

ADVANCED MEDICAL OPTICS INC  
Form 10-Q  
November 06, 2003  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 26, 2003

OR

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

**FOR THE QUARTER ENDED**  
**SEPTEMBER 26, 2003**

**COMMISSION FILE NUMBER**  
**001-31257**

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**ADVANCED MEDICAL OPTICS, INC.**

**A DELAWARE CORPORATION**

**IRS EMPLOYER IDENTIFICATION**  
**33-0986820**

**1700 E. ST. ANDREW PLACE, SANTA ANA, CALIFORNIA 92705**

**TELEPHONE NUMBER: 714/247-8200**

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Indicate by a 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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

As of November 1, 2003, there were 29,373,994 shares of common stock outstanding.

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FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 26, 2003

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## PART I FINANCIAL INFORMATION

Advanced Medical Optics, Inc.

Unaudited Condensed Consolidated Statements of Operations

(In thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	September 26, 2003	September 27, 2002	September 26, 2003	September 27, 2002
Net sales	\$ 151,152	\$ 139,302	\$ 434,464	\$ 390,978
Cost of sales	57,045	51,398	163,763	149,094
Gross profit	94,107	87,904	270,701	241,884
Selling, general and administrative	67,600	61,339	205,106	175,124
Research and development	9,256	6,571	26,996	21,439
Operating income	17,251	19,994	38,599	45,321
Non-operating expense (income):				
Interest expense	5,888	5,649	20,442	7,815
Unrealized (gain) loss on derivative instruments	(341)		(59)	1,931
Other, net	17,896	3,524	17,161	6,551
	23,443	9,173	37,544	16,297
Earnings (loss) before income taxes	(6,192)	10,821	1,055	29,024
Provision (benefit) for income taxes	(2,528)	4,983	443	11,900
Net earnings (loss)	\$ (3,664)	\$ 5,838	\$ 612	\$ 17,124
Net earnings (loss) per share (note 1):				
Basic	\$ (0.13)	\$ 0.20	\$ 0.02	
Diluted	\$ (0.13)	\$ 0.20	\$ 0.02	
Weighted average number of shares outstanding:				
Basic	29,110	28,724	28,962	
Diluted	29,110	28,905	29,274	

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See accompanying notes to unaudited condensed consolidated financial statements.

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Advanced Medical Optics, Inc.

Unaudited Condensed Consolidated Balance Sheets

(In thousands)

	September 26, 2003	December 31, 2002
ASSETS		
Current assets		
Cash and equivalents	\$ 35,209	\$ 80,578
Trade receivables, net	134,724	121,607
Inventories	44,292	46,129
Other current assets	21,986	26,180
Total current assets	236,211	274,494
Property, plant and equipment, net	39,997	39,830
Other assets	46,811	45,274
Goodwill and intangibles, net	105,027	103,608
Total assets	\$ 428,046	\$ 463,206
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Current portion of long-term debt	\$ 2,238	\$ 750
Accounts payable	44,302	42,356
Accrued compensation	20,303	17,651
Other accrued expenses	42,572	47,447
Total current liabilities	109,415	108,204
Long-term debt, net of current portion	232,896	277,559
Other liabilities	11,669	11,759
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$.01 par value; authorized 5,000,000 shares; none issued		
Common stock, \$.01 par value; authorized 120,000,000 shares; issued 29,170,033 and 28,723,512 shares	292	287
Additional paid-in capital	49,726	47,455
Retained earnings	15,236	14,624
Accumulated other comprehensive income	8,827	3,331
	74,081	65,697
Less treasury stock, at cost (997 and 3,151 shares)	(15)	(13)
Total stockholders' equity	74,066	65,684
Total liabilities and stockholders' equity	\$ 428,046	\$ 463,206

See accompanying notes to unaudited condensed consolidated financial statements.



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Advanced Medical Optics, Inc.

Unaudited Condensed Consolidated Statements of Cash Flows

(In thousands)

	Nine Months Ended	
	September 26,	September 27,
	2003	2002
Cash flows provided by operating activities:		
Net earnings	\$ 612	\$ 17,124
Non cash items included in net earnings:		
Amortization and write-off of original issue discount and debt issuance costs	9,140	442
Amortization and write-off of net realized gain on interest rate swaps	(2,498)	
Depreciation and amortization	11,618	11,049
Deferred income taxes		9,219
Loss on investments and assets	639	3,301
Unrealized (gain) loss on derivatives	(59)	1,931
Expense of compensation plan	64	
Changes in assets and liabilities:		
Trade receivables	(5,477)	(8,598)
Inventories	3,538	15,404
Other current assets	4,533	(9,102)
Accounts payable	533	13,951
Accrued expenses and other liabilities	(5,725)	34,089
Other non-current assets	(5,491)	1,805
Net cash provided by operating activities	11,427	90,615
Cash flows from investing activities:		
Additions to property, plant and equipment	(6,157)	(15,230)
Proceeds from the sale of property, plant and equipment	264	542
Additions to capitalized internal-use software	(172)	(903)
Additions to demonstration and bundled equipment	(5,363)	(3,746)
Net cash used in investing activities	(11,428)	(19,337)
Cash flows from financing activities:		
Proceeds from issuance of convertible senior subordinated notes	140,000	
Proceeds from issuance of senior subordinated notes		197,194
Long-term debt borrowings	22,376	108,363
Repayment of long-term debt	(205,000)	(114,363)
Financing related costs	(7,316)	(10,274)
Proceeds from the issuance of common stock	2,898	
Net proceeds from settlement of interest rate swaps	582	
Purchase of treasury stock	(120)	
Payment of Allergan, Inc. dividend		(50,597)
Distributions to Allergan, Inc., net of advances		(146,558)
Net cash used in financing activities	(46,580)	(16,235)



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Effect of exchange rates on cash and equivalents	1,212	278
Net increase (decrease) in cash and equivalents	(45,369)	55,321
Cash and equivalents at beginning of period	80,578	6,957
Cash and equivalents at end of period	\$ 35,209	\$ 62,278
Supplemental disclosure of cash flow information		
Cash paid for:		
Interest	\$ 21,246	\$ 2,766
Income taxes	\$ 12,915	\$ 1,113

See accompanying notes to unaudited condensed consolidated financial statements.

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

Note 1: Description of Business

Advanced Medical Optics, Inc. (AMO or the Company) develops, manufactures and markets surgical devices for the eyes, with a focus on devices that are used to perform cataract surgery, a surgery in which the natural focusing lens of the eye, having become hard and clouded, is broken up and removed and subsequently replaced with an artificial lens. The Company also offers a broad range of eye care products for use with virtually all available types of contact lenses. These products include disinfecting solutions to destroy harmful microorganisms in and on the surface of contact lenses, daily cleaners to remove undesirable film and deposits from contact lenses, enzymatic cleaners to remove protein deposits from contact lenses and lens rewetting drops to provide added wearing comfort.

The Company has operations in approximately 20 countries and sells its products in approximately 60 countries. On June 29, 2002, Allergan, Inc. (Allergan) transferred its optical medical device business consisting of the ophthalmic surgical and eye care product lines to the Company in connection with a tax-free spin-off. References to the Company and AMO refer to Allergan's optical medical device business for the six months ended June 28, 2002 and to AMO and its subsidiaries for the periods subsequent to the spin-off.

No earnings per share data for the nine months ended September 27, 2002 is presented as the Company's earnings were part of Allergan's earnings through the close of business on June 28, 2002.

Note 2: Basis of Presentation

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments necessary (consisting only of normal recurring accruals) to present fairly the financial information contained therein. These statements do not include all disclosures required by accounting principles generally accepted in the United States of America for annual financial statements and should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2002. The results of operations for the three and nine months ended September 26, 2003 are not necessarily indicative of the results to be expected for the year ending December 31, 2003.

Prior to the spin-off, Allergan did not account for the business that comprises AMO on the basis of separate legal entities, subsidiaries, divisions or segments. The accompanying unaudited condensed consolidated statement of operations for the nine months ended September 27, 2002 includes those revenues and expenses directly attributable to AMO's operations and allocations of certain Allergan corporate expenses to AMO through June 28, 2002. These amounts were allocated to AMO on the basis that was considered by Allergan management to reflect most fairly or reasonably the utilization of the services provided to or the benefit obtained by the Company. All material intercompany balances have been eliminated.

Certain reclassifications of prior year amounts have been made to conform with current year presentation.

Note 3: Recently Adopted Accounting Standards

In July 2002, Statement of Financial Accounting Standards No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS No. 146), was issued. SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. The Company adopted SFAS No. 146 during the quarter ended March 28, 2003. The adoption of SFAS No. 146 did not have a material effect on the Company's consolidated financial statements.

In December 2002, Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation* (SFAS No. 148), was issued. SFAS No. 148 amends the disclosure requirements of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), to require prominent disclosures in both interim and annual financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 also amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. The Company commenced quarterly footnote disclosure of the fair value based method of accounting for stock-based employee compensation beginning with the quarter ended March 28, 2003. The pro forma effect to net earnings (loss) is presented in Note 6 as if the fair value method had been applied. As the Company decided not to adopt the SFAS No. 123 fair value method of accounting for stock-based employee compensation, the new transition alternatives of SFAS No. 148 did not have an effect on the Company's consolidated financial statements.

In November 2002, the Emerging Issues Task Force finalized its consensus on EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21), which provides guidance on the method of revenue recognition for sales arrangements that

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

include the delivery of more than one product or service. Under EITF 00-21, revenue must be allocated to all deliverables regardless of whether an individual element is incidental or perfunctory. The Company adopted EITF 00-21 during the quarter ended September 26, 2003. The adoption of EITF 00-21 did not have a material effect on the Company's consolidated financial statements.

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). FIN 46 requires companies to evaluate variable interest entities to determine whether to apply the consolidation provisions of FIN 46 to those entities. Companies must apply FIN 46 to entities with which they are involved if the entity's equity has specified characteristics. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which a company obtains an interest after that date. The Company adopted FIN 46 during the quarter ended September 26, 2003. The adoption of FIN 46 did not have an effect on the Company's consolidated financial statements.

In April 2003, Statement of Financial Accounting Standards No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (SFAS No. 149), was issued. SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under Statement 133. The Company adopted SFAS No. 149 during the quarter ended September 26, 2003. The adoption of SFAS No. 149 did not have an effect on the Company's consolidated financial statements.

In May 2003, Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (SFAS No. 150), was issued. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The Company adopted SFAS No. 150 during the quarter ended September 26, 2003. The adoption of SFAS No. 150 did not have an effect on the Company's consolidated financial statements.

## Note 4: Composition of Certain Financial Statement Captions

The components of inventories were as follows:

	September 26, 2003	December 31, 2002
(In thousands)		
Finished goods, including inventory on consignment with customers of \$7,301 and \$7,417 in 2003 and 2002, respectively	\$ 38,626	\$ 39,500
Work in process	1,073	1,441
Raw materials	4,593	5,188
	<u>\$ 44,292</u>	<u>\$ 46,129</u>

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The components of amortizable intangibles and goodwill were as follows:

### *Intangibles*

	September 26, 2003		December 31, 2002	
	Gross Amount	Accumulated Amortization	Gross Amount	Accumulated Amortization
<b>(In thousands)</b>				
Amortized Intangible Assets:				
Licensing	\$ 3,940	\$ (3,940)	\$ 3,940	\$ (3,940)
Trademarks	572	(173)	652	(87)
	<u>\$ 4,512</u>	<u>\$ (4,113)</u>	<u>\$ 4,592</u>	<u>\$ (4,027)</u>

Amortization expense of intangible assets for the three and nine months ended September 26, 2003 and September 27, 2002 was immaterial.

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

*Goodwill*

	September 26, 2003	December 31, 2002
(In thousands)		
Goodwill:		
United States	\$ 12,783	\$ 12,783
Japan	27,059	25,474
Manufacturing operations	64,786	64,786
	<u>\$ 104,628</u>	<u>\$ 103,043</u>

There was no activity related to goodwill during the three and nine months ended September 26, 2003, except for the impact of foreign currency fluctuations.

**Note 5: Debt, Interest Rate Swap Agreements and Guarantor Subsidiaries**

In June 2003, the Company amended and restated its senior credit facility to retire the original \$100.0 million term loan, and increase the senior revolving credit facility from \$35.0 million to \$100.0 million. The amended and restated senior credit facility matures on June 30, 2007. As a result of the prepayment of the term loan in the quarter ended June 27, 2003, the Company wrote off debt issuance costs of approximately \$2.4 million and recognized a realized loss of approximately \$2.2 million on an interest rate swap. At September 26, 2003, the Company did not have any borrowings outstanding under the senior credit facility. Approximately \$12.2 million of the senior credit facility has been reserved to support letters of credit issued on the Company's behalf.

Borrowings under the senior credit facility, if any, bear interest at current market rates plus a margin based upon the Company's ratio of debt to EBITDA, as defined. The incremental interest rate margin decreases as the Company's ratio of debt to EBITDA decreases to specified levels. Under the senior credit facility, certain transactions may trigger mandatory prepayment of borrowings, if any. Such transactions may include equity or debt offerings, asset sales and extraordinary receipts. The Company pays a quarterly fee (3.20% per annum at September 26, 2003) on the average balance of outstanding letters of credit and a quarterly commitment fee (0.50% per annum at September 26, 2003) on the average unused portion of the senior credit facility.

On June 24, 2003, the Company issued \$140.0 million of 3½% convertible senior subordinated notes due April 15, 2023 (Notes). Interest on the Notes is payable on April 15 and October 15 of each year, commencing on October 15, 2003. The Notes are convertible into 48.69 shares of AMO's common stock for each \$1,000 principal amount of Notes (conversion price of \$20.54 per share), subject to adjustment. The Notes may be converted, at the option of the holders, on or prior to the final maturity date under certain circumstances, including:

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during any fiscal quarter commencing after September 30, 2003 if the closing sale price per share of AMO's common stock exceeds 120% of the conversion price for at least 20 trading days in the 30 consecutive trading-day period ending on the last trading day of the preceding fiscal quarter;

subject to certain exceptions, during the five business days after any five consecutive trading day period in which the trading price of the Notes for each day was less than 95% of the conversion value of the Notes. This conversion feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value has been assigned at issuance and at September 26, 2003;

upon the occurrence of specified rating events with respect to the notes. This conversion feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value has been assigned at issuance and at September 26, 2003;

if the Notes have been called for redemption; or

upon the occurrence of specified corporate events.

Upon conversion, the Company has the right to deliver, in lieu of shares of common stock, cash or a combination of cash and shares of common stock.

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

The Company may redeem some or all of the Notes for cash, on or after April 18, 2008 for a price equal to 100% of the principal amount plus accrued and unpaid interest, including contingent interest, if any, to, but excluding, the redemption date.

The Notes contain put options which may require the Company to repurchase all or a portion of the Notes on April 15, 2008, 2013 and 2018 at a repurchase price of 100% of the principal amount plus accrued and unpaid interest, including contingent interest, if any, to, but excluding the repurchase date. The Company may choose to pay the repurchase price in cash, shares of common stock or a combination of cash and shares of common stock.

Beginning with the six-month interest period commencing April 15, 2008, holders of the Notes will receive contingent interest payments during any six-month interest period if the trading price of the Notes for each of the five trading days ending on the second trading day immediately preceding the first day of the applicable six-month interest period equals or exceeds 120% of the principal amount of the Notes. The contingent interest payable will equal 0.25% of the average trading price of \$1,000 principal amount of Notes during the five trading days immediately preceding the first day of the applicable six-month interest period. This contingent interest payment feature represents an embedded derivative. However, based on the de minimis value associated with this feature, no value has been assigned at issuance and at September 26, 2003.

On July 23, 2003, the Company consummated its Modified Dutch Auction tender offer for \$115.0 million aggregate principal amount of 9¼% senior subordinated notes due July 15, 2010 utilizing a portion of the proceeds from the issuance of the Notes. As a result of the purchase of the senior subordinated notes, the Company recorded a charge of approximately \$18.6 million for the premium paid on the notes and for the write-off of the pro-rata portion of capitalized debt related costs.

In September 2003, the Company repurchased \$15.0 million aggregate principal amount of 9¼% senior subordinated notes on the open market. The Company recorded a charge of approximately \$2.0 million for the premium paid on the notes and for the write-off of the pro-rata portion of capitalized debt related costs. At September 26, 2003, \$70.0 million aggregate principal amount of senior subordinated notes remain outstanding.

On September 24, 2003, the Company's Japan subsidiary entered into a ¥2.5 billion term loan facility agreement with two banks. The term loan matures on September 28, 2006 and bears interest at TIBOR plus 3.0% (3.10% at September 26, 2003). Mandatory prepayment of the term loan is required from proceeds from certain debt offerings or asset sales of the subsidiary. At September 26, 2003, the outstanding term loan balance was approximately \$22.4 million.

The senior credit facility provides that the Company will maintain certain financial and operating covenants which include, among other provisions, maintaining specific leverage and interest coverage ratios. Certain covenants under the senior credit facility and the indenture relating to the senior subordinated notes also limit the incurrence of additional indebtedness. The senior credit facility prohibits dividend payments. The Company was in compliance with these covenants at September 26, 2003.



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The aggregate maturities of total long-term debt are as follows: \$2.2 million in each of 2004 and 2005; \$18.0 million in 2006; zero in 2007 and 2008; and \$210.0 million after 2008.

The Company had previously entered into various interest rate swap agreements which effectively converted the interest rate on \$150.0 million of the senior subordinated notes from a fixed to a floating rate and converted the interest rate on \$50.0 million of term loan borrowings from a floating rate to a fixed rate. The interest rate swaps had maturity dates beginning in 2005 and qualified as either fair value or cash flow hedges. Changes in fair value of the interest rate swap agreement qualifying as a cash flow hedge were recorded in other comprehensive income to the extent such changes were effective and as long as the cash flow hedge requirements were met.

In May 2003 and October 2002, the Company realized the value of the interest rate swaps qualifying as fair value hedges. The Company received an aggregate of approximately \$14.8 million, of which approximately \$6.3 million represented the net settlement of the accrued but unpaid amount between the Company and the swap counterparties. The remaining amount of approximately \$8.5 million was recorded as an adjustment to the carrying amount of the senior subordinated notes as a premium and is amortized over the remaining life of the notes. At September 26, 2003, after recognizing a pro-rata portion of the gain upon repurchase of a portion of the notes, the unamortized realized gain on these interest rate swaps was \$3.6 million.

In May 2003, the Company terminated the interest rate swap qualifying as a cash flow hedge. The Company paid approximately \$2.4 million and included the related loss of approximately \$2.3 million as a component of accumulated other comprehensive income. As a result of the prepayment of the term loan, the loss on the interest rate swap has been fully recognized as interest expense as of June 27, 2003.

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Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

In connection with the issuance of the senior subordinated notes, one of the Company's subsidiaries (Guarantor Subsidiary) jointly, fully, severally and unconditionally guaranteed such notes. Pursuant to the Securities and Exchange Commission regulations, certain condensed financial information about the Parent, Guarantor Subsidiary and Non-Guarantor Subsidiaries is required to be disclosed. The following provides this required financial information subsequent to the spin-off.

**Condensed Consolidated Statement of Operations****Three months ended September 26, 2003**

<b>(In thousands)</b>	<b>Parent</b>	<b>Guarantor Subsidiary</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net sales	\$ 51,415		140,951	(41,214)	\$ 151,152
Operating costs and expenses:					
Cost of sales	25,222		62,224	(30,401)	57,045
Selling, general and administrative	23,418		44,182		67,600
Research and development	7,720		1,536		9,256
Operating income (loss)	(4,945)		33,009	(10,813)	17,251
Non-operating income (expense)	(3,935)	23,200	25,517	(68,225)	(23,443)
Earnings (loss) before income taxes	(8,880)	23,200	58,526	(79,038)	(6,192)
Provision (benefit) for income taxes	724	(1,866)	(1,386)		(2,528)
Net earnings (loss)	\$ (9,604)	25,066	59,912	(79,038)	\$ (3,664)

**Condensed Consolidated Statement of Operations****Three months ended September 27, 2002**

<b>(In thousands)</b>	<b>Parent</b>	<b>Guarantor Subsidiary</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net sales	\$ 47,465		119,927	(28,090)	\$ 139,302
Operating costs and expenses:					
Cost of sales	23,340		51,638	(23,580)	51,398
Selling, general and administrative	20,443		40,896		61,339
Research and development	5,838		733		6,571
Operating income (loss)	(2,156)		26,660	(4,510)	19,994
Non-operating income (expense)	(5,977)		69	(3,265)	(9,173)
Earnings (loss) before income taxes	(8,133)		26,729	(7,775)	10,821
Income tax expense (benefit)	(2,115)		7,098		4,983
Net earnings (loss)	(6,018)		19,631	(7,775)	\$ 5,838

**Condensed Consolidated Statement of Operations**  
**Nine months ended September 26, 2003**

<b>(In thousands)</b>	<b>Parent</b>	<b>Guarantor Subsidiary</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net sales	\$ 145,008		410,395	(120,939)	\$ 434,464
Operating costs and expenses:					
Cost of sales	70,790		183,084	(90,111)	163,763
Selling, general and administrative	70,537		134,570	(1)	205,106
Research and development	22,796		4,200		26,996
Operating income (loss)	(19,115)		88,541	(30,827)	38,599
Non-operating income (expense)	28,229	49,241	66,588	(181,602)	(37,544)
Earnings (loss) before income taxes	9,114	49,241	155,129	(212,429)	1,055
Provision (benefit) for income taxes	(1,721)	1,084	1,080		443
Net earnings (loss)	\$ 10,835	48,157	154,049	(212,429)	\$ 612

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (continued)

**Condensed Consolidated Balance Sheet****September 26, 2003**

<b>(In thousands)</b>	<b>Parent</b>	<b>Guarantor Subsidiary</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Assets:</b>					
Cash and equivalents	\$ 6,680		28,529		\$ 35,209
Trade receivables, net	19,896		114,828		134,724
Inventories	16,253		28,039		44,292
Other current assets	12,460		9,526		21,986
<b>Total current assets</b>	<b>55,289</b>		<b>180,922</b>		<b>236,211</b>
Property, plant and equipment, net	12,970		27,027		39,997
Other assets	273,143	200,614	233,332	(660,278)	46,811
Goodwill and intangibles, net	13,111		127,622	(35,706)	105,027
<b>Total assets</b>	<b>\$ 354,513</b>	<b>200,614</b>	<b>568,903</b>	<b>(695,984)</b>	<b>\$ 428,046</b>
<b>Liabilities and stockholders' equity:</b>					
Current portion of long-term debt	\$		2,238		\$ 2,238
Accounts payable and accrued expenses	36,163	1,084	34,410	35,520	107,177
<b>Total current liabilities</b>	<b>36,163</b>	<b>1,084</b>	<b>36,648</b>	<b>35,520</b>	<b>109,415</b>
Long-term debt, net of current portion	212,759		20,137		232,896
Other liabilities	4,706		6,963		11,669
<b>Total liabilities</b>	<b>253,628</b>	<b>1,084</b>	<b>63,748</b>	<b>35,520</b>	<b>353,980</b>
Total stockholders' equity	100,885	199,530	505,155	(731,504)	74,066
<b>Total liabilities and stockholders' equity</b>	<b>\$ 354,513</b>	<b>200,614</b>	<b>568,903</b>	<b>(695,984)</b>	<b>\$ 428,046</b>

**Condensed Consolidated Balance Sheet****December 31, 2002**

<b>(In thousands)</b>	<b>Parent</b>	<b>Guarantor Subsidiary</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Assets:</b>					
Cash and equivalents	\$ 5,388		75,190		\$ 80,578
Trade receivables, net	20,152		101,455		121,607
Inventories	20,092		26,037		46,129
Other current assets	12,797		13,383		26,180
<b>Total current assets</b>	<b>58,429</b>		<b>216,065</b>		<b>274,494</b>
Property, plant and equipment, net	13,197		26,633		39,830

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Other assets	323,681	200,614	230,955	(709,976)	45,274
Goodwill and intangibles, net	13,111		123,141	(32,644)	103,608
Total assets	\$ 408,418	200,614	596,794	(742,620)	\$ 463,206
Liabilities and stockholders' equity:					
Current portion of long-term debt	\$ 750				\$ 750
Accounts payable and accrued expenses	36,627		49,130	21,697	107,454
Total current liabilities	37,377		49,130	21,697	108,204
Long-term debt, net of current portion	277,559				277,559
Other liabilities	5,838		5,921		11,759
Total liabilities	320,774		55,051	21,697	397,522
Total stockholders' equity	87,644	200,614	541,743	(764,317)	65,684
Total liabilities and stockholders' equity	\$ 408,418	200,614	596,794	(742,620)	\$ 463,206

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (continued)

**Condensed Consolidated Statement of Cash Flows****Nine months ended September 26, 2003**

<b>(In thousands)</b>	<b>Parent</b>	<b>Guarantor Subsidiary</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Consolidated</b>
Net cash provided by (used in) operating activities	\$ 10,077		1,350	\$ 11,427
Cash flows from investing activities:				
Additions to property, plant and equipment	(1,030)		(5,127)	(6,157)
Additions to capitalized internal-use software			(172)	(172)
Additions to demonstration and bundled equipment	(2,570)		(2,793)	(5,363)
Proceeds from the sale of property, plant and equipment			264	264
Net cash used in investing activities	(3,600)		(7,828)	(11,428)
Cash flows from financing activities:				
Proceeds from issuance of senior subordinated notes	140,000			140,000
Long-term debt borrowings			22,376	22,376
Net intercompany borrowings (repayments)	63,005		(63,005)	
Repayment of long-term debt	(205,000)			(205,000)
Financing related costs	(6,550)		(766)	(7,316)
Proceeds from issuance of common stock	2,898			2,898
Net proceeds from settlement of interest rate swaps	582			582
Purchase of treasury stock	(120)			(120)
Net cash used in financing activities	(5,185)		(41,395)	(46,580)
Effect of exchange rates on cash and equivalents			1,212	1,212
Net increase (decrease) in cash and equivalents	1,292		(46,661)	(45,369)
Cash and equivalents at beginning of period	5,388		75,190	80,578
Cash and equivalents at end of period	\$ 6,680		28,529	\$ 35,209

**Condensed Consolidated Statement of Cash Flows****Three months ended September 27, 2002**

<b>(In thousands)</b>	<b>Parent</b>	<b>Guarantor Subsidiary</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Consolidated</b>
Net cash provided by operating activities	\$ 1,693		38,526	\$ 40,219
Cash flows from investing activities:				
Additions to property, plant and equipment	(5,111)		(1,399)	(6,510)
Proceeds from sale of property, plant and equipment			542	542
Additions to capitalized software	(11)		(17)	(28)

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Additions to demonstrated and bundled equipment	(349)		(733)	(1,082)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net cash used in investing activities	(5,471)		(1,607)	(7,078)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Cash flows from financing activities:				
Repayment of long-term debt	(3,000)			(3,000)
Payment of Allergan, Inc. dividend	(50,597)			(50,597)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net cash used in financing activities	(53,597)			(53,597)
Effect of exchange rates on cash and equivalents			(368)	(368)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net increase (decrease) in cash and equivalents	(57,375)		36,551	(20,824)
Cash and equivalents at beginning of period	80,608		2,494	83,102
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Cash and equivalents at end of period	\$ 23,233		39,045	\$ 62,278
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (continued)

## Note 6: Stock-Based Compensation

The Company measures stock-based compensation for option grants to employees and members of the board of directors using the intrinsic value method. Restricted stock awards were valued based on the market price of a share of nonrestricted stock on the grant date. No compensation expense has been recognized for stock-based incentive compensation plans other than for restricted stock awards. Had compensation expense for the Company's stock options and employee stock purchase plans been recognized based upon the fair value for awards granted, the Company's net earnings (loss) would have been decreased (increased) to the following pro forma amounts (in thousands, except per share data):

	Three Months Ended September 26, 2003	Three Months Ended September 27, 2002	Nine Months Ended September 26, 2003
Net earnings (loss):			
As reported	\$ (3,664)	\$ 5,838	\$ 612
Stock-based compensation expense included in reported net earnings, net of tax	23		38
Stock-based compensation expense determined under fair value based method, net of tax	(1,122)	(1,624)	(3,720)
Pro forma	\$ (4,763)	\$ 4,214	\$ (3,070)
Earnings (loss) per share:			
As reported:			
Basic	\$ (0.13)	\$ 0.20	\$ 0.02
Diluted	\$ (0.13)	\$ 0.20	\$ 0.02
Pro forma Basic and Diluted	\$ (0.16)	\$ 0.15	\$ (0.11)

These pro forma effects are not indicative of future amounts. The Company expects to grant additional awards in the future.

## Note 7: Arrangements with Allergan

Prior to June 29, 2002, the Company participated in various Allergan administered functions including shared services surrounding selling, general and administrative expenses, retirement and other post retirement benefit plans, income taxes and cash management. The allocated portion of the expenses for these shared services for the nine months ended September 27, 2002 (through June 28, 2002) were \$23.2 million and are included in selling, general and administrative expenses in the accompanying unaudited condensed consolidated statement of operations.



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Prior to June 29, 2002, the Company entered into several agreements with Allergan in connection with, among other things, transitional services, employee matters, manufacturing and tax sharing. These agreements generally require the Company to indefinitely indemnify Allergan from liabilities related to the business contributed to AMO.

The transitional services agreement set forth charges generally intended to allow Allergan to fully recover the allocated costs of providing certain services, plus all out-of-pocket expenses, except that AMO paid to Allergan a commission related to AMO products that were sold by Allergan during the transition period. The Company recovered costs from Allergan in a similar manner for services provided by AMO.

Under the manufacturing agreement, Allergan manufactures certain eye care products and VITRAX<sup>®</sup> viscoelastics for a period of up to three years from the date of the spin-off. The Company purchases these products from Allergan at a price equal to Allergan's fully allocated costs plus 10%. During the three and nine months ended September 26, 2003, the Company purchased \$21.3 million and \$58.1 million, respectively, of product from Allergan. On an annual basis, a pricing true up calculation is to be performed during the first calendar quarter. This true up calculation is based upon the actual volume of products shipped by Allergan to AMO during the preceding year versus the forecasted volume submitted by AMO that was used to calculate the invoiced prices. During the year, the Company periodically reviews the volume of purchases and accrues for estimated shortfalls, if any.

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (continued)

The following table summarizes the charges and payment from Allergan for the above-mentioned services (in thousands):

	Three Months Ended September 26, 2003	Three months Ended September 27, 2002	Nine Months Ended September 26, 2003
Selling, general and administrative expenses, net of \$249, \$204 and \$800 charged to Allergan	\$ 205	\$ 2,415	\$ 2,067
Research and development	98	173	367
Manufacturing true up payment received			(629)
Foreign currency option contract		686	

The tax sharing agreement governs Allergan's and the Company's respective rights, responsibilities and obligations with respect to taxes for any tax period ending before, on or after the spin-off. Generally, Allergan is liable for all pre-spin-off taxes except that the Company will indemnify Allergan for all pre-spin-off taxes attributable to its business for 2002. In addition, the tax sharing agreement provides that Allergan is liable for taxes that are incurred as a result of restructuring activities undertaken to effectuate the spin-off. The Company has filed its statutory accounts in certain foreign jurisdictions and believes that there is a remote possibility that additional taxes related to pre-spin-off periods may be owed. Additionally, the Company believes Allergan would be responsible for the tax liability, if any, under the tax sharing agreement.

The Company and Allergan have made representations to each other and to the Internal Revenue Service in connection with the private letter ruling that Allergan received regarding the tax-free nature of the spin-off of the Company's common stock by Allergan to its stockholders. If either the Company or Allergan breaches its representations to the other or to the Internal Revenue Service, or if the Company or Allergan takes or fails to take, as the case may be, actions that result in the spin-off failing to meet the requirements of a tax-free spin-off pursuant to Section 355 of the Internal Revenue Code, the party in breach will indemnify the other party for any and all resulting taxes.

**Note 8: Income Taxes**

Income taxes are provided using an estimated annual effective tax rate, which is greater than the U.S. Federal statutory rate as the Company has, in addition to foreign income taxes, provided for U.S. federal income taxes and foreign withholding taxes on the portion of the undistributed earnings of non-U.S. subsidiaries expected to be remitted.

**Note 9: Earnings (Loss) Per Share**

Basic earnings (loss) per share are calculated by dividing net earnings (loss) by the weighted average number of common shares outstanding during the period. Diluted earnings per share are calculated by adjusting weighted average outstanding shares, assuming the conversion of all

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potentially dilutive stock options and awards.

The following represents a reconciliation from basic earnings (loss) per share to diluted earnings (loss) per share (in thousands except per share data):

	Three Months Ended September 26, 2003	Three Months Ended September 27, 2002	Nine Months Ended September 26, 2003
Net earnings (loss)	\$ (3,664)	\$ 5,838	\$ 612
Basic shares outstanding	29,110	28,724	28,962
Dilutive effective of stock options and awards		181	312
Diluted shares outstanding	29,110	28,905	29,274
Basic earnings (loss) per share	\$ (0.13)	\$ 0.20	\$ 0.02
Diluted earnings (loss) per share	\$ (0.13)	\$ 0.20	\$ 0.02

The effect of approximately 6.8 million common shares related to the assumed conversion of the \$140.0 million convertible senior subordinated notes due 2023 has been excluded from the computation of diluted earnings per share for both 2003 periods presented because none of the conditions that would permit conversion had been satisfied during the periods. In addition, options to purchase 5.2 million shares of common stock have been excluded from the computation of diluted earnings per share for three months ended September 26, 2003 as the effect would be anti-dilutive.

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (continued)

## Note 10: Other Comprehensive Income

The following table summarizes components of comprehensive income (in thousands):

	Three Months Ended					
	September 26, 2003			September 27, 2002		
	Before-tax amount	Tax (expense) or benefit	Net-of-tax amount	Before-tax amount	Tax (expense) or benefit	Net-of-tax amount
Unrealized gain on derivatives	\$	\$	\$	\$ 160	\$ (5)	\$ 155
Foreign currency translation adjustments	2,215	(984)	1,231	39		39
Net earnings (loss)			(3,664)			5,838
Total comprehensive income (loss)			\$ (2,433)			\$ 6,032

	Nine Months Ended					
	September 26, 2003			September 27, 2002		
	Before-tax amount	Tax (expense) or benefit	Net-of-tax amount	Before-tax amount	Tax (expense) or benefit	Net-of-tax amount
Unrealized gain (loss) on derivatives	\$ 4,252	(1,745)	\$ 2,507	\$ (1,868)	\$ 766	\$ (1,102)
Reclassification adjustment for realized loss on derivatives included in net earnings	(2,263)	928	(1,335)			
Foreign currency translation adjustments	7,457	(3,133)	4,324	2,560		2,560
Net earnings			612			17,124
Total comprehensive income			\$ 6,108			\$ 18,582

## Note 11: Business Segment Information

The Company operates in regions or geographic operating segments. The United States information is presented separately as it is the Company's headquarters country, and U.S. sales represented 26.2% and 27.8% of total net sales for the three months ended September 26, 2003 and September 27, 2002, respectively, and 25.9% and 29.0% of total net sales for the nine months ended September 26, 2003 and September 27, 2002, respectively. Additionally, sales in Japan represented 28.1% and 29.2% of total net sales for the three months ended September 26, 2003 and September 27, 2002, respectively, and 27.4% and 26.9% of total net sales for the nine months ended September 26, 2003 and September 27, 2002, respectively. No other country, or single customer, generates over 10% of total net sales.

Operating income attributable to each operating segment is based upon the management assignment of costs to such regions, which includes the manufacturing standard cost of goods produced by the Company's manufacturing operations (or the cost to acquire goods from third parties), freight, duty and local distribution costs, and royalties. Prior to the spin-off, operating income for all operating segments and manufacturing operations included a charge for corporate services and asset utilization which management used to measure segment performance by including a cost of capital in the determination of operating income for each segment.

Income from manufacturing operations is not assigned to geographic regions because most manufacturing operations produce products for more than one region. Research and development costs are corporate costs.

Identifiable assets are assigned by region based upon management responsibility for such assets. Corporate assets are primarily cash and equivalents, goodwill and intangibles and long-term investments. Assets in each geographic operating segment have not changed materially since December 31, 2002.

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (continued)

### Geographic Operating Segments

(In thousands)	Property, Plant and Equipment	
	September 26, 2003	December 31, 2002
United States	\$ 12,970	\$ 13,197
Europe/Africa/Asia Pacific	3,944	3,881
Japan	1,640	1,545
Other	90	70
Segments total	18,644	18,693
Manufacturing operations	21,353	21,137
Total	\$ 39,997	\$ 39,830

  

(In thousands)	Net Sales		Operating Income (Loss)	
	Three Months Ended		Three Months Ended	
	September 26, 2003	September 27, 2002	September 26, 2003	September 27, 2002
United States	\$ 39,613	\$ 38,681	\$ 9,257	\$ 9,279
Europe/Africa/Asia Pacific	62,451	54,695	12,051	10,968
Japan	42,498	40,685	15,060	13,841
Other	6,590	5,241	1,119	217
Segments total	151,152	139,302	37,487	34,305
Manufacturing operations			6,951	4,242
Research and development			(9,256)	(6,571)
Elimination of inter-company profit			(8,195)	(5,223)
General corporate			(9,736)	(6,759)
Total	\$ 151,152	\$ 139,302	\$ 17,251	\$ 19,994

  

(In thousands)	Net Sales		Operating Income (Loss)	
	Nine Months Ended		Nine Months Ended	
	September 26, 2003	September 27, 2002	September 26, 2003	September 27, 2002
United States	\$ 39,613	\$ 38,681	\$ 9,257	\$ 9,279
Europe/Africa/Asia Pacific	62,451	54,695	12,051	10,968
Japan	42,498	40,685	15,060	13,841
Other	6,590	5,241	1,119	217
Segments total	151,152	139,302	37,487	34,305
Manufacturing operations			6,951	4,242
Research and development			(9,256)	(6,571)
Elimination of inter-company profit			(8,195)	(5,223)
General corporate			(9,736)	(6,759)
Total	\$ 151,152	\$ 139,302	\$ 17,251	\$ 19,994

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(In thousands)	September 26,	September 27,	September 26,	September 27,
	2003	2002	2003	2002
United States	\$ 112,561	\$ 113,466	\$ 25,509	\$ 23,314
Europe/Africa/Asia Pacific	184,190	153,822	34,309	27,100
Japan	119,095	105,133	37,342	35,818
Other	18,618	18,557	2,023	774
Segments total	434,464	390,978	99,183	87,006
Manufacturing operations			22,145	6,191
Research and development			(26,996)	(21,439)
Elimination of inter-company profit			(26,869)	(15,902)
General corporate			(28,864)	(10,535)
Total	\$ 434,464	\$ 390,978	\$ 38,599	\$ 45,321

In each geographic segment, the Company markets products in two product lines: Ophthalmic Surgical and Eye Care. The Ophthalmic Surgical product line markets intraocular lenses, phacoemulsification equipment, viscoelastics, and other products related to cataract and refractive surgery. The Eye Care product line markets cleaning, storage and disinfection products for the consumer contact lens market. The Company provides global marketing strategy teams to ensure development and execution of a consistent marketing strategy for products in all geographic operating segments. There are no transfers between product lines.

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Advanced Medical Optics, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (continued)

## Net Sales by Product Line

(In thousands)	Three Months Ended		Nine Months Ended	
	September 26, 2003	September 27, 2002	September 26, 2003	September 27, 2002
Ophthalmic Surgical	\$ 74,157	\$ 66,808	\$ 219,982	\$ 195,120
Eye Care	76,995	72,494	214,482	195,858
<b>Total Net Sales</b>	<b>\$ 151,152</b>	<b>\$ 139,302</b>	<b>\$ 434,464</b>	<b>\$ 390,978</b>

## Note 12: Commitments and Contingencies

As part of the spin-off from Allergan, Allergan transferred to the Company certain assets, which included a receivable for reimbursement of certain previously paid value added taxes, or VAT, in the amount of approximately \$5.8 million. In August 2003, the Company was notified that Allergan had received an aggregate of approximately \$4.2 million from the applicable tax authorities related to these VAT assets. The Company submitted a formal request to Allergan for recovery of the amount held by Allergan, which Allergan denied. AMO is pursuing the collection of the funds through the dispute resolution procedures required by the spin-off agreements. Management believes Allergan has improperly withheld these funds. However, an unfavorable outcome in this matter would have a material adverse effect on the Company's results of operations.

The Company is involved in various litigation and claims arising in the normal course of business. Additionally, the Company is obligated to indemnify Allergan regarding pre-spin-off liabilities associated with AMO's business and for one-third of certain employee-related matters. The Company maintains accruals for losses that are expected to be incurred. Although the ultimate outcome of any pending litigation or claims cannot be ascertained at this time, the Company believes that the liability, if any, resulting from the aggregate amount of uninsured damages not previously accrued for outstanding lawsuits and asserted claims will not have a material adverse effect on the Company's consolidated financial statements.

## Note 13: Subsequent Event

On July 17, 2003, a Spanish subsidiary of the Company entered into an agreement with Alcon CUSI, S.A., a subsidiary of Alcon, Inc., to purchase an existing manufacturing facility in Madrid, Spain. The acquisition was completed on November 5, 2003. The Company paid approximately \$21.6 million for the facility, which will manufacture eye care products, including the Complete® branded product line.





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### ADVANCED MEDICAL OPTICS, INC.

#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED SEPTEMBER 26, 2003

*This section and other parts of this Form 10-Q contain forward-looking statements that involve risks and uncertainties. Our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in the subsection entitled "Certain Factors and Trends Affecting AMO and Its Businesses." The following discussion should be read in conjunction with the 2002 Form 10-K and the condensed consolidated financial statements and notes thereto included elsewhere in this Form 10-Q.*

## **OVERVIEW**

We are a global leader in the development, manufacture and marketing of medical devices for the eye and contact lens care products. Our products in the ophthalmic surgical market include intraocular lenses, phacoemulsification systems, viscoelastics and surgical packs used in cataract surgery, and microkeratomes used in refractive surgery. Our eye care products include disinfecting solutions to destroy harmful microorganisms in and on the surface of contact lenses, daily cleaners to remove undesirable film and deposits from contact lenses, enzymatic cleaners to remove protein deposits from contact lenses and lens rewetting drops to provide added wearing comfort.

We have operations in approximately 20 countries, sell our products in approximately 60 countries and have organized our operations into three regions:

Americas (North and South America);

Europe, Africa and Asia Pacific (excluding Japan, but including Australia and New Zealand); and

Japan.

### *Separation from Allergan*

On June 29, 2002, Allergan transferred its optical medical device business consisting of the ophthalmic surgical and eye care product lines to us in connection with a tax-free spin-off. The accompanying unaudited condensed consolidated financial statements for the nine months ended September 27, 2002 (through June 28, 2002) include those revenues and expenses directly attributable to our operations and allocations of certain Allergan corporate expenses. These amounts were allocated on a basis that was considered by Allergan management to reflect most fairly or reasonably the utilization of the services provided to us or the benefit obtained by us. All material intercompany balances have been eliminated. The financial information included herein does not necessarily reflect what the financial position and results of our operations would have been had we operated as a stand-alone public entity during the pre-spin-off period presented, and may not be indicative of our future operations or financial position.

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Prior to the spin-off, we participated in various Allergan administered functions including shared services surrounding selling, general and administrative expenses, retirement and other post retirement benefit plans, income taxes and cash management. Our allocated portion of the expenses for these shared services were \$23.2 million through June 28, 2002 and are included in selling, general and administrative expenses in our unaudited condensed consolidated statement of operations for the nine months ended September 27, 2002.

Prior to the spin-off, we entered into several agreements with Allergan in connection with, among other things, transitional services, employee matters, manufacturing and tax sharing.

The transitional services agreement set forth charges generally intended to allow Allergan to fully recover the allocated costs of providing certain services, plus all out-of-pocket expenses, except that we paid to Allergan a commission related to our products that were sold by Allergan during the transition period. We recovered costs from Allergan in a similar manner for services provided by us.

Under the manufacturing agreement, Allergan manufactures certain eye care products and VITRAX<sup>®</sup> viscoelastics for a period of up to three years from the date of the spin-off. We purchase these products from Allergan at a price equal to Allergan's fully allocated costs plus 10%. During the three and nine months ended September 26, 2003, we purchased \$21.3 million and \$58.1 million, respectively, of product from Allergan. On an annual basis, a pricing true up calculation is to be performed during the first calendar quarter. This true up calculation is based upon the actual volume of products shipped by Allergan to us during the preceding year versus the forecasted volume submitted by us that was used to calculate the invoiced prices. During the year, we periodically review the volume of purchases and accrue for estimated shortfalls, if any. In March 2003, we received a payment of \$0.6 million from Allergan based upon the true up calculation for the period subsequent to the spin-off through December 31, 2002. This payment has been recorded as a credit to cost of sales in the accompanying unaudited condensed consolidated statement of operations.

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Advanced Medical Optics, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE  
QUARTER ENDED SEPTEMBER 26, 2003

### **OVERVIEW (Continued)**

The tax sharing agreement governs Allergan's and our respective rights, responsibilities and obligations with respect to taxes for any tax period ending before, on or after the spin-off. Generally, Allergan is liable for all pre-spin-off taxes except that we will indemnify Allergan for all pre-spin-off taxes attributable to our business for the 2002 taxable year. In addition, the tax sharing agreement provides that Allergan is liable for taxes that are incurred as a result of restructuring activities undertaken to effectuate the spin-off.

We and Allergan have made representations to each other and to the Internal Revenue Service in connection with the private letter ruling that Allergan received regarding the tax-free nature of the distribution of our common stock by Allergan to its stockholders. If either we or Allergan breach our representations to each other or to the Internal Revenue Service, or if we or Allergan take or fail to take, as the case may be, actions that result in the distribution failing to meet the requirements of a tax-free distribution pursuant to Section 355 of the Internal Revenue Code, the party in breach will indemnify the other party for any and all resulting taxes.

### **CRITICAL ACCOUNTING POLICIES**

#### *Revenue and Accounts Receivable*

We recognize revenue from product sales when title and risk of loss transfers, delivery has occurred, the price to the buyer is determinable and collectibility is reasonably assured, with the exception of intraocular lenses distributed on a consignment basis, which are recognized as revenue upon implantation in a patient. We generally permit returns of product from a customer if the product is returned in a timely manner, in good condition, and through the normal channels of distribution. Return policies in certain international markets can be more stringent and are based on the terms of contractual agreements with customers. Allowances for returns are provided for based upon an analysis of our historical patterns of returns matched against the sales from which they originated. Historically, product returns have been within the amounts estimated.

The allowance for doubtful accounts is determined by analyzing specific customer accounts and assessing the risk of uncollectibility based on insolvency, disputes or other collection issues. In addition, we routinely analyze the different receivable aging categories and establish allowances based on the length of time receivables are past due.

#### *Inventories*

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Inventories are valued at the lower of first-in, first-out cost or market. On a regular basis, we evaluate inventory balances for excess quantities and obsolescence by analyzing estimated demand, inventory on hand, sales levels and other information. Based on these evaluations, inventory balances are reduced, if necessary.

### *Deferred Taxes*

We account for income taxes using the asset and liability method, which recognizes deferred tax assets and liabilities for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. We regularly review historical and anticipated future pre-tax results of operations to determine whether we will be able to realize the benefit of net deferred tax assets.

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Advanced Medical Optics, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED SEPTEMBER 26, 2003

**RESULTS OF OPERATIONS**

*Net Sales.* The following table compares net sales by product line for the three month and nine months ended September 26, 2003 and September 27, 2002:

(in thousands)	Three Months Ended		Nine Months Ended	
	September 26, 2003	September 27, 2002	September 26, 2003	September 27, 2002
Ophthalmic Surgical	\$ 74,157	\$ 66,808	\$ 219,982	\$ 195,120
Eye Care	76,995	72,494	214,482	195,858
Total Net Sales	\$ 151,152	\$ 139,302	\$ 434,464	\$ 390,978
Domestic	26.2%	27.8%	25.9%	29.0%
International	73.8%	72.2%	74.1%	71.0%

Net sales increased \$11.8 million, or 8.5%, to \$151.2 million in the three months ended September 26, 2003 from \$139.3 million in the three months ended September 27, 2002. Net sales for the nine months ended September 26, 2003 were \$434.5 million, an 11.1% increase from the comparable 2002 amount.

The increase in net sales in the three and nine months ended September 26, 2003 compared with the same periods last year was primarily the result of an increase in sales of our ophthalmic surgical products and favorable foreign currency changes. Foreign currency fluctuations increased sales by \$7.4 million, or 5.3%, and \$32.5 million, or 8.3%, in the three and nine months ended September 26, 2003, respectively, as compared to average rates in effect in the prior year periods.

Global sales of our ophthalmic surgical products increased \$7.3 million, or 11.0%, and increased \$24.9 million, or 12.7%, in the three and nine months ended September 26, 2003, respectively, compared with the same periods last year. In the United States, sales of our ophthalmic surgical products increased \$0.7 million, or 2.7%, and increased \$2.7 million, or 3.6%, in the three and nine months ended September 26, 2003, respectively, compared with the same periods last year, primarily due to increases in sales of the *SENSAR*® and *CLARIFLEX*® intraocular lenses. International sales of our ophthalmic surgical products increased \$6.6 million, or 16.4%, and increased \$22.2 million, or 18.7%, in the three and nine months ended September 26, 2003, respectively, compared with the same periods last year, primarily due to increases in sales of the *SENSAR*® intraocular lens and refractive surgical products and favorable currency changes. Foreign currency fluctuations increased international ophthalmic surgical sales by \$3.6 million, or 5.4%, and by \$15.8 million, or 8.1%, in the three and nine months ended September 26, 2003, respectively. We believe that global sales of ophthalmic surgical products will continue to grow due to the successful launch of our *SOVEREIGN*® COMPACT phacoemulsification system and increased sales of the *SENSAR*® and the *CLARIFLEX*® intraocular lenses, both with the *OPTIEDGE* design.

Global sales of our eye care products increased \$4.5 million, or 6.2%, and increased \$18.6 million, or 9.5%, in the three and nine months ended September 26, 2003, respectively, as compared with the same periods last year. Sales of our eye care products in the United States were relatively flat, and decreased \$3.6 million, or 9.9%, in the three and nine months ended September 26, 2003, respectively, as compared with the same periods last year primarily due to the continued reduction of sales of lower-margin private label eye care products and peroxide-based disinfection systems. International sales of our eye care products increased \$4.3 million, or 7.1%, and increased \$22.2 million, or 14.0%, in the three and nine months ended September 26, 2003, respectively, as compared with the same periods last year primarily due to an increase in sales of our *COMPLETE*® branded products and favorable currency changes. Foreign currency fluctuations increased international eye care sales by \$3.8 million, or 5.2%, and by \$16.7 million, or 8.5%, in the three and nine months ended September 26, 2003, respectively. We believe that global eye care sales will continue to grow due to increased sales of our *COMPLETE*® branded products and continued sales growth in Europe and Japan.

*Gross margin.* Our gross margin was 62.3% of net sales in the three months ended September 26, 2003, a decrease of 0.8 percentage points from the comparable prior year period. Our gross margin was 62.3% of net sales in the nine months ended September 26, 2003, an increase of 0.4 percentage points from the comparable prior year period. The higher gross margin in the three months ended September 27, 2002 reflects the favorable margins associated with lower-cost inventory transferred to us at the time of the spin-off. The increase in gross margin as a percent of net sales in the nine months ended September 26, 2003 as compared to the same period last year was primarily due to a change in product sales mix to higher margin surgical products, including the SENSAR® and CLARIFLEX® intraocular lenses, and growth in the *COMPLETE*® branded line of eye care solutions. We expect our eye care product gross margin percentage to be impacted by our manufacturing agreement with Allergan and temporarily impacted subsequent to the acquisition of the

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Advanced Medical Optics, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED SEPTEMBER 26, 2003

### RESULT OF OPERATIONS (continued)

manufacturing facility in Spain, largely offset by improved ophthalmic surgical product gross margins and continued growth in sales of our *COMPLETE*® branded products.

*Selling, general and administrative.* Selling, general and administrative expenses were \$67.6 million, or 44.7% of net sales, and \$205.1 million, or 47.2% of net sales, in the three and nine months ended September 26, 2003, respectively, compared to \$61.3 million, or 44.0% of net sales, and \$175.1 million, or 44.8% of net sales, in the three and nine months ended September 27, 2002. The increase in selling, general and administrative expenses was primarily a result of our continued investment in the global eye care business and incremental costs associated with running an independent public company.

*Research and development.* Research and development expenses were \$9.3 million, or 6.1% of net sales, and \$27.0 million, or 6.2% of net sales, in the three and nine months ended September 26, 2003, respectively, compared to \$6.6 million, or 4.7% of net sales, and \$21.4 million, or 5.5% of net sales, in the three and nine months ended September 27, 2002. The increase in research and development was due primarily to the research efforts in the ophthalmic surgical business. We expect research and development expenses as a percentage of net sales to be in the range of 6.0% to 6.5% for the full year 2003. Our continued investment in research and development has yielded new products, such as our new *SOVEREIGN*® *COMPACT* phacoemulsification system and our next generation multi-purpose solution, *COMPLETE*® *MoisturePLUS*.

*Non-operating expense.* Non-operating expense was \$23.4 million and \$37.5 million in the three and nine months ended September 26, 2003, respectively, compared to \$9.2 million and \$16.3 million in the three and nine months ended September 27, 2002, respectively. Interest expense increased \$12.6 million in the nine months ended September 26, 2003, as compared with the same period last year primarily due to the debt incurred just prior to the spin-off. In addition, interest expense includes aggregate costs of \$5.8 million comprised of the pro-rata write-off of debt issuance costs and original issue discount of \$7.8 million and recognition of a pro-rata portion of net realized gains on interest rate swaps of \$2.0 million associated with the prepayment of the term loan in June 2003, the consummation of the Modified Dutch Auction tender offer for \$115.0 aggregate principal amount of 9¼% senior subordinated notes in July 2003 and the repurchase of an additional \$15.0 million aggregate principal amount of 9¼% senior subordinated notes in September 2003. We recorded an unrealized gain on foreign currency derivative instruments of \$0.3 million and \$0.1 million in the three and nine months ended September 26, 2003, respectively, compared to an unrealized loss of zero and \$1.9 million in the three and nine months ended September 27, 2002, respectively. We record as unrealized (gain) loss on derivative instruments the mark to market adjustments on the outstanding foreign currency options which we entered into or were allocated as part of Allergan's overall risk management strategy to reduce the volatility of expected earnings in currencies other than the U.S. dollar. The three and nine months ended September 26, 2003 include early debt extinguishment costs of \$19.4 million associated with the tender offer and repurchase of 9¼% senior subordinated notes partially offset by foreign exchange gains and interest income and the nine months ended September 27, 2002 includes early debt extinguishment costs of \$3.5 million associated with the prepayment of debt in Japan in June 2002.

*Income taxes.* The effective tax rate for the nine months ended September 26, 2003 was 42% compared to the effective tax rate of 41% for the nine months ended September 27, 2002. During 2003, we have repatriated cash from foreign jurisdictions to facilitate our debt refinancing efforts. Income taxes are provided on taxable income at the statutory rates applicable to such income. We have provided for U.S. federal income



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taxes and foreign withholding taxes on the portion of undistributed earnings of non-U.S. subsidiaries expected to be remitted.

We believe our future effective income tax rate may vary depending on our mix of domestic and international taxable income or loss and the various tax and treasury methodologies that we implement, including our policy regarding repatriation of future accumulated foreign earnings.

*Net earnings (loss).* Net earnings (loss) for the three and nine months ended September 26, 2003 were \$(3.7) million and \$0.6 million, respectively, compared to \$5.8 million and \$17.1 million in the three and nine months ended September 27, 2002, respectively. The net loss for the three months ended September 26, 2003 is primarily the result of the increase in non-operating expense due to increased interest expense and early debt extinguishment costs. The decrease in net earnings for the nine months ended September 26, 2003 as compared to the same period last year is primarily the result of the \$6.7 million decrease in operating income due to the additional costs of our operations as an independent public company and early debt extinguishment costs.

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Advanced Medical Optics, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED SEPTEMBER 26, 2003

## **LIQUIDITY AND CAPITAL RESOURCES**

Management assesses our liquidity by our ability to generate cash to fund operations. Significant factors in the management of liquidity are: funds generated by operations; levels of accounts receivable, inventories, accounts payable and capital expenditures; adequate lines of credit; and financial flexibility to attract long-term capital on satisfactory terms.

Historically, we have generated cash from operations in excess of working capital requirements, and we expect to do so in the future. The net cash provided by operating activities was \$11.4 million in the nine months ended September 26, 2003 compared to \$90.6 million in the nine months ended September 27, 2002. Operating cash flow decreased in the nine months ended September 26, 2003 compared to the nine months ended September 27, 2002 primarily as a result of lower net earnings due to the additional costs of our operations as an independent company, increased interest expense and early debt extinguishment costs, a decrease in accrued expenses and other liabilities and an increase in accounts receivable, partially offset by a decrease in inventories and other current assets.

Net cash used in investing activities was \$11.4 million and \$19.3 million in the nine months ended September 26, 2003 and September 27, 2002, respectively. Expenditures for property, plant and equipment totaled \$6.2 million and \$15.2 million in the nine months ended September 26, 2003 and September 27, 2002, respectively. The decrease in expenditures in 2003 as compared to the same period last year is primarily due to the large amount of improvements in 2002 to our leased headquarters. We expect to invest approximately \$16.0 million to \$20.0 million in property, plant and equipment in 2003 excluding the November 2003 purchase of the manufacturing facility in Madrid, Spain. We financed the approximately \$21.6 million purchase of this facility with available cash and borrowings under our senior credit facility. Expenditures for demonstration (demo) and bundled equipment, primarily phacoemulsification and microkeratome surgical equipment, were \$5.4 million and \$3.7 million in the nine months ended September 26, 2003 and September 27, 2002, respectively. We maintain demo and bundled equipment to facilitate future sales of similar equipment and related products to our customers. We expect to invest approximately \$7.0 million to \$9.0 million in demo and bundled equipment in 2003. Expenditures for capitalized internal-use software were \$0.2 million and \$0.9 million in the nine months ended September 26, 2003 and September 27, 2002, respectively. We expect to invest approximately \$1.0 million to \$3.0 million in capitalized internal-use software in 2003.

Net cash used in financing activities was \$46.6 million in the nine months ended September 26, 2003, which was primarily comprised of \$162.4 million of long-term borrowings reduced by long-term debt repayments of \$205.0 million and financing related costs of \$7.3 million. Net cash used in financing activities was \$16.2 million in the nine months ended September 27, 2002, which was comprised of \$305.6 million of long-term debt borrowings reduced by long-term debt repayments of \$114.4 million, financing related costs of \$10.3 million and \$197.2 million of net distributions to Allergan. A majority of cash generated from operations prior to June 28, 2002 was transferred to Allergan. Net transfers to Allergan ceased as of June 28, 2002 as a result of the spin-off.

As of the spin-off date, we incurred \$300.0 million of debt. We used approximately \$258.1 million of these credit facilities to repay indebtedness borrowed from Allergan to purchase various assets from Allergan, make a distribution to Allergan in exchange for various assets contributed to us and repay a portion of Allergan's debt assumed by us in connection with the spin-off. As of September 26, 2003, we had repaid \$230.0 million of this debt.

In June 2003, we amended and restated our senior credit facility to retire the original \$100.0 million term loan, and increase the senior revolving credit facility from \$35.0 million to \$100.0 million. The amended and restated senior credit facility matures on June 30, 2007. As of September 26, 2003, we had no borrowings outstanding under this senior credit facility. Additionally, in June 2003, we consummated the offering of \$140.0 million of 3½% convertible senior subordinated notes due 2023. Part of the proceeds from this offering were used to consummate our Modified Dutch Auction tender offer for \$115.0 million aggregate principle amount of our 9¼% senior subordinated notes in July 2003. In September 2003, we repurchased an additional \$15.0 million aggregate principal amount of 9¼% senior subordinated notes. As a result of the tender offer and the repurchase of the senior subordinated notes, we recorded an aggregate charge of approximately \$20.6 million for the premium paid on the notes and for the write-off of the pro-rata portion of capitalized debt related costs.

Our cash position includes amounts denominated in foreign currencies, and the repatriation of those cash balances from some of our non-U.S. subsidiaries will result in additional tax costs. However, these cash balances are generally available without legal restriction to fund ordinary business operations.

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Advanced Medical Optics, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE QUARTER ENDED SEPTEMBER 26, 2003

### LIQUIDITY AND CAPITAL RESOURCES (continued)

We believe that the net cash provided by our operating activities, supplemented as necessary with borrowings available under our senior credit facility and existing cash and equivalents, will provide sufficient resources to meet our working capital requirements, debt service and other cash needs over the next year.

We are partially dependent upon the reimbursement policies of government and private health insurance companies. Government and private sector initiatives to limit the growth of health care costs, including price regulation and competitive pricing, are continuing in many countries where we do business. As a result of these changes, the marketplace has placed increased emphasis on the delivery of more cost-effective medical therapies. While we have been unaware of significant price resistance resulting from the trend toward cost containment, changes in reimbursement policies and other reimbursement methodologies and payment levels could have an adverse effect on our pricing flexibility.

Additionally, the current trend among U.S. hospitals and other customers of medical device manufacturers is to consolidate into larger purchasing groups to enhance purchasing power. The enhanced purchasing power of these larger customers may also increase the pressure on product pricing, although we are unable to estimate the potential impact at this time.

*Inflation.* Although at reduced levels in recent years, inflation may cause upward pressure on the cost of goods and services used by us. The competitive and regulatory environments in many markets substantially limit our ability to fully recover these higher costs through increased selling prices. We continually seek to mitigate the adverse effects of inflation through cost containment and improved productivity and manufacturing processes.

*Foreign currency fluctuations.* Approximately 74% of our revenues for the nine months ended September 26, 2003 were derived from operations outside the United States, and a significant portion of our cost structure is denominated in currencies other than the U.S. dollar. Therefore, we are subject to fluctuations in sales and earnings reported in U.S. dollars as a result of changing currency exchange rates.

The impact of foreign currency fluctuations on sales was a \$7.4 million and a \$32.5 million increase for the three and nine months ended September 26, 2003, respectively, and a \$4.8 million increase and a \$0.8 million decrease for the three and nine months ended September 27, 2002, respectively.

*Contractual obligations.* The following represents a list of our material contractual obligations and commitments:

(in millions)	Payments Due by Year						
	2003	2004	2005	2006	2007	Thereafter	Total
Long-term debt	\$	2.2	2.2	18.0		210.0	\$ 232.4
Lease obligations	15.0	12.0	7.0	4.9	4.1	29.0	72.0
IT services	5.4	5.4	5.4	5.2	4.7		26.1

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Advanced Medical Optics, Inc.

### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We routinely monitor our risks associated with fluctuations in currency exchange rates and interest rates. We address these risks through controlled risk management that may include the use of derivative financial instruments to economically hedge or reduce these exposures. We do not expect to enter into financial instruments for trading or speculative purposes. For all periods presented through June 28, 2002 we were considered in Allergan's overall risk management strategy. As part of this strategy, Allergan managed its risks based on management's judgment of the appropriate trade-off between risk, opportunity and costs. With respect to our risks, Allergan primarily utilized foreign currency option and forward contracts to economically hedge or reduce these exposures.

Given the inherent limitations of forecasting and the anticipatory nature of the exposures intended to be hedged, there can be no assurance that such programs will offset more than a portion of the adverse financial impact resulting from unfavorable movements in either interest or foreign exchange rates. In addition, the timing of the accounting for recognition of gains and losses related to mark-to-market instruments for any given period may not coincide with the timing of gains and losses related to the underlying economic exposures and, therefore, may adversely affect our operating results and financial position.

To ensure the adequacy and effectiveness of our interest rate and foreign exchange hedge positions, we continually monitor, from an accounting and economic perspective, our interest rate swap positions and foreign exchange forward and option positions, when applicable, both on a stand-alone basis and in conjunction with our underlying interest rate and foreign currency exposures.

*Interest rate risk.* Our \$210.0 million of fixed rate debt is comprised solely of domestic borrowings and our \$22.4 million of variable rate debt is comprised of borrowings in Japan. Thus, our interest expense will fluctuate with rate changes in Japan.

We had previously entered into various interest rate swap agreements which effectively converted the interest rate on \$150.0 million of the senior subordinated notes from a fixed to a floating rate and converted the interest rate on \$50.0 million of term loan borrowings from a floating rate to a fixed rate. The interest rate swaps had maturity dates beginning in 2005 and qualified as either fair value or cash flow hedges. Changes in fair value of the interest rate swap agreement qualifying as a cash flow hedge were recorded in other comprehensive income to the extent such changes were effective and as long as the cash flow hedge requirements were met.

In May 2003 and October 2002, we realized the value of the interest rate swaps qualifying as fair value hedges. We received an aggregate of approximately \$14.8 million, of which approximately \$6.3 million represented the net settlement of the accrued but unpaid amount between us and the swap counterparties. The remaining amount of approximately \$8.5 million was recorded as an adjustment to the carrying amount of the senior subordinated notes as a premium and is amortized over the remaining life of the notes. At September 26, 2003, after recognizing a pro-rata portion of the gain upon repurchase of a portion of the notes, the unamortized realized gain on these interest rate swaps was \$3.6 million.

In May 2003, we terminated the interest rate swap qualifying as a cash flow hedge. We paid approximately \$2.4 million and included the related loss of approximately \$2.3 million as a component of accumulated other comprehensive income. As a result of the prepayment of the term loan in June 2003, the loss on the interest rate swap has been fully recognized as interest expense.

If interest rates in Japan were to increase or decrease by 1%, annual interest expense would increase or decrease by approximately \$224,000.

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Advanced Medical Optics, Inc.

**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (continued)**

The table below presents information about our debt obligations as of September 26, 2003:

	Maturing in						Fair
	2003	2004	2005	2006	2007	Thereafter	Market Value
	(in millions, except interest rates)						
LIABILITIES							
Debt Obligations:							
Fixed Rate	\$	\$	\$	\$	\$	\$ 70.0	\$ 75.0
Weighted Average Interest Rate						9.25%	9.25%
Fixed Rate	\$	\$	\$	\$	\$	\$ 140.0	\$ 140.0
Weighted Average Interest Rate						3.50%	3.50%
Variable Rate	\$	\$ 2.2	\$ 2.2	\$ 18.0	\$	\$	\$ 22.4
Weighted Average Interest Rate		3.10%	3.10%	3.10%			3.10%
Total Debt Obligations	\$	\$ 2.2	\$ 2.2	\$ 18.0	\$	\$ 210.0	\$ 232.4
Weighted Average Interest Rate		3.10%	3.10%	3.10%		5.42%	5.19%

*Foreign currency risk.* Overall, we are a net recipient of currencies other than the U.S. dollar and, as such, we benefit from a weaker dollar and are adversely affected by a stronger dollar relative to major currencies worldwide. Accordingly, changes in exchange rates, and in particular a strengthening of the U.S. dollar, may negatively affect our consolidated sales and gross profit as expressed in U.S. dollars.

We may enter into foreign exchange option and forward contracts to reduce earnings and cash flow volatility associated with foreign exchange rate changes to allow management to focus its attention on its core business issues and challenges. Accordingly, we enter into contracts which change in value as foreign exchange rates change to economically offset the effect of changes in value of foreign currency assets and liabilities, commitments and anticipated foreign currency denominated sales and operating expenses. We enter into foreign exchange option and forward contracts in amounts between minimum and maximum anticipated foreign exchange exposures, generally for periods not to exceed one year.

We use foreign currency option contracts, which provide for the sale of foreign currencies to offset foreign currency exposures expected to arise in the normal course of our business. While these instruments are subject to fluctuations in value, such fluctuations are anticipated to offset changes in the value of the underlying exposures. The principal currencies subject to this process are the Japanese yen and the euro.

The foreign currency options are entered into to reduce the volatility of earnings generated in currencies other than the U.S. dollar, primarily earnings denominated in Japanese yen and the euro. As a result, the changes in the fair value of foreign currency option contracts are recorded through earnings as Unrealized (gain) loss on derivative instruments while any realized gains or losses on expired contracts are recorded through earnings as Other, net in the accompanying unaudited condensed consolidated statements of operations. The premium cost of purchased foreign



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exchange option contracts are recorded in Other current assets and amortized over the life of the options.

Prior to the spin-off and as part of Allergan's risk management strategy, foreign exchange forward contracts were entered into to protect the value of foreign currency denominated intercompany receivables and the changes in the fair value of the foreign currency forward contracts were economically designed to offset the changes in the revaluation of the foreign currency denominated intercompany receivables. As a result, our allocated portion of current changes in both the foreign currency forward contracts and revaluation of the foreign currency denominated intercompany receivables was recorded through Other, net in the accompanying unaudited condensed consolidated statements of operations.

At September 26, 2003, the aggregate notional and average strike amounts of our outstanding yen and euro currency option contracts were \$83.3 million and 121.96, and \$37.9 million and 1.05, respectively. The notional principal amount provides one measure of the transaction volume outstanding as of the end of the period, and does not represent the amount of our exposure to market loss. The fair

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Advanced Medical Optics, Inc.

### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (continued)**

value of these foreign currency option contracts was \$1.1 million at September 26, 2003. The estimate of fair value is based on applicable and commonly used prevailing financial market information as of September 26, 2003. The amounts ultimately realized upon settlement of these financial instruments, together with the gains and losses on the underlying exposures, will depend on actual market conditions during the remaining life of the instruments.

### **NEW ACCOUNTING STANDARDS**

In July 2002, Statement of Financial Accounting Standards No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS No. 146), was issued. SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. We adopted SFAS No. 146 during the quarter ended March 28, 2003. The adoption of SFAS No. 146 did not have a material effect on our consolidated financial statements.

In December 2002, Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation* (SFAS No. 148), was issued. SFAS No. 148 amends the disclosure requirements of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), to require prominent disclosures in both interim and annual financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 also amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. We have commenced quarterly footnote disclosure of the fair value based method of accounting for stock-based employee compensation beginning with the quarter ended March 28, 2003. The pro forma effect to net loss is presented in Note 6 to the unaudited condensed consolidated financial statements as if the fair value method had been applied. As we decided not to adopt the SFAS No. 123 fair value method of accounting for stock-based employee compensation, the new transition alternatives of SFAS No. 148 did not have an effect on our consolidated financial statements.

In November 2002, the Emerging Issues Task Force finalized its consensus on EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables* (EITF 00-21), which provides guidance on the method of revenue recognition for sales arrangements that include the delivery of more than one product or service. Under EITF 00-21, revenue must be allocated to all deliverables regardless of whether an individual element is incidental or perfunctory. We adopted EITF 00-21 during the quarter ended September 26, 2003. The adoption of EITF 00-21 did not have a material effect on our consolidated financial statements.

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46). FIN 46 requires companies to evaluate variable interest entities to determine whether to apply the consolidation provisions of FIN 46 to those entities. Companies must apply FIN 46 to entities with which they are involved if the entity's equity has specified characteristics. FIN 46 applies immediately to variable interest entities created after January 31, 2003, and to variable interest entities in which a company obtains an interest after that date. We adopted FIN 46 during the quarter ended September 26, 2003. The adoption of FIN 46 did not have an effect on our consolidated financial statements.

In April 2003, Statement of Financial Accounting Standards No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (SFAS No. 149), was issued. SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under Statement 133. We adopted SFAS No. 149 during the quarter ended September 26, 2003. The adoption of SFAS No. 149 did not have an effect on our consolidated financial statements.

In May 2003, Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (SFAS No. 150), was issued. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. We adopted SFAS No. 150 during the quarter ended September 26, 2003. The adoption of SFAS No. 150 did not have an effect on our consolidated financial statements.

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Advanced Medical Optics, Inc.

### **CERTAIN FACTORS AND TRENDS AFFECTING AMO AND ITS BUSINESSES**

Certain statements we made in this report and in other reports and statements released by us constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, such as comments which express our opinions about trends and factors which may impact future operating results. Disclosures that use words such as we believe, anticipate, expect and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from expectations. Any such forward-looking statements, whether made in this report or elsewhere, should be considered in context with the various disclosures made by us about our businesses including, without limitation, the factors discussed below:

**WE HAVE A LIMITED HISTORY OPERATING AS AN INDEPENDENT COMPANY UPON WHICH YOU CAN EVALUATE US.** Financial information for all periods prior to June 29, 2002 includes those revenues and expenses directly attributable to our operations and allocations of certain Allergan corporate expenses. Such financial information does not necessarily reflect what the results of our operations would have been as a stand-alone public entity.

**OUR ABILITY TO ENGAGE IN ACQUISITIONS AND OTHER STRATEGIC TRANSACTIONS USING OUR STOCK IS SUBJECT TO LIMITATIONS BECAUSE OF THE FEDERAL INCOME TAX REQUIREMENTS FOR A TAX-FREE SPIN-OFF.** In addition, our tax sharing agreement and contribution and distribution agreement with Allergan may limit our ability to use our stock for acquisitions and other similar strategic transactions. Our competitors do not face similar constraints and may therefore have an advantage over us.

**WE MAY BE REQUIRED TO SATISFY CERTAIN INDEMNIFICATION OBLIGATIONS TO ALLERGAN, OR MAY NOT BE ABLE TO COLLECT ON INDEMNIFICATION RIGHTS FROM ALLERGAN.** Under the terms of the contribution and distribution agreement, we and Allergan have each agreed to indemnify each other from and after the spin-off with respect to the indebtedness, liabilities and obligations retained by our respective companies. These indemnification obligations could be significant. The ability to satisfy these indemnities, if called upon to do so, will depend upon the future financial strength of each of our companies. We cannot determine whether we will have to indemnify Allergan for any substantial obligations, and we do not have control over or clear visibility to the settlement of certain claims and lawsuits which require partial indemnification by us, such as employment-related claims. We also cannot assure you that if Allergan has to indemnify us for any substantial obligations, Allergan will have the ability to satisfy those obligations or will satisfy them promptly.

**WE MAY BE RESPONSIBLE FOR FEDERAL INCOME TAX LIABILITIES THAT RELATE TO THE DISTRIBUTION OF OUR COMMON STOCK BY ALLERGAN.** Allergan has received a ruling from the Internal Revenue Service to the effect that the spin-off qualified as a tax-free transaction. If either we or Allergan breach representations to each other or to the Internal Revenue Service, or if we or Allergan take or fail to take, as the case may be, actions that result in the spin-off failing to meet the requirements of a tax-free spin-off pursuant to Section 355 of the Internal Revenue Code, the party in breach will indemnify the other party for any and all resulting taxes. If we were required to pay any of the potential taxes described above, the payment would have a material adverse effect on our financial position.

**WE FACE INTENSE COMPETITION AND OUR FAILURE TO COMPETE EFFECTIVELY COULD HAVE A MATERIAL ADVERSE EFFECT ON OUR PROFITABILITY AND RESULTS OF OPERATIONS.** The markets for our ophthalmic surgical device and eye care products are intensely competitive and are subject to rapid and significant technological change. Many of our competitors have substantially more resources and a greater marketing scale than we do. If we are unable to develop and produce or market our products to effectively compete against our competitors, our operating results will materially suffer.

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OUR BUSINESS IS SUBJECT TO EXTENSIVE GOVERNMENT REGULATION. Compliance with these regulations is expensive and time-consuming; and, if we fail to comply, we may be subject to fines, injunctions and penalties that could harm our business. Failure to obtain regulatory clearance or approvals of new products we develop, any limitations imposed by regulatory agencies on new product use or the costs of obtaining regulatory clearance or approvals could have a material adverse effect on our business, financial condition and results of operations. In addition, if we or our subcontractors fail to comply with applicable manufacturing regulations, our business could be harmed. Health care initiatives and other cost-containment pressures could cause us to sell our products at lower prices, resulting in less revenue to us.

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Advanced Medical Optics, Inc.

**CERTAIN FACTORS AND TRENDS AFFECTING AMO AND ITS BUSINESSES (continued)**

**WE COULD EXPERIENCE LOSSES DUE TO PRODUCT LIABILITY CLAIMS OR PRODUCT RECALLS OR CORRECTIONS.** We have in the past been, and continue to be, subject to recalls and product liability claims. We have assumed the defense of any litigation involving claims related to our business and will indemnify Allergan for all related losses, costs and expenses. As part of our risk management policy, we have obtained third-party product liability insurance coverage. Product liability claims against us may exceed the coverage limits of our insurance policies or cause us to record a self-insured loss. Even if any product liability loss is covered by an insurance policy, these policies have substantial retentions or deductibles that provide that we will not receive insurance proceeds until the losses incurred exceed the amount of those retentions or deductibles. To the extent that any losses are below these retentions or deductibles, we will be responsible for paying these losses. A product liability claim in excess of applicable insurance or a substantial product recall could have a material adverse effect on our business, financial position and results of operations.

**OUR EYE CARE BUSINESS COMPETES IN A MARKET WITH MARGINAL GROWTH ON A GLOBAL BASIS.** We believe that revenue growth of the eye care market in international markets is offset by a decline in the U.S. market, resulting in marginal growth on a global basis in 2002 as compared to 2001. Our eye care business is impacted by trends in the contact lens care market such as technological and medical advances in surgical techniques for the correction of vision impairment. Less expensive one-bottle chemical disinfection systems have gained popularity among soft contact lens wearers instead of peroxide-based lens care products, which historically have been our strongest family of lens care products. Also, the growing use and acceptance of daily and extended wear contact lenses and laser correction procedures, along with the other factors above, could have the effect of continuing to reduce demand for lens care products generally. We cannot assure you that we have established appropriate or sufficient marketing and sales plans to mitigate the effect of these trends upon our eye care business. If we cannot timely generate new sources of revenue to offset any decline in revenues from these trends, our operating results will materially suffer.

**WE CONDUCT A SIGNIFICANT AMOUNT OF OUR SALES AND OPERATIONS OUTSIDE OF THE UNITED STATES.** SUCH SALES AND OPERATIONS SUBJECT US TO ADDITIONAL BUSINESS RISKS, SUCH AS BUSINESS INTERRUPTION, INCREASED COSTS AND CURRENCY EXCHANGE RATE FLUCTUATIONS, WHICH MAY CAUSE OUR PROFITABILITY TO DECLINE. Our two manufacturing sites are located outside the continental United States, in Añasco, Puerto Rico and Hangzhou, China, and, in November 2003, we completed the purchase of a third facility in Madrid, Spain. In 2002, we derived approximately \$386.8 million, or 72% of our total revenue, from sales of our products outside of the United States. In addition, in 2002 we derived approximately 27% of our net sales in Japan. Our international operations are, and will continue to be, subject to a number of risks and potential costs, including: the impact of severe acute respiratory syndrome (SARS) on sales of our products and on our manufacturing capacity in China for certain eye care products; unexpected changes in foreign regulatory requirements; differing local product preferences and product requirements; fluctuations in foreign currency exchange rates; political and economic instability; changes in foreign medical reimbursement and coverage policies and programs; diminished protection of intellectual property in some countries outside of the United States; trade protection measures and import or export licensing requirements; difficulty in staffing and managing foreign operations; differing labor regulations; and potentially negative consequences from changes in tax laws. Any of these factors may, individually or as a group, have a material adverse effect on our business and results of operations. In addition, we are particularly susceptible to the occurrence of any of these risks in Japan due to our high concentration of sales in Japan.

**WE HAVE A SIGNIFICANT AMOUNT OF DEBT WHICH CONTAINS COVENANTS THAT MAY LIMIT OUR ACTIVITIES.** This level of debt could limit cash flows available for working capital, capital expenditures, acquisitions and other corporate purposes, could limit our ability to obtain additional financing and could limit our flexibility to react to competitive or other changes in our industry, and to economic conditions generally. Our ability to comply with loan covenants and to repay or refinance our indebtedness will depend upon our future operating performance, which will be affected by general economic, financial, competitive, legislative, regulatory and other factors beyond our control.

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IF WE ARE UNABLE TO PROTECT OUR INTELLECTUAL PROPERTY RIGHTS, OUR BUSINESS AND PROSPECTS MAY BE HARMED. Our ability to compete effectively is dependent upon the proprietary nature of the designs, processes, technologies and materials owned, used by or licensed to us. Although we attempt to protect our proprietary property, technologies and processes through a combination of patent law, trade secrets and non-disclosure agreements, these may be insufficient.

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Advanced Medical Optics, Inc.

### **CERTAIN FACTORS AND TRENDS AFFECTING AMO AND ITS BUSINESSES (continued)**

WE MAY BE SUBJECT TO INTELLECTUAL PROPERTY LITIGATION AND INFRINGEMENT CLAIMS, WHICH COULD CAUSE US TO INCUR SIGNIFICANT EXPENSES OR PREVENT US FROM SELLING OUR PRODUCTS. There is a substantial amount of litigation over patent and other intellectual property rights in the eye care industry, and in the ophthalmic surgical device and contact lens care markets particularly. The fact that we have patents issued to us for our products does not mean that we will always be able to successfully defend our patents and proprietary rights against challenges or claims of infringement by our competitors. In addition, litigation to defend out intellectual property is costly and time consuming.

OUR MANUFACTURING CAPACITY MAY NOT BE ADEQUATE TO MEET THE DEMANDS OF OUR BUSINESS. We manufacture our products or contract with third parties to manufacture our products. Our products are manufactured in quantities sufficient to satisfy our current level of product sales. If we experience increases in sales, we will need to increase our production beyond our present manufacturing capacity. Additionally, in June 2005 our manufacturing agreement with Allergan will terminate and we will be required to increase our manufacturing capacities or to contract with additional parties to manufacture our products. The process to transfer manufacturing of our products to new facilities is lengthy and requires regulatory approval. We cannot assure you that we can successfully increase our capacity on a profitable basis, complete the regulatory approval process in a timely manner, or contract with additional parties on terms acceptable to us, if at all. Any prolonged disruption in the operation of our manufacturing facilities or those of our third party manufacturers could materially harm our business. Furthermore, we cannot assure you that if we choose to scale-up our manufacturing operations, we will be able to maintain compliance with Food and Drug Administration or other regulatory standards.

#### Item 4. Disclosure Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be disclosed in our periodic reports filed with the SEC. In addition, we evaluated our internal control over financial reporting and there have been no changes that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



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Advanced Medical Optics, Inc.

### **PART II OTHER INFORMATION**

#### **Item 5. Other Information**

AMO's Chief Executive Officer and Chief Financial Officer have each signed the certifications required by Section 906 of the Sarbanes-Oxley Act of 2002, which certifications accompany this filing as exhibits. These certifications shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, nor shall they be incorporated by reference in any filing under the Securities Act of 1933.

#### **Item 6. Exhibits and Reports on Form 8-K**

##### **(a) Exhibits**

- 10.1 Amendment No. 2 to Amended and Restated Credit Agreement, dated September 19, 2003.
- 10.2 Term Loan Facility Agreement, dated September 24, 2003, by and among AMO Japan K.K., as Borrower, Advanced Medical Optics, Inc., as Guarantor, Bank of America N.A., Tokyo Branch, as a Lender and Agent, and the Lenders named therein.
- 10.3 Second Amendment to Advanced Medical Optics, Inc. 401(k) Plan, dated October 21, 2003.
- 10.4 First Amendment to Advanced Medical Optics, Inc. Executive Deferred Compensation Plan, dated October 21, 2003.
- 31.1 Certification of James V. Mazzo pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Richard A. Meier pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of James V. Mazzo and Richard A. Meier pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

##### **(b) Reports on Form 8-K**

On July 1, 2003, the Company filed with the Securities and Exchange Commission a Current Report on Form 8-K attaching the Company's press release announcing that it had amended its Modified Dutch Auction tender offer for up to \$75.0 million aggregate principal amount at maturity of its outstanding 9¼% Senior Subordinated Notes due 2010 by increasing the offer amount up to \$115.0 million aggregate principal amount at maturity and increasing the maximum offer price to \$1,115.00 per \$1,000 principal amount at maturity.

On July 8, 2003, the Company filed with the Securities and Exchange Commission a Current Report on Form 8-K reporting the resignation of David E.I. Pyott, the Chairman of the Board, President and Chief Executive Officer of Allergan, from the Company's board of directors, effective June 29, 2003.

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On July 17, 2003, the Company filed with the Securities and Exchange Commission a Current Report on Form 8-K attaching a press release reporting that a Spanish subsidiary of the Company had entered into an agreement with Alcon CUSI, S.A., a subsidiary of Alcon, Inc., to purchase an existing Alcon manufacturing facility in Madrid, Spain. The form also attached a press release announcing the extension of the Modified Dutch Auction tender offer.

On July 23, 2003, the Company filed with the Securities and Exchange Commission a Current Report on Form 8-K attaching the Company's July 21, 2003 press release announcing the preliminary results of its Modified Dutch Auction tender offer for its 9¼% Senior Subordinated Notes due 2010 and attaching the Company's July 23, 2003 press release announcing the final results of its Modified Dutch Auction tender offer.

On July 30, 2003, the Company filed with the Securities and Exchange Commission a Current Report on Form 8-K furnishing the Company's press release regarding financial results for the quarter ended June 27, 2003.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 6, 2003

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ADVANCED MEDICAL OPTICS, INC.

/s/ RICHARD A. MEIER

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**Richard A. Meier**

**(Principal Financial Officer)**

/s/ ROBERT F. GALLAGHER

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**Robert F. Gallagher**

**(Principal Accounting Officer)**