earned. The Company revalues stock options granted to non-employees at each reporting date as the underlying equity instruments vest.

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Stock-based compensation expense by department recognized during the *three* months ended *March 31, 2018* and *2017* were as follows (in thousands):

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2018 | 2017 |
| Cost of revenue | \$154 | \$129 |
| Sales and marketing | | |
| Employee | 452 | 420 |
| Non-employee | 37 | - |
| Research and development | 191 | 237 |
| General and administrative | 854 | 609 |
| Total stock-based compensation expense | \$1,688 | \$1,395 |

Note 10. Net Loss Per Share

Basic net income (loss) per share is computed using the weighted-average number of shares outstanding during the period. In periods of net income, diluted shares outstanding include the dilutive effect of in-the-money equity awards (stock options, restricted stock units, performance stock units and employee stock purchase plan contributions), which is calculated based on the average share price for each fiscal period using the treasury stock method. In accordance with ASC 718, the assumed proceeds under the treasury stock method include the average unrecognized compensation expense of in-the money stock options and restricted stock units. This results in the assumed buyback of additional shares, thereby reducing the dilutive impact of equity awards.

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

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

| | Three months ended March 31, 2018 | Three months ended March 31, 2017 |
|--|--|--|
| Numerator: | | |
| Net loss | \$(2,032) | \$(1,022) |
| Denominator: | | |
| Weighted-average shares outstanding in basic calculation | 13,587 | 13,840 |
| Add: dilutive effect of potential common shares | — | — |
| Weighted-average shares used in computing diluted net income per share | 13,587 | 13,840 |
| Net loss per share: | | |
| Net loss per share, basic and diluted | \$(0.15) | \$(0.07) |

Basic net loss per share is calculated by dividing net loss by the weighted-average number of common shares outstanding during the year. Diluted net loss per common share is the same as basic net loss per common share, as the effect of the potential common stock equivalents is anti-dilutive and as such is excluded from the calculations of the diluted net loss per share.

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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 March 31, 2018 2017 | |
|-------------------------------------|--|-------|
| Options to purchase common stock | 807 | 1,088 |
| Restricted stock units | 396 | 384 |
| Performance stock units | 23 | 164 |
| Employee stock purchase plan shares | 34 | 49 |
| Total | 1,260 | 1,685 |

Note 11. Income Taxes

The Company calculates the provision for income taxes during interim reporting periods by applying an estimate of the annual effective tax rate for the full year to "ordinary" income or loss (pretax income or loss excluding unusual or infrequently occurring discrete items) for the reporting period. When applicable, the year-to-date tax provision reflects adjustments from discrete tax items. The income tax benefit for the *three* months ended *March 31, 2018* reflects a projected income tax expense for U.S. and non-U.S. operations resulting in an annual effective tax rate applied to the year-to-date ordinary loss. This tax benefit is increased by excess tax benefit generated by stock deductions exercised or vested in the *three* months ended *March 31, 2018*. For the *three* months ended *March 31, 2018*, the Company's income tax benefit was \$2,619,000, compared to a tax benefit of \$118,000 for the same period in 2017. The income tax benefit for the *three* months ended *March 31, 2018* includes a tax benefit for excess tax deductions of approximately \$1,460,000, recorded discretely in the reporting period.

The Company utilizes the asset and liability method of accounting for income taxes, under which deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using enacted tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is more likely than *not* that some of the deferred tax assets will *not* be realized. As of *December 31, 2017*, the Company released its valuation allowance against U.S. Federal and all other domestic state net deferred tax assets except for California and Massachusetts. The Company maintained this valuation allowance position through *March 31, 2018*. Significant management judgment is required in determining any valuation allowance recorded against deferred tax assets. In evaluating the ability to recover deferred tax assets, the Company considered available positive and negative evidence giving greater weight to its recent cumulative profits and lesser weight to its projected financial results due to the subjectivity involved in forecasting future periods. The Company

also considered, commensurate with its objective verifiability, the forecast of future taxable income including the reversal of temporary differences, the implementation of feasible and prudent tax planning strategies and the impact of the Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act").

Note 12. 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 CEO, and makes decision on allocating resources and in assessing performance. The CODM 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 United States. The Company's chief operating decision maker viewed its operations, managed its business, and used *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.

The following table presents a summary of revenue by geography for the three months ended March 31, 2018 and 2017:

| | Three Months Ended | |
|---|-------------------------------|-----------------|
| | March 31, | |
| Revenue mix by geography: | 2018 | 2017 |
| United States | \$ 21,136 | \$ 16,544 |
| Japan | 3,555 | 3,880 |
| Asia, excluding Japan | 2,843 | 3,184 |
| Europe | 2,570 | 2,225 |
| Rest of the world | 4,021 | 3,466 |
| Total consolidated revenue | \$34,125 | \$29,299 |
| | | |
| Revenue mix by product category: | | |
| Products | \$ 27,239 | \$ 22,992 |
| Consumables (Hand Piece Refills) | 769 | 499 |
| Skincare | 1,256 | 984 |
| Total product revenue | \$29,264 | \$24,475 |
| Service | 4,861 | 4,824 |
| Total consolidated revenue | \$34,125 | \$29,299 |

Note 13. Commitments and Contingencies***Operating Leases***

The Company leases space for operations in United States, Japan and France. Future minimum lease commitments under the Company's facility operating leases as of *March 31, 2018* were as follows (in thousands):

| Year Ending March 31, | Amount |
|-------------------------------------|---------------|
| 2018 | \$2,266 |
| 2019 | 3,002 |
| 2020 | 2,937 |
| 2021 | 2,529 |
| 2022 | 2,495 |
| 2023 and beyond | 213 |
| Total future minimum lease payments | \$ 13,442 |

In addition to the above facility leases, the Company also routinely leases automobiles for certain sales and field service employees under operating leases for which the remaining committed lease payments are *not* material.

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Contingencies

The Company is named from time to time as a party to other legal proceeds product liability, commercial disputes, employee disputes, and contractual lawsuits in the normal 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 *March 31, 2018* and *December 31, 2017*, the Company had accrued *\$40,000* and *\$91,000* 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 possible.

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

You should read the following management's discussion and analysis of our financial condition and results of operations in conjunction with our unaudited condensed consolidated financial statements and notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q and with our audited financial statements and notes thereto for the year ended December 31, 2017, included in our annual report on Form 10-K filed on March 26, 2018 with the U.S. Securities and Exchange Commission (SEC).

Special note regarding forward-looking statements

This report contains forward-looking statements that involve risks and uncertainties. Our 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 and Section 21E of the Securities Exchange Act of 1934, as amended, or 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 thereof to identify forward-looking statements. These statements are based on the beliefs and assumptions of our 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, we undertake 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 our common stock price;
- the ability of our sales force to effectively market and promote our products, and the extent to which those products gain market acceptance;
- the existence and timing of any product approvals or changes;
- the rate and size of expenditures incurred on our clinical, manufacturing, sales, marketing and product development efforts;
- our ability to obtain and retain personnel;
- the availability of key components, materials and contract services, which depends on our ability to forecast sales, among other things;

investigations of our 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;
product recalls or safety alerts;
litigation, including product liability, patent, employment, securities class action, stockholder derivative, general commercial and other lawsuits;
continued volatility in the global market and worldwide economic conditions, including, but not limited to, the impact of events such as Brexit;
changes in tax laws, including changes due to Brexit, or exposure to additional income tax liabilities;
the financial health of our customers and their ability to purchase our 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 our business, a brief discussion of our product lines and the opportunities, trends, challenges and risks we focus 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 our analysis and outlook for the significant line items on our Condensed Consolidated Statements of Operations.

Liquidity and Capital Resources. This section provides an analysis of our liquidity and cash flows, as well as a discussion of our commitments that existed as of March 31, 2018.

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Executive Summary

Company Description

We are a leading medical device company specializing in the research, development, manufacture, marketing and servicing of laser and other energy based aesthetics systems for practitioners worldwide. In addition to internal development of products, we distribute third party sourced products under our own brand names. We offer easy-to-use products which enable physicians and other qualified practitioners to perform safe and effective aesthetic procedures, including treatment for body contouring, skin resurfacing and rejuvenation, tattoo removal, removal of benign pigmented lesions, vascular conditions, hair removal, toenail fungus and vaginal health. Our 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, we generate revenue from the sale of post warranty service contracts, providing services for products that are out of warranty, hand piece refills, and distribution of third-party manufactured skincare products.

Our ongoing research and development activities are primarily focused on improving and enhancing our portfolio of products. We are exploring ways to expand our product offerings through the launch of new products. We introduced *Juliet*, a product for women's health, in December 2017, and *Secret RF*, a fractional RF microneedling device for skin rejuvenation, in January 2018. *Enlighten SR* also began sales in the first quarter of 2018.

Our corporate headquarters and U.S. operations are located in Brisbane, California, from where we conduct our manufacturing, warehousing, research and development, regulatory, sales and marketing, service, and administrative activities. We market, sell and service our products through direct sales and service employees in the U.S., Australia, Belgium, Canada, France, Hong Kong, Japan, Spain, Switzerland and the United Kingdom. Sales and Service outside of these direct markets are made through a worldwide distributor network in over 40 countries.

Products and Services

Our revenue is derived from the sale of Products and Services. Product revenue is derived from the sale and upgrade of systems (classified as "Systems" revenue), sale of replacement hand pieces, as well as single use disposable tips applicable to *Juliet*, *Secret RF* (classified as "Consumables"), and the sale of skincare products (classified as "Skincare" revenue). System revenue represents the sale of a system or an upgrade of a system. A system consists of a console that incorporates a universal graphic user interface, a laser and/or other energy based module, control system software and high voltage electronics; as well as one or more hand pieces. However, depending on the application, the laser or other energy based module is sometimes contained in the hand piece such as with our *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.

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

Our primary system platforms include: *excel V*, *excel HR*, *enlighten*, *Juliet*, *Secret RF*, *truSculpt* and *xeo*.

Service revenue relates to amortization of prepaid service contracts, training, *enlighten* installation, direct billings for detachable hand piece replacements and revenue for parts and labor on out-of-warranty products.

Significant Business Trends

We believe that our ability to grow revenue will be primarily dependent on the following:

- continuing to expand our product offerings both through internal development and sourcing from other vendors;
- ongoing investment in our 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 our products can be displayed and used to assist in selling efforts);
- customer demand for our products;
- strengthening against the U.S. dollar of key international currencies in which we transact (Australian Dollar, Japanese Yen, Euro, Swiss Franc and British Pound);
- consumer demand for the application of our products;
- marketing to physicians in the core dermatology and plastic surgeon specialties, as well as outside those specialties;
- and
 - generating recurring revenue from our growing installed base of customers through the sale of system upgrades, services, hand piece refills, skincare products and replacement tips for *Juliet* and *Secret RF* products.

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For a detailed discussion of the significant business trends impacting our business, please see the section titled “Results of Operations” below.

Factors that May Impact Future Performance

Our industry is impacted by numerous competitive, regulatory and other significant factors. Our industry is highly competitive and our future performance depends on our ability to compete successfully. Additionally, our future performance is dependent upon our ability to continue to expand our product offerings with innovative technologies, obtain regulatory clearances for our products, protect the proprietary technology of our products and our manufacturing processes, manufacture our products cost-effectively, and successfully market and distribute our products in a profitable manner. If we fail to execute on the aforementioned initiatives, our business would be adversely affected. A detailed discussion of these and other factors that could impact our future performance are provided in Part I, Item 1A “Risk Factors” and elsewhere in this Form 10-Q, (1) our 2017 Form 10-K, (2) our reports and registration statements filed and furnished from time to time with the SEC, and (3) other announcements we make from time to time.

Critical accounting policies, significant judgments and use of estimates

The Company's management discussion and analysis of financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, (“U.S. GAAP”). The preparation of these condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities and expenses. On an ongoing basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable in the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions and conditions. Our significant accounting policies are more fully described in Note 1 of the accompanying unaudited condensed consolidated financial statements and in Note 2 to our audited consolidated financial statements contained in the Annual Report on Form 10-K filed on March 26, 2018 with the Securities Exchange Commission, or the SEC. With the exception of the change in revenue recognition as a result of the adoption of ASC 606, (see Notes 2 and 7) there have been no new or material changes to the critical accounting policies and estimates discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017, that are of significance, or potential significance to the Company.

Results of Operations

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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 March 31, 2018 2017 | |
|--------------------------------|--|-------|
| Net revenue | 100% | 100 % |
| Cost of revenue | 49 % | 47 % |
| Gross margin | 51 % | 53 % |
| Operating expenses: | | |
| Sales and marketing | 38 % | 37 % |
| Research and development | 10 % | 10 % |
| General and administrative | 16 % | 11 % |
| Total operating expenses | 64 % | 58 % |
| Loss from operations | (14)% | (5)% |
| Interest and other income, net | — % | 1 % |
| Loss before income taxes | (14)% | (4)% |
| Benefit for income taxes | (8)% | — % |
| Net loss | (6)% | (4)% |

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The Company primarily generate revenue from the sale of systems, training on the systems, extended service contracts, consumables and other accessories. The timing of our 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 2 in the notes to consolidated financial statements on the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017 and notes 2 and 7 to the condensed consolidated financial statements.

As of March 31, 2018, approximately 14% of the Company's revenue is recognized over time, and the remainder of the revenue is recognized upon completion of delivery. Revenue recognized over time includes revenue from the Company's extended contract services, training, and Installation of the Enlighten systems. Revenue recognized upon delivery is primarily generated by the sales of system products, consumables and skincare.

During the first quarter of fiscal 2018, we recognized revenue based on the ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)," but revenue for the three months ended March 31, 2017 was recognized based on Topic 605. Therefore, the periods are not directly comparable. For additional information on the impact of the new accounting standard on our revenue, see Notes 2 and 7 in the notes to condensed consolidated financial statements.

Total Net Revenue

| (Dollars in thousands) | Three Months Ended March 31, | | | |
|---|------------------------------|----------|------|----------|
| | 2018 | % Change | 2017 | |
| Revenue mix by geography: | | | | |
| United States | \$21,136 | 28 | % | \$16,544 |
| International | 12,989 | 2 | % | 12,755 |
| Consolidated total revenue | \$34,125 | 16 | % | \$29,299 |
| <i>United States as a percentage of total revenue</i> | 62 | % | | 56 % |
| <i>International as a percentage of total revenue</i> | 38 | % | | 44 % |
| Revenue mix by product category: | | | | |
| Systems – North America | \$18,944 | 31 | % | \$14,460 |
| Systems – Rest of World | 8,295 | (3) |)% | 8,532 |
| <i>Total Systems</i> | 27,239 | 18 | % | 22,992 |

| | | | | |
|--------------------------|----------|----|---|----------|
| Consumables | 769 | 54 | % | 499 |
| Skincare | 1,256 | 28 | % | 984 |
| <i>Total Products</i> | 29,264 | 20 | % | 24,475 |
| Service | 4,861 | 1 | % | 4,824 |
| <i>Total Net Revenue</i> | \$34,125 | 16 | % | \$29,299 |

Total Net Revenue:

The Company's revenue increased by 16% in the three month period ended March 31, 2018, compared to the same period in 2017, due primarily to increased system revenues.

Revenue by Geography:

The Company's U.S. revenue increased by \$4.6 million, or 28%, in the three months ended March 31, 2018, compared to the same period in 2017. This increase was due primarily to new products introduced into the market in January 2018.

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The Company's international revenue was relatively flat, increasing by \$234,000, or 2%, in the three months ended March 31, 2018, compared to the same period in 2017. The increase was due to growth in the Company's business in Europe and the Middle East, partially offset by decline in sales in Asia including Japan.

Revenue by Product Type:

Systems Revenue

Systems revenue in North America increased by \$4.5 million, or 31%, in the three months ended March 31, 2018, compared to the same period in 2017 due to strong sales in Canada and the new products launched during the first quarter of 2018. The rest of the world systems revenue decreased by \$237,000 or 3%. The decrease in rest of world revenue was primarily a result of a decline in revenue from the Company's direct business in Asia, including Japan, partially offset by increases in our direct business in Australia, as well as increases in our distributor business in the Middle East, and Europe.

Consumables Revenue

Consumables revenue increased by \$270,000, or 54%, in the three months ended March 31, 2018, compared to the same period in 2017. The increase in consumables was due to the introduction of *Secret RF* and *Juliet* during January 2018, all of which have consumable elements.

Skincare Revenue

The Company's revenue from Skincare products in Japan increased by \$272,000, or 28%, in the three months ended March 31, 2018, compared to the same period in 2017. This increase was due primarily to increased marketing and promotional activities for this distributed product.

Service Revenue

The Company's Service revenue increased by \$37,000, or 1%, in the three months ended March 31, 2018, compared to the same period in 2017. This increase was due primarily to increased sales of system parts to the Company's network of international distributors.

Gross Profit

| (Dollars in thousands) | Three Months Ended March 31, | | | |
|--------------------------------------|------------------------------|----------|------------|---|
| | 2018 | % Change | 2017 | |
| Gross profit | \$17,334 | 12 | % \$15,521 | |
| As a percentage of total net revenue | 51 | % | 53 | % |

The Company's cost of revenue consists primarily of material, personnel expenses, product warranty costs, and manufacturing overhead expenses.

The gross profit as a percentage of total revenues was 51% in 2018, compared to 53% in 2017, due primarily to increased material, manufacturing and warranty costs, as well as higher Service personnel costs due to an investments in additional headcount to fuel future growth.

Sales and Marketing

| (Dollars in thousands) | Three Months Ended March 31, | | | |
|--------------------------------------|------------------------------|----------|------------|---|
| | 2018 | % Change | 2017 | |
| Sales and marketing | \$13,088 | 21 | % \$10,773 | |
| As a percentage of total net revenue | 38 | % | 37 | % |

Sales and marketing expenses consist primarily of personnel expenses, expenses associated with customer-attended workshops and trade shows, post-marketing studies, and advertising. Sales and marketing expenses increased by \$2.3 million, and represented 38% of total net revenue in the three months ended March 31, 2018, compared to 37% in the same period in 2017. The \$2.3 million increase was due primarily to:

\$1.8 million net increase in personnel related expenses, which were driven primarily by higher headcount and commissions in North America due to higher revenue;

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\$0.4 million of higher promotional and product demonstration expenses, primarily in North America; and \$0.1 million of consulting costs and travel related expenses in North America associated with the increased activity and headcount.

Research and Development (“R&D”)

| (Dollars in thousands) | Three Months Ended March 31, | | | |
|--------------------------------------|---------------------------------|-------------|------|---------|
| | 2018 | % Change | 2017 | |
| Research and development | \$3,556 | 21 | % | \$2,945 |
| As a percentage of total net revenue | 10 | % | | 10 % |

R&D expenses consist primarily of personnel expenses, clinical research, regulatory and material costs. R&D expenses increased by \$611,000, and represented 10% of total net revenue, in the three months ended March 31, 2018, compared to 10% for the same period in 2017. This increase in expense was due primarily to increased material and regulatory expenses, as well as personnel and consulting related expenses.

General and Administrative (“G&A”)

| (Dollars in thousands) | Three Months Ended March 31, | | | |
|--------------------------------------|---------------------------------|-------------|------|---------|
| | 2018 | % Change | 2017 | |
| General and administrative | \$5,439 | 69 | % | \$3,216 |
| As a percentage of total net revenue | 16 | % | | 11 % |

G&A expenses consist primarily of personnel expenses, legal fees, accounting, higher audit and tax consulting fees, and other general and administrative expenses. G&A expenses increased by \$2.2 million and represented 16% of total net revenue in the three months ended March 31, 2018, compared to 11% in the same period in 2017. This increase is primarily attributable to higher audit and tax fees related to the adoption of ASC 606, as well as increased personnel costs related to increased headcount.

Interest and Other Income, Net

Interest and other income, net, consists of the following:

| | Three Months Ended March 31, | | |
|--------------------------------|---|---------------------|-------------|
| (Dollars in thousands) | 2018 | % Change | 2017 |
| Interest and other income, net | \$98 | (64 %) | \$273 |

Interest and other income, net, decreased \$175,000 in the three months ended March 31, 2018, compared to the same period in 2017. This decrease was due primarily to increase in net foreign exchange losses, interest expense on multi-year contracts with customers related to the adoption of ASC 606 as well as a decrease in interest income from our marketable investments.

Provision for Income Taxes

| | Three Months Ended March 31, | | |
|-------------------------------|---|---------------------|-------------|
| (Dollars in thousands) | 2018 | % Change | 2017 |
| Loss before income taxes | \$(4,651) | 308% | \$(1,140) |
| Benefit for income taxes | (2,619) | 2119% | (118) |

For the three months ended March 31, 2018, our income tax benefit was \$2,619,000, compared to a tax benefit of \$118,000 in the same period in 2017. In the three months ended March 31, 2018, we calculated the provision for income taxes 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. Our income tax benefit for the three months ended March 31, 2018 reflects a projected income tax expense for U.S. and non-U.S. operations resulting in an annual effective tax rate applied to the year-to-date ordinary loss. The income tax benefit includes excess tax benefits generated by stock deductions exercised or vested in the three months ended March 31, 2018.

For our income tax provision in the three months ended March 31, 2017, the tax benefit was primarily related to projected U.S. alternative minimum taxes and income taxes from non-U.S. operations. The income tax benefit resulted from applying the annual effective tax rate by the year-to-date ordinary loss. The projected income tax reflected utilization of net operating loss carryforwards. However, the tax effect of such utilization was offset by a change in valuation allowance for the three months ended March 31, 2017.

Table of Contents**Liquidity and Capital Resources**

Liquidity is the measurement of our ability to meet potential cash requirements, fund the planned expansion of our operations and acquire businesses. Our sources of cash include operations, stock option exercises, and employee stock purchases. We actively manage our cash usage and investment of liquid cash to ensure the maintenance of sufficient funds to meet our daily needs. The majority of our cash and investments are held in U.S. banks and our foreign subsidiaries maintain a limited amount of cash in their local banks to cover their short-term operating expenses.

At March 31, 2018 and December 31, 2017, we had 40.3 million and \$45.1 million of working capital, and our cash and cash equivalents and marketable investments totaled \$23.9 and \$35.9 million as of March 31, 2018 and December 31, 2017 respectively. Our combined cash and cash equivalents and marketable investments balance decreased by \$11.9 million in the quarter end March 31, 2018 principally due to the settlement of Accrued liabilities, increased inventory purchases related to the increasing demand of our products, and an increase in investments in sales, service and other management headcount to facilitate continued revenue expansion. The following table summarizes our cash and cash equivalents and marketable investments:

Cash, Cash Equivalents and Marketable Investments

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

| (Dollars in thousands) | March 31, 2018 | December 31, 2017 | Change |
|-------------------------------|-------------------------------|----------------------------------|---------------|
| Cash and cash equivalents | \$10,910 | \$ 14,184 | \$(3,274) |
| Marketable investments | 13,062 | 21,728 | (8,666) |
| Total | \$23,972 | \$ 35,912 | \$(11,940) |

Cash Flows

| (Dollars in thousands) | Three Months Ended March 31, | |
|--------------------------------------|---|-------------|
| | 2018 | 2017 |
| Net cash flow provided by (used in): | | |
| Operating activities | \$(10,047) | \$(3,785) |
| Investing activities | 8,550 | 3,274 |
| Financing activities | (1,777) | (1,821) |

Net decrease in cash and cash equivalents \$(3,274) \$(2,332)

Cash Flows from Operating Activities

Net cash used in operating activities in the three months ended March 31, 2018 was \$10.0 million, which was due primarily to:

\$2.4 million used due to the net loss of \$2.0 million increased by non-cash related items of \$(0.4) million consisting primarily of income tax benefit of \$2.7 million, stock-based compensation expense of \$1.7 million, depreciation expense of \$254,000 and amortization expense related to capitalized commission costs of \$372,000;
\$1.2 million generated from an increase in accounts payable; partially offset by
\$6.7 million used to pay down the high year-end accrued liabilities balance;
\$0.9 million provided by accounts receivables;
\$2.2 million used to increase inventories.
\$0.4 million used to increase prepaid expenses and other assets (includes capitalized commission costs of \$4.7 million less other increase in prepaid and other expenses); and
 \$0.4 million related to decrease in
 deferred revenue

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Cash Flows from Investing Activities

The Company generated net cash of \$8.6 million in our investing activities in the three months ended March 31, 2018, which was attributable primarily to:

\$13.0 million in net proceeds from the sales of marketable investments; partially offset by

\$4.4 million of cash used to purchase marketable investments.

Cash Flows from Financing Activities

Net cash used in financing activities was \$1.8 million in the three months ended March 31, 2018, which was primarily due to:

\$2.3 million of cash used for taxes paid related to net share settlement of equity awards; payments for capital lease obligations of \$122,000; partially offset by proceeds of \$633,000 from the issuance of common stock due to employees exercising their stock options.

Adequacy of Cash Resources to Meet Future Needs

We had cash, cash equivalents, and marketable investments of \$24.0 million as of March 31, 2018. For the first three months of 2018, we financed our operations through the sales of marketable investments and cash from the sale of stock due to employees exercising their stock options. We believe that our existing cash resources are sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next several years.

Commitments and Contingencies

During the three months ended March 31, 2018, there were no material changes to our commitments and contingencies described under Management's Discussion and Analysis of Financial Condition and Results of Operations in the Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 26, 2018.

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 our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 26, 2018.

Interest Rate Fluctuations

The Company holds cash equivalents as well as short-term and long-term fixed income securities. The Company's investment portfolio includes fixed and floating rate securities. Changes in interest rates could impact our anticipated interest income. Fixed rate securities may have their fair market value adversely impacted due to fluctuations in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectation due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates. The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we invest in debt instruments of the U.S. Government and its agencies and municipal bonds, high grade corporate bonds, commercial paper, CDs and money markets, and, by policy, restrict our exposure to any single type of investment or issuer by imposing concentration limits. To minimize the exposure due to adverse shifts in interest rates, we maintain investments at a weighted average maturity of generally less than eighteen months. Based on discounted cash flow modeling with respect to our total investment portfolio as of March 31, 2018, assuming a hypothetical increase in interest rates of one percentage point, the fair value of our total investment portfolio would potentially decline by approximately \$66,000.

Inflation

The Company does not believe that inflation has had a material effect on our business, financial condition, or results of operations. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our 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 our 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 our results of operations upon translation of The Company's revenue denominated in these currencies, as well as the remeasurement of our international subsidiaries' financial statements into U.S. dollars

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

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

An evaluation as of March 31, 2018 was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our “disclosure controls and procedures.” Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended, or 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 Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at March 31, 2018.

Attached as exhibits to this Quarterly Report are certifications of our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended (“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 our internal control over financial reporting during the three-month period ended March 31, 2018 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, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure control system are met. As set forth above, our Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of the end of the period covered by this report, that our disclosure controls and procedures were effective to provide reasonable assurance that the objectives of our 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 12 to the Company's consolidated financial statements entitled "Litigation and Related Matters," in the Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 26, 2018.

ITEM 1A. RISK FACTORS

The Company's business faces many risks. Any of the risks referenced in this Form 10-Q or the Company's other SEC filings could have a material impact on our business and consolidated financial position or results of operations. Additional risks and uncertainties not presently known to us or that we currently believe to be immaterial may also impair our business operations.

There have been no material changes in the risk factors set forth in Part I, Item 1A, "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. For detailed discussion of risk factors that should be understood by any investor contemplating investment in our stock, please refer to "Part I. Item 1A. Risk Factors" in our 2017 Form 10-K and elsewhere in this Form 10-Q.

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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 | (1) <u>Amended and Restated Certificate of Incorporation of the Registrant (Delaware).</u> |
| 3.4 | (1) <u>Bylaws of the Registrant.</u> |
| 4.1 | (2) <u>Specimen Common Stock certificate of the Registrant.</u> |
| 10.14 | (3) <u>Cutera, Inc. 2004 Amended and Restated Equity Incentive Plan.</u> |
| 31.1 | <u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| 31.2 | <u>Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |

| | |
|---------|--|
| 32.1 | <u>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.</u> |
| 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 our Registration Statement on Form S-1 (Registration No. 333-111928) which was declared effective on March 30, 2004.

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

(3) Incorporated by reference from our Definitive Proxy Statement on Form 14A filed with the SEC on April 27, 2015.

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) 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 9th day of May, 2018.

CUTERA, INC.

/S/ SANDRA A. GARDINER

Sandra A. Gardiner

Executive Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)