1 800 CONTACTS INC
Form 10-K
March 18, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

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

For the fiscal year ended January 3, 2004 or

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

For the transition period from to .

Commission file number: 0-23633

1-800 CONTACTS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**87-0571643**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
66 E. Wadsworth Park Drive, Draper, UT	**84020**
(Address of principal executive offices)	(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act: Not applicable

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

Common Stock, par value $.01 per share
(Title of Class)

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

ý Yes o No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

ý Yes o No

The aggregate market value of voting common equity held by non-affiliates of the registrant as of June 28, 2003 at a closing sale price of $25.00 as reported by the Nasdaq National Market (Nasdaq) was approximately $173.0 million. Shares held by each officer and director and by each person who owns or may be deemed to own 10% or more of the outstanding Common Stock have been excluded since such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 3, 2004, the Registrant had 13,114,777 shares of Common Stock, par value $0.01 per share, outstanding.

Documents Incorporated by Reference

Portions of the Registrant s Proxy Statement to be used in connection with the solicitation of proxies for the Annual Meeting of Stockholders to be held on May 21, 2004 (the Proxy Statement) are incorporated by reference in Part III of this Annual Report on Form 10-K (the Form 10-K).

1-800 CONTACTS, INC.

INDEX TO ANNUAL REPORT ON FORM 10-K

PART I

Item 1. **Business.**

Overview

1-800 CONTACTS, INC. (the Company) was incorporated under the laws of the State of Utah in February 1995 and was reincorporated under the laws of the State of Delaware in February 1998 in conjunction with its initial public offering of common stock. The Company s principal executive office is located at 66 E. Wadsworth Park Drive, Draper, Utah 84020, and its telephone number is (801) 924-9800. The Company maintains various websites on the Internet, including, www.1800contacts.com , www.contacts.com and www.contactlenses.com . The Company provides on these websites, free of charge, periodic and current reports as soon as is reasonably practicable after such material is filed with or furnished to the SEC.

The Company is the leading direct marketer of replacement contact lenses. The Company recently announced that it had shipped its ten millionth order to more than 5 million customers since inception. Through its easy-to-remember, toll-free telephone number, 1-800 CONTACTS (1-800-266-8228), and through its Internet addresses, the Company sells all of the popular brands of contact lenses, including those manufactured by Johnson & Johnson Vision Care, CIBA Vision, Bausch & Lomb, Ocular Sciences and CooperVision. The Company s high volume, cost-efficient operations, supported by its proprietary management information systems, enable it to offer consumers an attractive alternative for obtaining replacement contact lenses in terms of convenience, price, speed of delivery and customer service. As a result of its extensive inventory of more than 35,000 SKUs, the Company generally ships approximately 95% of its orders within one business day of receipt and verification of prescriptions.

The Company s Internet sales channel continued to grow in fiscal 2003 and enhances the Company s ability to cost effectively serve its customers. The Company s Internet sales accounted for approximately half of its total revenue during 2003. Its online presence enables the Company to operate more efficiently by substantially reducing the payroll and long distance costs associated with telephone orders. This increased efficiency allows the Company to offer Internet customers free shipping in addition to other services such as e-mail shipping confirmation, online order tracking and e-mail correspondence.

The Company markets its products through a national advertising campaign that aims to increase recognition of the 1-800 CONTACTS brand name, increase traffic on its website, add new customers, continue to build strong customer loyalty and maximize repeat purchases. As compared to other direct marketers of replacement contact lenses, the Company believes that its toll-free telephone number and Internet addresses afford it a significant competitive advantage in generating consumer awareness and repeat business. The Company spent approximately $20.2 million on advertising in fiscal 2003 and has invested more than $130 million in its national advertising campaign over the last several years. The Company s experience has been that increases in advertising expenditures have a direct impact on the growth of net sales.

On July 24, 2002, the Company completed the acquisition of certain net assets and the majority of the business operations of IGEL, a developer and manufacturer of contact lenses based in Singapore. The acquisition was effected through a wholly owned subsidiary of the Company, IGEL Acquisition Co. Pte Ltd (subsequently renamed ClearLab Pte Ltd). Subsequent to year-end, ClearLab Pte Ltd has been renamed ClearLab International. ClearLab International will be the principal marketing organization for the Company s international wholesale manufacturing business, focusing on the marketing of contact lens products to major retailers and distributors, as well as providing contract manufacturing

capacity for other contact lens manufacturers. ClearLab International manufactures a wide range of frequent replacement spherical and toric lenses and is focused on developing new lens materials.

On February 24, 2004, the Company acquired VisionTec, a developer and manufacturer of daily contact lenses based in the United Kingdom. VisionTec has developed a method for low cost, high quality production of daily

disposable contact lenses using a unique proprietary material. VisionTec has subsequently been renamed ClearLab UK Ltd (ClearLab UK). The business will operate as a manufacturing affiliate of ClearLab International. The Company has recently completed the testing of its manufacturing capabilities for ClearLab UK s daily products and is currently expanding its production capabilities. The Company will increase its product offerings to the international markets in fiscal 2004, as it begins to market the products.

ClearLab International s and ClearLab UK s development and manufacturing capabilities also provide the Company with greater access to future contact lens products for the U.S. retail market. This is critical to the Company s strategy should the Company s access to contact lenses from the major contact lens manufacturers be disrupted, curtailed or otherwise negatively impacted, or if the manufacturers do not provide the Company with contact lenses at competitive pricing and with competitive marketing support.

For more information regarding recent transactions by the Company, see Management s Discussion and Analysis of Financial Condition and Results of Operations Recent Transactions**.**

Industry Overview

Industry analysts estimate that over 50% of the United States population needs some form of corrective eyewear. Contact lenses are a convenient, cost-effective alternative to eyeglasses. The number of contact lens wearers is expected to increase as technology further improves the convenience, comfort and fit of contact lenses. As a result, the contact lens market is large and growing. The growth in the disposable market is largely due to the shift in the contact lens market away from traditional soft lenses, which generally are replaced on an annual basis, to disposable lenses, which are generally replaced on a daily, weekly, or bi-weekly basis.

Traditionally, contact lenses were sold to consumers almost exclusively by either ophthalmologists or optometrists (referred to herein collectively as eye care practitioners). Eye care practitioners would typically supply a patient with his or her initial pair of contact lenses in connection with providing the patient an eye examination and subsequently provide replacement lenses. Because the initial fitting of contact lenses requires a prescription written by an eye care practitioner, the initial sale of contact lenses still takes place primarily in this manner. Over the last two decades, however, a number of alternative sellers of replacement contact lenses have emerged, including direct marketers.

The Company believes that increased consumer awareness of the benefits of the direct marketing of contact lenses will lead to further growth of this method of buying and selling contact lenses. Purchasing replacement contact lenses from a direct marketer offers the convenience of shopping at home, rapid home delivery, quick and easy telephone or Internet ordering and competitive pricing. In addition, the growth in popularity of disposable contact lenses, which require patients to purchase replacement lenses more frequently, has contributed to the growth of the direct marketing channel. The direct marketing industry continues to grow as many retail customers have migrated towards the convenience and service offered by home shopping. The Company expects the direct marketing segment of the contact lens industry to grow in tandem with the growth in the direct marketing industry as a whole. Penetration of mail order direct marketing in the contact lens segment of the market remains in the single digit percentage points. This lags in comparison to the penetration of direct marketing of other prescription items such as pharmaceuticals. The company remains optimistic that there is great potential for growth as the contact lens segment enjoys the same growth that the corresponding pharmaceutical market has experienced.

The Company believes that the growth and acceptance of the Internet presents significant opportunities for direct marketers of contact lenses such as the Company. The factors driving this growth include the increasing number and decreasing cost of personal computers in homes and

offices, technological innovations providing easier, faster and cheaper access to the Internet, the proliferation of content and services being provided on the Internet and the increasing use of the Internet by businesses and consumers as a medium for conducting business.

The Internet possesses a number of unique and commercially powerful characteristics that differentiate it from traditional media: users communicate or access information without geographic limitations; users access

dynamic and interactive content on a real-time basis; and users communicate and interact instantaneously. The Internet has created a dynamic and particularly attractive medium for commerce; empowering customers to gather more comparative purchasing data than is feasible with traditional commerce systems, to shop in a more convenient manner and to interact with sellers in many new ways. The Company believes that the Internet provides a convenient and efficient medium for the sale of replacement contact lenses.

Historically, sales of contact lenses by direct marketers have been impeded by eye care practitioners and contact lens manufacturers. Many eye care practitioners have been reluctant to provide patients with a copy of their prescription or to release such information to direct marketers upon request, thereby limiting a patient s choice to purchase lenses from a direct marketer. Until recently, substantially all of the major manufacturers of contact lenses refused to sell contact lenses directly to direct marketing companies and sought to prohibit their distributors from doing so. These traditional barriers to the direct marketing of contact lenses have been reduced and may be completely eliminated in the future. For example, Congress recently passed the Fairness to Contact Lens Consumers Act (FCLCA), requiring all eye care practitioners to give patients a copy of their prescription as soon as they have been fitted, whether they ask for it or not. The FCLCA also requires all eye care practitioners to respond to direct marketers requests to verify patient prescriptions and provides that their failure to respond within eight business hours shall result in the prescription being presumed valid, thereby eliminating the ability of eye care practitioners to impede sales by direct marketers simply by ignoring or refusing to respond to their requests to verify prescriptions. The regulatory body which oversees the necessity of vigorous competition in the market the Federal Trade Commission (FTC) has been tasked by Congress to study and report its findings on the overall competitiveness of the contact lens market and any recommendations it may have to improve competition. This study and findings may lead to even further pro-consumer initiatives on which the Company may capitalize. Likewise, nearly all of the manufacturers are now subject to legal injunctions requiring them to sell contact lenses to direct marketers under certain conditions or have specific agreements with the Company to supply it contact lenses. See Purchasing and Principal Suppliers and Government Regulation.

Product Offerings

Contact lenses can be divided into two categories: soft lenses and hard lenses (primarily rigid gas permeable). There are three principal wearing regimes for soft contact lenses: conventional, disposable and planned replacement. Conventional lenses are designed to be worn indefinitely but are typically replaced after 12 to 24 months. Disposable soft contact lenses were introduced in the late 1980s based on the concept that changing lenses on a more regular basis was important to comfort, convenience, maintaining healthy eyes and patient compliance. Disposable lenses are changed as often as daily and up to every two weeks, depending on the product. Planned replacement lenses are designed to be changed as often as every two weeks and up to every three months.

The Company has access to all of the major brands and product types in the industry, including spherical, toric, multifocal and colored lenses either directly from the manufacturer or through distributors. The Company s sales by brand and product type are representative of the industry.

The Company maintains the World s largest inventory of contact lenses. Given the proliferation of SKUs in the industry via numerous brands, colored and specialty lenses, the Company s substantial inventory provides contact lens wearers with ready access to their lenses.

The Company is a direct marketer of replacement contact lenses and does not provide eye examinations or related services to its customers. The Company offers substantially all of the soft and hard contact lenses produced by the leading contact lens manufacturers, including Johnson & Johnson Vision Care, CIBA Vision, Bausch & Lomb, Ocular Sciences and CooperVision. The Company stocks a large inventory of lenses from which it can ship approximately 95% of its orders within one business day of receipt and verification of prescriptions. The Company believes that its large inventory of contact lenses provides it with a competitive advantage over eye care practitioners, optical chains and discount stores and serves as an effective barrier to entry to potential entrants in direct marketing of contact lenses.

The Company purchases products directly from certain manufacturers, including Johnson & Johnson Vision Care, CIBA Vision, Bausch & Lomb, and CooperVision. See Purchasing and Principal Suppliers. The Company s products are delivered in the same sterile, safety sealed containers in which the lenses were packaged by the manufacturer. From time to time, the Company purchases contact lenses that were labeled as samples by the manufacturer. Such lenses are sometimes offered by the Company to customers as part of promotional programs at reduced prices.

The Company s wholly owned subsidiary, ClearLab International, manufactures injection cast molded soft contact lenses on a contract basis for various contact lens manufacturers. ClearLab International also manufactures and distributes branded and private label contact lenses via distributors and other sales channels internationally. ClearLab International produces a wide range of frequent replacement spherical and toric lenses and is focused on developing new lens materials.

On February 24, 2004, the Company completed the acquisition of VisionTec (now known as ClearLab UK), a developer and manufacturer of daily contact lenses based in the United Kingdom. ClearLab UK has developed a method for low cost, high quality production of daily disposable contact lenses using a unique proprietary material. The business will operate as a manufacturing affiliate of ClearLab International. The Company has recently completed the testing of its manufacturing capabilities for ClearLab UK s daily products and is currently expanding its production capabilities. The Company will increase its product offerings to the international markets in fiscal 2004, as it begins to market the products.

Based on previously conducted test marketing, the Company believes that its customers are receptive to an offer from the Company to try both a new product and a new eye care practitioner. The Company believes that a more active role in the product/provider decision may help it address the policies of certain manufacturers that continue to refuse to sell certain brands to the Company and seek to sell these same brands exclusively to eye care practitioners. The Company also believes that by educating consumers as to specific eye care practitioners anti-consumer activities - and as appropriate, recommending more consumer focused eye care practitioners - that it can influence the consumer decision making process which will directly affect overall practices in the industry. The Company s first preference is to sell to the customer the lens she is already wearing. In cases where manufacturers or eye care practitioners stand in the way of the customer s choice to purchase from the Company, the Company will be able to offer the customer the opportunity to try an alternative eye care provider and an alternative product**.**

The Company also offers certain products related to contact lenses including solutions and lens cases for storing contact lenses. The Company offers solutions produced by CIBA Vision and purchased directly from CIBA Vision. The lens cases are produced by and purchased from an outside party on a contract basis.

Customers and Marketing

The Company s direct marketing customers are located principally throughout the United States. The percentage of the Company s customers that are located in each state is approximately equal to the percentage of the United States population, which resides in such state, with the largest concentration of the Company s customers residing in California. The Company strives to deliver a high level of customer service in an effort to maintain and expand its loyal customer base. The Company utilizes a focused marketing strategy that is designed to enhance the awareness and value of its brand. The Company continually researches and analyzes new ways in which to advertise its products. After identifying an attractive potential new advertisement or advertising medium, the Company commits to such advertising for an initial test period. After the initial test period, the Company continues to closely monitor its advertising in order to identify and react to trends and patterns as appropriate.

The majority of contact lens wearers are between the ages of 14 and 49. Approximately two-thirds of contact lens wearers are women and contact lens wearers generally have higher incomes than eyeglass wearers do. Through its national advertising campaign, the Company is able to target its advertising to contact lens wearers in these key demographic groups, as well as certain other persons based on other important demographics.

During 2003, the Company spent approximately $20.2 million on advertising and intends to increase advertising spending in fiscal 2004 as it continues its nationwide advertising campaign. The Company s advertising campaign targets both its traditional telephone customers and its online customers and is designed to drive new and repeat purchases. In addition, the Company intends to continue its direct marketing campaign to its more than 5 million customers through the U.S. mail and e-mail.

A brief description of the principal components of the Company s national advertising campaign is set forth below:

Broadcast. The Company utilizes a nationwide broadcast advertising campaign with significant purchases on both cable and network television. The Company s television ads typically focus on making the process of replacing contact lenses easier for consumers by rapidly delivering to customers the same contact lenses offered by eye care practitioners and by streamlining an otherwise complicated process of ordering prescription medical devices from an alternative seller. The Company believes that its easy-to-remember phone number and Internet addresses make television a particularly effective marketing vehicle and that television advertising will continue to be the key to building awareness for its 1-800 CONTACTS brand name.

Internet. The Company uses the Internet as a means of marketing in an effort to drive new and repeat traffic. The Company uses emails as an effective tool to provide reminders to existing customers when it is time to reorder. The Company continues to seek opportunities to expand its presence within highly trafficked content sites.

Direct-Mailing. The Company uses direct-mail to advertise its products to selected groups of consumers. The Company utilizes mailing lists obtained from both private and public sources to target its advertisements specifically to contact lens wearers.

Cooperative Mailings. The Company advertises its products in cooperative mail programs sponsored by the leading cooperative mail companies in the United States. This advertising medium permits the Company to target consumers in specific zip codes according to age, income and other important demographics.

ClearLab International markets its products internationally and is expected to market ClearLab UK products in 2004. Based on previous test marketing, the Company believes that its customers are receptive to an offer from the Company to try both a new product and a new eye care practitioner. The Company believes that a more active role in the product/provider decision may help it address the policies of certain manufacturers that continue to refuse to sell their brands to the Company and seek to sell their brands exclusively to eye care practitioners. The Company also believes that by educating consumers as to specific eye care practitioners anti-consumer activities - and as appropriate, recommending more consumer focused eye care practitioners - that it can influence the consumer decision making process which will directly affect overall practices in the industry. The Company s first preference is to sell to the customer the lens she is already wearing. In cases where manufacturers or eye care practitioners stand in the way of the customer s choice to purchase from the Company, the Company will be able to offer the customer the opportunity to try an alternative eye care provider and an alternative product.

ClearLab International s customers include various international contact lens manufacturers and distributors. ClearLab International currently manufactures frequent replacement disposable lenses for one of the leading contact lens manufacturers.

Operations

Direct Marketing

The primary components of the Company s direct marketing operations include its teleservices, order entry, Internet order taking, prescription verification, doctor referral network, customer service and distribution and fulfillment.

Teleservices, Order Entry, Internet Order Taking and Customer Service. The Company provides its customers with toll-free telephone access to its Customer Service Representatives (CSRs). The Company s call center generally operates from 6:00 a.m. to 10:00 p.m. (MST) Monday through Thursday, 6:00 a.m. to 9:00 p.m. (MST) on Friday, 7:00 a.m. to 9:00 p.m. (MST) on Saturday and 8:00 a.m. to 4:00 p.m. (MST) on Sunday. Customers may place orders via the Internet 24 hours a day, 7 days a week. Potential customers may also obtain product, pricing or other information over the Internet or through an interactive voice response system. The Company s orders are received by phone, Internet, mail, facsimile and electronic mail. CSRs process orders directly into the Company s proprietary management information systems, which provide customer order history and information, product specifications, product availability, expected shipping date and order number. CSRs are provided with a sales script and are trained to provide information about promotional items. Additionally, CSRs are trained to provide customer service and are authorized to resolve all customer service issues, including accepting returns and issuing refunds, as appropriate.

The Company believes its customers are particularly sensitive to the way merchants and salespeople communicate with them. The Company strives to hire energetic, service-oriented CSRs who can understand and relate to customers. CSRs participate in an extensive training program. The Company also has a quality assurance department. This department monitors and reviews the CSRs performance and coaches the CSRs as necessary.

The Company continually upgrades and enhances its management information systems. The Company believes its management information systems have the capacity to handle up to 30,000 calls per day. The Company s CSRs currently handle approximately 8,000 calls per day.

Prescription Verification. The sale and delivery of contact lenses are governed by both federal and state laws and regulations, including the recently enacted federal Fairness to Contact Lens Consumer Act (FCLCA). The FCLCA requires that contact lenses only be sold to consumers based on a valid prescription. Satisfying this prescription requirement obligates the seller either to obtain a copy of the prescription itself or to verify the prescription by direct communication with the customer s prescriber. Consistent with this requirement, the Company s current operating practice is to require all customers to provide either a valid copy of their prescription or the contact information for their prescriber so that the Company can verify their prescription by direct communication with their prescriber. If the Company does not have a valid copy of the customer s prescription, the Company directly communicates to the customer s prescriber the precise prescription information received from the customer and informs the prescriber that it will proceed with the sale based on this prescription information unless the prescriber advises it within eight business hours that such prescription information is expired or otherwise invalid. If the prescriber properly advises the

Company within this time period that the customer s prescription is expired or otherwise invalid, the Company s practice is to cancel the customer s order. On the other hand, if the prescriber either advises the Company that the prescription is valid or fails to properly respond within the communicated time period, the Company s practice is to complete the sale based on the prescription information communicated to the prescriber, as expressly permitted by the FCLCA. The Company retains copies of the written prescriptions that it receives and maintains records of its communications with the customer s prescriber. The Company believes that it is complying with the regulations of the new federal Act. See Government Regulation .

Internet. The Company s principal websites, www.contacts.com and www.1800contacts.com, provide customers with a quick, efficient and cost-effective source for obtaining replacement contact lenses 24 hours a day, 7 days a week. The Company is continually upgrading the content and functionality of its website. The website allows customers to easily browse and purchase substantially all of the Company s products, promotes brand loyalty and

encourages repeat purchases by providing an inviting customer experience. The Company has designed its website to be fast, secure and easy to use and to enable its customers to purchase products with minimal effort. The Company also offers Internet customers services such as free shipping, shipping confirmation and online order tracking. During the call center s operating hours, the Company offers service and support to its Internet customers over the telephone. The Company also provides e-mail support to customers 24 hours a day, 7 days a week. The Company s website allows customers to dispense with providing personal profile information after their initial order. The website has permitted the Company to expand its customer base through better service while reducing transaction costs.

The Company s online service automates the processing of customer orders, interacts with the management information systems and allows the Company to gather, store and use customer and transaction information in a comprehensive and cost-efficient manner. The Company s website contains customized software applications that interface with the Company s management information systems.

The Company maintains a database containing information compiled from customer profiles, shopping patterns, sales data and eye care practitioner prescribing habits. The Company analyzes information in this database to develop targeted marketing programs and provide personalized and enhanced customer service. This database is scaleable to permit large transaction volumes. The Company s systems support automated e-mail communications with customers to facilitate confirmations of orders, provide customer support, obtain customer feedback and engage in targeted marketing programs.

The Company uses a combination of proprietary and industry-standard encryption and authentication measures designed to protect a customer s information. The Company maintains an Internet firewall to protect its internal systems and all credit card and other customer information.

Doctor Referral Network. The company has a referral agreement with Cole National and select independent practitioners nationally. When a customer s prescription is found to be invalid or expired, the Company can now facilitate the process of obtaining an eye examination. This process minimizes the interruptions in product consumption for the consumer and improves the Company s ability to retain its customers.

Distribution and Fulfillment. Approximately 95% of the Company s orders are shipped within one business day of receipt and verification of prescriptions. Customers generally receive orders within one to five business days after shipping, depending upon the method of delivery chosen by the customer. A shipping and handling fee is generally charged on each customer order, except those orders received via the Internet and those received by mail with an enclosed check. Customers have the option of having their order delivered by overnight courier for an additional charge. The Company s management information systems automatically determine the anticipated delivery date for each order.

The Company uses an integrated packing and shipping system via a direct connection to the Company s management information systems. This system monitors the in-stock status of each item ordered, processes the order and generates warehouse selection tickets and packing slips for order fulfillment operations. The Company s management information systems are specifically designed with a number of quality control features to help ensure the accuracy of each order.

The Company s distribution center is approximately 84,000 square feet and is strategically located near the Salt Lake City, Utah international airport.

Customer Service

On June 30, 2003, the Company and Cole National Corporation (Cole) announced that they had signed an agreement under which the Company s customers can receive discounted eye exams and value pricing on eyeglasses, sunglasses and other vision products that the Company does not sell from a network of doctors contracted with Cole Managed Vision and associated with more than 1,500 Pearle Vision, Pearle VisionCare, Sears Optical and Target

Optical stores in the U.S. Cole will offer its network of doctors for at least one year. The Company will retain the contact lens business of customers referred to Cole stores.

As part of the agreement, the Company and Cole are also working together on a variety of cross-marketing programs and promotions of their respective products in select test markets. The goal of these cross-marketing programs is to find other ways that the Company and Cole can help create value together.

The Company believes this is a unique offering for Internet, phone or mail order companies, allowing it to recapture customer orders that would otherwise need to be cancelled under Federal law.

Manufacturing

Prior to the acquisition of ClearLab UK, all of ClearLab International s products were manufactured in one production facility located in Singapore. See Properties. This facility currently has the capacity to produce in excess of 40 million lenses annually and is operating at approximately 40 to 45 percent of capacity. ClearLab International manufactures its soft contact lenses by way of injection cast molding of plastic molds in which it doses various polymers. This process yields dry lenses which are then hydrated to their final wet state in order to become a complete lens. ClearLab International also has the ability to wet cast mold lenses. In wet cast molding, the lenses are formed fully hydrated. With the acquisition of ClearLab UK, the Company has added an additional production facility in the UK. The Company will have the capability to develop and manufacture daily contact lenses in this facility using a unique proprietary process.

Management Information Systems

The Company has developed proprietary management information systems that integrate the Company s order entry and order fulfillment operations. The Company is continually upgrading and enhancing these systems and believes that these systems enable it to operate efficiently and provide enhanced customer service. The key features of these management information systems are their ability to: (i) process numerous types of orders, including telephone, Internet and others; (ii) continually monitor and track the Company s inventory levels for substantially all of its products; (iii) rapidly process credit card orders; (iv) increase the speed of the shipping process with integrated and automated shipping functions; (v) increase accuracy through the scanning of each order prior to shipment to ensure it contains the correct quantity and type of lenses and (vi) communicate directly with eye care provider s offices to accurately verify contact lens prescriptions.

The management information systems provide the Company s CSR with real-time product availability information for substantially all of its products through a direct connection with the Company s distribution center, whereupon information is immediately updated as lenses are shipped. In addition, Internet customers can obtain real-time product availability information for many products. The management information systems also have an integrated direct connection for processing credit card payments which allows the CSR to ensure that a valid card number and authorization have been received in approximately five seconds while the CSR is on the phone with the customer. CSRs also have access to records of all prior contact with a customer, including the customer s address, prescription information, order history and payment history and notes of any prior contact with the customer made by phone, Internet, e-mail, mail or fax. Based on product availability provided by the management information systems, the CSR provides the customer with an estimated date of delivery of their lenses. If a customer s order will not be shipped by the promised delivery date, the management information systems notify the CSR who entered the order and provide any information explaining the delay, and the CSR contacts the customer to inform them of the delay.

After an order has been entered into the management information systems either by a CSR or directly by a customer through the company s order entry system on its internet website, it is sent through the Company s verification process to attempt to confirm the validity of the prescription. Once it is verified or the verification hold time has elapsed (see Government Regulations section) it is sent to the Company s distribution center via a direct connection. If the prescription is expired or determined to be invalid during the verification process, the order is then cancelled and the customer s information is made available to the Company s national doctor network department to

inform the customer of the cancellation. At this time one of the Company s doctor network specialists offers to assist the customer by referring the customer to a Cole National or independent doctor within its national doctor referral network, which includes independent eye care practitioners as well as those participating in the Cole agreement, and provides the customer with promotional offers which includes an offer for a discounted eye exam.

After the distribution center receives an order, the invoice for the order is printed and the customer s credit card is charged, if applicable. The invoice for each order contains the type and quantity of the lenses, as well as a shipping label for the order. Tracking, manifesting, billing and other shipping functions are integrated into the Company s management information systems so that all necessary bar codes and tracking information for shipment via independent couriers are printed directly on the Company s shipping label, and separate labeling or a separate computer is not needed to ship packages via independent couriers.

After the invoice for an order is printed at the Company s distribution center, the order is pulled from inventory and scanned to ensure that the prescription and quantity of each item matches the order in the Company s management information systems. Audible notices inform the shipping agent of any errors in the order. After the order has been scanned for accuracy, the management information systems update the Company s inventory level. Then the order is placed in a box folded by the Company s automated box folder and is sent to an automatic sealer. After the package leaves the sealer, another scanner reads the bar code on the shipping label to determine which method of shipment is being used, adds the package to the appropriate carrier s manifest and directs the appropriate hydraulic diverter to push the package into the appropriate carrier s shipping bin.

The Company has installed a battery powered back-up system capable of supporting its entire call center, computer room and phone switch. This system is further protected by a generator capable of supporting the Company s call center operations for a period of five days. All critical data is simultaneously written to a series of back-up drives throughout the day and at the end of the day the Company s data is transmitted to various offsite locations as well as an onsite fireproof safe. There can be no assurance that the Company s back-up system will be sufficient to prevent an interruption in the Company s operations in the event of disruption in the Company s management information systems, and an extended disruption in the management information systems could adversely affect the Company s business, financial condition and results of operations.

Purchasing and Principal Suppliers

Until recently, substantially all of the major manufacturers of contact lenses refused to sell lenses to direct marketers, including the Company, and sought to prohibit their distributors from doing so. After opening direct accounts with Ciba Vision and Bausch and Lomb, the Company began buying directly from Johnson & Johnson Vision Care during March 2003. Currently, Ocular Sciences is the only remaining major manufacturer who refuses to sell directly to the Company. Historically, the Company has purchased a substantial portion of its products from unauthorized distributors, but currently the Company purchases the majority of its products directly from the manufacturers with the exception of all Ocular Sciences products and select CooperVision products. The purchases from unauthorized distributors are expected to decrease in the future as the Company expands its purchasing relationships in the industry and as Federal regulatory authorities analyze the business practices of manufacturers which refuse to sell to direct marketing companies.

As a result of some manufacturers refusal to sell to the Company, the Company is not an authorized dealer for some of the products it sells. In addition, the Company believes that the price which it pays for certain products is sometimes higher than those paid by eye care practitioners, retail chains and mass merchandisers, who are able to buy directly from the manufacturers of such lenses and who benefit from being allowed to participate in cooperative advertising funds, coupon, sample, rebate and other marketing and promotional programs. Although the Company has been able to obtain most contact lens brands at competitive prices in sufficient quantities on a regular basis, there can be no assurance that the

Company will not encounter difficulties in the future. The inability of the Company to obtain sufficient quantities of contact lenses at competitive prices would have a material adverse effect on the Company s business, financial condition and results of operations.

Although the Company seeks to reduce its reliance on any one supplier by establishing relationships with a number of distributors, manufacturers and other sources, the Company acquired from a single distributor approximately 46 percent, 35 percent and 23 percent of its contact lenses purchased in fiscal 2001, 2002 and 2003, respectively. The Company s top three suppliers accounted for approximately 70 percent, 63 percent and 59 percent of the Company s inventory purchased in fiscal 2001, 2002 and 2003, respectively. The Company continually seeks to establish new relationships with potential suppliers in order to obtain adequate inventory at competitive prices. In the event that these suppliers could no longer supply the Company with contact lenses, there can be no assurance that the Company could secure other adequate sources of supply, or that such supply could be obtained on terms no less favorable to the Company than its current supply, which could adversely affect the Company by increasing its costs or, in the event adequate replacement supply cannot be secured, reducing its net sales. In that regard, the Company does not have any contracts with manufacturers or distributors of contact lenses which provide for an absolute guarantee of supply to the Company.

During the latter part of 2003, the Company reached agreements with its top three vendors for improved pricing and marketing support. This support will come in the form of cooperative marketing and proprietary rebate programs designed to promote the manufacturer s products and build sales. The Company believes it is one of the largest U.S. customers for the three largest contact lens manufacturers.

ClearLab International has developed a new brand of contact lenses that is expected to provide the Company increased control of inventory and the flexibility with which to make a variety of offers to its customers and to enhance its capability to provide high quality, cost-effective products. These manufacturing capabilities also provide the Company with greater access to contact lens products for future distribution in the U.S. should the Company s access to contact lenses from the major contact lens manufacturers be disrupted, curtailed or otherwise negatively impacted, or if the manufacturers do not provide the Company with contact lenses at competitive pricing and with competitive marketing support**.**

Competition

The retail sale of contact lenses is a highly competitive and fragmented industry. Traditionally, contact lenses were sold to customers almost exclusively by eye care practitioners in connection with providing them an eye examination. Competition for patients and the revenue related to providing contact lenses to those customers significantly increased as optical chains and large discount retailers began providing optical services and has further intensified with the entry of direct marketers such as the Company. The Company believes that the eye care profession suffers from a surplus of eye care practitioners and that the resulting competitive pressure has been exacerbated by the increased prevalence of retail optical chains, mass merchandisers and direct marketers. Consequently, the competition amongst eye care practitioners to acquire customers and the competition to provide replacement lenses to such customers has intensified. To a lesser extent, the Company also competes with manufacturers of eyeglasses and providers of other vision correction, including refractive surgical procedures.

The Company s principal competitors include ophthalmologists and optometrists in private practice. The Company also competes with national optical chains, such as Cole Vision, LensCrafters and National Vision Association and mass merchandisers, such as Wal-Mart, Sam s Club and Costco. In addition, the Company competes with other direct marketers of contact lenses. The Company may face increased competition in the future from new entrants in the direct marketing business, which may include national optical chains and mass merchandisers, some of which may have significantly greater resources than the Company.

The Company believes that many of its competitors, including most eye care practitioners, national optical chains and mass merchandisers, have direct supply arrangements with contact lens manufacturers which in some cases afford those competitors with better pricing terms, access to supply and other sales and marketing programs. In addition, some of the competitors are significantly larger in overall revenues and have significantly greater resources than the Company. The Company believes that the principal elements of competition in the industry include

price, product availability, customer service and consumer awareness.

In addition, the manufacturing of contact lenses is highly competitive. With respect to its manufacturing operations, the Company faces competition from other contact lens manufacturers such as Johnson & Johnson Vision Care, CIBA Vision, Bausch & Lomb, Ocular Sciences and CooperVision. Most of the Company s competitors have substantially greater resources to invest in product development and customer support, and greater access to financial and other resources than the Company.

Government Regulation

Direct Marketing

Federal Regulation

Contact lenses are regulated by the Food and Drug Administration (FDA) as medical devices. The FDA classifies medical devices as Class I, Class II or Class III and regulates them to varying degrees, with Class I medical devices subject to the least amount of regulation and Class III medical devices subject to the most stringent regulations. Rigid gas permeable and soft contact lenses are classified as Class II medical devices if intended only for daily wear and as Class III medical devices if intended for extended wear. These regulations generally apply only to the manufacturing of contact lenses, and therefore do not directly impact the direct marketing operations of the Company. Federal regulations also require the labels on medical devices to contain adequate instructions for their safe and proper use. However, there is an exemption from this requirement for medical devices the use of which is not safe except under the supervision of a practitioner licensed by law to direct the use of such device. Devices which fall within this exception must contain as part of their labeling the statement Caution: Federal law restricts this device to sale by or on the order of (physician or other licensed practitioner), the blank to be filled in with the word physician or other practitioner authorized by the law of the state in which the practitioner practices to use or order the use of the device. The FDA considers contact lenses to qualify for this labeling exemption; however, a device bearing this legend that is dispensed without a prescription may be considered misbranded by the FDA. Potential penalties for misbranding include warning letters from the FDA, seizure, injunction, civil penalties, or prosecution. To date, the FDA has not taken any such action against the Company.

In November 2003, Congress passed the Fairness to Contact Lens Consumer Act (FCLCA) which establishes a national uniform standard for both eye care practitioners and direct marketers with regard to releasing and verifying consumer contact lens prescriptions as well as other requirements relating to the sale of contact lenses. The FCLCA became effective February 4, 2004, and now requires all eye care practitioners to give patients a copy of their prescription as soon as they have been fitted for contact lenses, whether the patients ask for it or not. It also requires all eye care practitioners to respond to direct marketers requests to verify consumer prescriptions and provides that their failure to respond within eight business hours shall result in the prescription being presumed valid, thereby eliminating the ability of eye care practitioners to impede sales by direct marketers simply by ignoring or refusing to respond to their requests to verify prescriptions The FCLCA also provides that prescriptions will be valid for a minimum of at least one year (absent some special medical reason justifying a shorter period) and that the time for expiration shall not begin to run until the eye care practitioner has given the patient a copy of his or her prescription. It also directs the Federal Trade Commission (FTC) to promulgate implementing rules and to conduct a study examining the strength of competition in the market for contact lenses and to submit a report to Congress within twelve months. This FTC study will specifically address, among other things, the use of doctor exclusive brands (i.e., contact lenses available only for sale from an eye care practitioner) and other practices that impede competition.

The FCLCA also requires that contact lenses only be sold to consumers based on a valid prescription. Satisfying this prescription requirement obligates the seller either to obtain a copy of the prescription itself or to verify the prescription by direct communication with the customer s prescriber. Consistent with this requirement, the Company s current operating practice is to require all customers to provide either a valid copy of their prescription or the contact information for their prescriber so that the Company can verify their prescription by direct communication

with their prescriber. If the Company does not have a valid copy of the customer s prescription, the Company directly communicates to the customer s prescriber the precise prescription information received from the customer and

informs the prescriber that it will proceed with the sale based on this prescription information unless the prescriber advises it within eight business hours that such prescription information is expired or otherwise invalid. If the prescriber properly advises the Company within this time period that the customer s prescription is expired or otherwise invalid, the Company s practice is to cancel the customer s order. On the other hand, if the prescriber either advises the Company that the prescription is valid or fails to respond properly within the required time period, the Company s practice is to complete the sale based on the prescription information communicated to the prescriber, as expressly permitted by the FCLCA. The Company retains copies of the written prescriptions that it receives and maintains records of its communications with the customer s prescriber.

The Company believes that the FCLCA eliminates much of the previous legal risk and uncertainty associated with numerous differing and often ambiguous or archaic state laws and regulations that had previously governed the sale of contact lenses. In addition, as eye care practitioners begin to automatically release contact lens prescriptions to their patients (as required by the FCLCA) the Company expects that it will be easier for consumers to send a copy of their prescription to the Company and that more consumers will become aware of their option to purchase contact lenses from the Company rather than their prescriber. At the same time, the Company anticipates that its adherence to the FCLCA s new requirements nationwide will result in it canceling a greater portion of its customers orders due to their prescriptions being expired or otherwise invalid. The Company s net sales for fiscal 2003 were negatively impacted by canceled orders due to the prescription verification procedures implemented as part of its agreement with Johnson & Johnson Vision Care (the Johnson & Johnson Vision Care Agreement). Since the FCLCA s prescription verification requirements closely resemble those of its Johnson & Johnson Vision Care Agreement, the Company expects that there will be a similar impact on its non-Johnson & Johnson Vision Care orders.

State Regulation

Although the FCLCA overrides state laws or regulations that purport to impose stricter prescription verification procedures on direct marketers or that otherwise conflict with the general purposes and objectives of the FCLCA, the sale and delivery of contact lenses to consumers may also be subject to limited regulation by the state where the customer is located. For example, a substantial number of states require that contact lenses only be sold by persons licensed or registered to do so under that state s laws. A dispenser may be required to be licensed as an eye care professional (i.e., optometrist, ophthalmologist or optician) or to be licensed or registered as a contact lens seller depending on the requirements of the particular state in which the customer is located. Such state laws or regulations may or may not run afoul of the FCLCA or other federal or constitutional requirements depending on their particular provisions. Neither the Company nor any of its employees is a licensed eye care professional in many of the states in which the Company does business.

Any action brought against the Company based on its failure to comply with applicable state laws and regulations could result in significant fines to the Company, the Company being prohibited from making sales in a particular state, the Company being required to comply with such laws or could constitute a misdemeanor. Such required compliance could result in: (i) increased costs to the Company; (ii) the inability to sell to customers at all in a particular state if the Company cannot comply with such state s laws and (iii) misdemeanor penalties and civil fines. The occurrence of any of the above results could have a material adverse effect on the Company s ability to sell contact lenses and to continue to operate profitably. The Company has not obtained an opinion of counsel with regard to its compliance with all applicable state laws and regulations or the enforceability of such state laws and regulations, and information contained herein regarding the Company s compliance with applicable state laws and regulations should not be construed as being based on an opinion of counsel. The Company has in the past, and intends in the future, to vigorously defend any actions brought against it.

From time to time the Company receives notices, inquiries or other correspondence from states or their regulatory bodies charged with overseeing the sale of contact lenses. The Company s practice is to review such notices with legal counsel to determine the appropriate response

on a case-by-case basis.

It is the opinion of management, after discussion with legal counsel, that the Company has formulated an appropriate policy, and as needed, takes appropriate steps to address the various notices it has received or may in the future receive. See Legal Proceedings for formal complaints filed against the Company concerning its business practices.

Manufacturing

The Company s products are generally regulated in the United States and in foreign countries as medical devices. As a manufacturer of medical devices, the Company is subject to regulation in the United States by the FDA and corresponding state and foreign regulatory agencies where the Company sells products. These regulations generally govern the introduction of new medical devices, the maintenance of certain records, the labeling of devices and other matters. The regulatory environment in which the Company operates can be expensive, time-consuming and uncertain.

FDA Regulation

Pursuant to the Federal Food, Drug, and Cosmetic Act (FDC Act), and implementing regulations, the FDA regulates the testing, manufacturing, labeling, distribution, and promotion of medical devices. Noncompliance with applicable requirements can result in, among other things, fines, injunctions, civil penalties, recall or seizure of products, total or partial suspension of product distribution, failure of the government to grant premarket clearance or approval for devices, withdrawal of marketing clearances or approvals, and criminal prosecution. The FDA also has the authority to request the recall, repair, replacement or refund of the cost of any device manufactured or distributed by the Company.

Under the FDC Act, clearance or approval by the FDA is required prior to the commercialization of a medical device. The FDA classifies medical devices as Class I, Class II or Class III, depending on the nature of the medical device and the existence in the market of any similar devices. The nature of the clearance or approval procedures is dependent on the classification of the medical device in question. Class I medical devices are subject to general controls, including labeling, premarket notification and adherence to the FDA s quality systems regulations governing all medical device manufacturing. Class II medical devices are subject to general and special controls, including performance standards, postmarket surveillance, patient registries and FDA guidelines. Class III medical devices are those which must receive premarket approval by the FDA to ensure their safety and effectiveness, are generally life-sustaining, life-supporting devices or implantable devices or new devices which have been found not to be substantially equivalent to currently marketed medical devices.

Before a new device can be introduced into the U.S. market, it must receive from the FDA premarket notification clearance under Section 510(k) of the FDC Act or premarket approval pursuant to the more costly and time-consuming premarket approval application (PMA) procedure. The FDA grants a 510(k) clearance if the submitted information establishes that the proposed device is substantially equivalent to a legally marketed Class I or Class II medical device or a Class III medical device for which the FDA has not called for PMAs. For any devices that are cleared through the 510(k) process, modifications or enhancements that could significantly affect safety or effectiveness, or constitute a major change in the intended use of the device, will require new 510(k) submissions. While less expensive and time-consuming than obtaining PMA clearance, securing 510(k) clearance may involve the submission of a substantive review of six months or more. Any products manufactured or distributed pursuant to 510(k) clearance are subject to pervasive and continuing regulation by the FDA, including record keeping requirements and reporting of adverse experience with the use of the device.

Most of Clearlab International s products have 510(k) clearance and any new products under development, including ClearLab UK s, to be marketed in the United States will undergo clinical studies to support a 510(k) or PMA. There is no certainty that clinical studies involving new products will be completed in a timely manner or that the data and information obtained will be sufficient to support the filing of a PMA or 510(k) clearance. The Company cannot assure that it will be able to obtain necessary clearances and approvals to market new devices or any other

products under development on a timely basis, if at all, and delays in receipt or failure to receive such clearances or approvals, the loss of previously received clearances, or failure to comply with existing or future regulatory requirements could have a material adverse effect on the Company s business, financial condition and results of operations.

As a manufacturer of medical devices, ClearLab International is required to register with the FDA and comply with the FDA s Code of Federal regulations quality system requirements. These regulations require that ClearLab International manufacture products and maintain manufacturing, testing and control activities records in a prescribed manner, and maintain careful records of, and control over, device design development. Further, ClearLab International and the Company are required to comply with FDA requirements for labeling and promoting products. ClearLab International is subject to periodic inspections by the FDA and can be subjected to a number of regulatory actions if the FDA finds ClearLab International to be not in compliance with applicable laws and regulations. If the FDA believes that ClearLab International may not be operating in compliance with applicable laws and regulations, it can record its observations on a Form FDA 483; place ClearLab International under observation and re-inspect the facilities; institute proceedings to issue a warning letter apprising of violative conduct; detain or seize products; mandate a recall; enjoin future violations; and assess civil and criminal penalties against ClearLab International, its officers or its employees. In addition, in appropriate circumstances, the FDA could withdraw clearances or approvals. Failure to comply with regulatory requirements or any adverse regulatory action could have a material adverse affect on ClearLab International and the Company.

Manufacturers of medical devices for marketing in the United States also must comply with medical device reporting (MDR) requirements that companies report to the FDA any incident in which its product may have caused or contributed to a death or serious injury, or in which its product malfunctioned and, if the malfunction were to recur, it would be likely to cause or contribute to a death or serious injury. Labeling and promotional activities are subject to scrutiny by the FDA. Current FDA enforcement policy prohibits the marketing of approved medical devices for unapproved uses.

ClearLab International is subject to routine inspection by the FDA for compliance with quality systems requirements, MDR requirements, and other applicable regulations. The Company cannot assure that it will not incur significant costs to comply with laws and regulations in the future or that laws and regulations will not have a material adverse effect upon the Company s business, financial condition or results of operation. The Company believes that all of its products offered for sale have received all required FDA approvals or clearance, and that it is in substantial compliance with FDA regulations, including quality systems and MDR requirements.

International Regulation

ClearLab International s products also are subject to regulation in other countries in which its products are sold. The laws and regulations of such countries range from comprehensive medical device approval procedures such as those described above to simple requests for product data or certifications. The number and scope of these laws and regulations are increasing. In particular, medical devices in the EU are subject to the EU s medical devices directive (the Directive).

Under the system established by the Directive, all medical devices other than active implants and in vitro diagnostic products currently must qualify for CE marking. CE marking means the manufacturer certifies that its product bearing the CE mark satisfies all requirements essential for the product to be considered safe and fit for its intended purpose.

In order to qualify for CE marking, the manufacturer must comply with the Essential Requirements of the Directive, relating to the safety and performance of the product. In order to demonstrate compliance, a manufacturer is required to undergo a conformity assessment, which includes assessment of the manufacturer s quality assurance system by self-selected certification organizations referred to as a Notified Body. After all necessary conformity assessment tests have been completed to the satisfaction of the Notified Body and the manufacturer is convinced that it is in full compliance with the Directive, CE marking may be affixed on the products concerned. ClearLab

International has undergone such conformity assessment and has received CE marking authorization for all products that it currently markets in the EU.

Although member countries must accept for marketing medical devices bearing a CE marking without imposing further requirements related to product safety and performance, each country may require the use of its own language or labels and instructions for use. National Competent Authorities who are required to enforce compliance with the requirements of the Directive, can restrict, prohibit and recall CE-marked products if they are unsafe. Such a decision must be confirmed by the European Commission in order to be valid. Member countries can impose additional requirements as long as they do not violate the Directive or constitute technical barriers to trade.

Additional approvals from foreign regulatory authorities may be required for international sale of the Company s products in non-EU countries. Failure to comply with applicable regulatory requirements can result in the loss of previously received approvals and other sanctions and could have a material adverse effect on the Company s business, financial condition and results of operations.

Intellectual Property

The Company conducts its business under the trade name and service marks 1-800 CONTACTS. The Company has taken steps to register and protect these marks and believes that such marks have significant value and are an important factor in the marketing of its products. To this end, the Company has secured trademark registration for the 1-800 CONTACTS name. The Company owns the right to use the 1-800 CONTACTS telephone number. However, under applicable FCC rules and regulations, the Company does not have and cannot acquire any property rights to the telephone number. The Company does not expect to lose the right to use the 1-800 CONTACTS number; however, there can be no assurance in this regard. The loss of the right to use the 1-800 CONTACTS number would have a material adverse effect on the Company s business, financial condition and results of operations. In addition, the Company has obtained the rights to international equivalents for the 1-800 CONTACTS phone number; however, like the 1-800 CONTACTS number, the Company does not have and cannot acquire any property rights in these telephone numbers.

The Company also has obtained the rights to various Internet addresses, including but not limited to www.1800contacts.com, www.contacts.com and www.contactlenses.com. As with phone numbers, the Company does not have and cannot acquire any property rights in Internet addresses. The Company does not expect to lose the ability to use the Internet addresses; however, there can be no assurance in this regard and such loss would have a material adverse effect on the Company s business, financial position and results of operations.

The Company has certain intellectual property rights, including patents important to the operations of ClearLab International and ClearLab UK and various other patent applications relating to contact lenses and the manufacturing of contact lenses.

Employees

As of January 3, 2004, the Company had 819 full-time and part-time employees, including 600 in the United States and 219 in Singapore. None of the Company s employees are covered by a collective bargaining agreement. The Company believes its relationship with its employees to be good.

Item 2. **Properties.**

The Company s headquarters and call center operations are located in approximately 77,000 square feet of leased space located in Draper, Utah, a suburb of Salt Lake City. The operating leases relating to these facilities expire in 2009.

The Company s distribution center is approximately 84,000 square feet and is located near the Salt Lake

City, Utah international airport. The operating lease term for the distribution center has been extended through December 2005.

The ClearLab International manufacturing facility is located in Singapore. All manufacturing activities are conducted in approximately 110,000 square feet of space at this location of which approximately half is used for operations. ClearLab International leases a portion of the building to other tenants. The Company has a leasehold interest in the building with approximately 17 years remaining.

Item 3. **Legal Proceedings.**

On April 7, 1999, the Kansas Board of Examiners in Optometry (KBEO) commenced a civil action against the Company. The action was filed in the District Court of Shawnee County, Kansas, Division 6. The complaint was amended on May 28, 1999. The amended complaint alleges that on one or more occasions the Company sold contact lenses in the state of Kansas without receipt of a prescription. The amended complaint seeks an order enjoining the Company from further engaging in the alleged activity. The amended complaint does not seek monetary damages. The Company filed an answer to the amended complaint and, at the request of the Court, filed a motion for summary judgment. In November 2000, the Court issued an order denying the summary judgment motion, finding that there were factual issues regarding whether the KBEO can meet the requirements necessary to obtain injunctive relief, and whether the Kansas law violates the Commerce Clause of the United States Constitution. On June 18, 2002, the court granted a summary judgment motion in favor of the KBEO. However, the court made no findings of any violations of Kansas law. Further, the court based its decision on a Kansas optometry law that has been repealed and amended by the Kansas legislature. To preserve the issues for appeal, on July 2, 2002, the Company filed a motion to alter or amend judgment, asking the court to reverse its decision, and to enter summary judgment in favor of defendant, or to dismiss the KBEO s lawsuit as moot based on the new law. The court denied the motion on September 12, 2002, finding that no new evidence had been presented to persuade the court to change its prior ruling. The court made no new findings of fact and did not change its conclusions of law. On October 11, 2002, the Company filed its Notice of Appeal with the Kansas Court of Appeals; the Docketing Statement was filed on October 30, 2002. All pleadings were timely filed and an oral argument was held on August 27, 2003. On November 7, 2003, the Kansas Court of Appeals reversed the trial court s order that entered summary judgment in favor of the Board. The Appellate court remanded the case back to the trial court for further proceedings. Thus, as a result of the Appellate court s order, there is no injunction against the Company, and the matter is again pending before the trial court. The parties have each submitted proposed orders to the trial court. The Board has asked the court to re-enter summary judgment in its favor, and to reinstate the injunction. The Company has asked the court to dismiss the case, based either on the lack of any basis for injunctive relief, or because the case is now moot based on changes to Kansas law which took effect while the case was pending on appeal, or based on the recent passage of the FCLCA which took effect on February 4, 2004. As of the date of this summary, the trial court has made no ruling, and the case remains pending.

From time to time the Company is involved in other legal matters generally incidental to its business.

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

Item 4. **Submission of Matters to a Vote of Security Holders.**

No matters were submitted to a vote of the Company s security holders in the fourth quarter of fiscal 2003.

Item 4A. **Executive Officers of the Registrant.**

The information under this Item is furnished pursuant to Instruction 3 to Item 401(b) of Regulation S-K. Executive officers of the Company are elected by and serve at the discretion of the Board of Directors.

Name	Age	Position
Jonathan C. Coon	34	Chief Executive Officer and Director
Brian W. Bethers	44	President and Chief Financial Officer
John F. Nichols	43	Vice President, Trade Relations and Director
Kevin K. McCallum	42	Senior Vice President, Marketing and Sales
Robert G. Hunter	37	Vice President, Finance and Treasurer
R. Joe Zeidner	38	Chief Legal Officer and Secretary
S. Todd Witzel	33	Chief Information Officer
Graham Mullis	41	President and Managing Director of ClearLab International
David M. Saylor	44	Vice President, Operations
Steve Newman	47	Chief Technology Officer of ClearLab International

Jonathan C. Coon is a co-founder of the Company and has served as Chief Executive Officer and Director of the Company since its founding in 1995. Mr. Coon received his Bachelor s Degree from Brigham Young University in 1994. Mr. Coon has over ten years of experience in the contact lens distribution industry.

Brian W. Bethers is President and Chief Financial Officer of the Company. He joined the company in 2003 from TAC Worldwide, a privately held technology staffing company in Dedham, Massachusetts where he served as Chief Financial Officer. Prior to TAC Worldwide, Mr. Bethers was Chief Financial Officer of SupplierMarket.com, where he led the company s financial expansion and SEC registration for an IPO prior to the company s sale to Ariba Corporation in 2000. Prior to this, Mr. Bethers was Chief Financial Officer of Host Marriott Services. He led the company s listing on the New York Stock Exchange in 1995 and sale in 1999. Mr. Bethers previously spent ten years at Marriott Corporation in various finance and development positions. He received both a Bachelor of Arts degree and MBA from Brigham Young University.

John F. Nichols is a co-founder of the Company and currently serves as Vice President, Trade Relations and Director. Prior to his current position, Mr. Nichols served as Vice President, Sales until March 2003. Mr. Nichols is a certified optician in the State of California and was the owner of the Discount Lens Club from 1991 until February 1995. Mr. Nichols worked with Bausch & Lomb as a Senior Sales Representative from 1989 to 1991.

Kevin K. McCallum has served as Senior Vice President, Marketing and Sales of the Company since 2003. Prior to his current position, Mr. McCallum served as Vice President, Marketing of the Company since March 2000. Prior to

joining the Company, Mr. McCallum, a 9-year veteran of Procter & Gamble from 1991 to 2000, served as a Director of Marketing for several of Procter & Gamble s global laundry and cleaning brands. Prior thereto, Mr. McCallum served as a line officer in the U.S. Navy from 1984 to 1989. Mr. McCallum received a Bachelor s Degree from the United States Naval Academy and an MBA from the Georgia Institute of Technology.

Robert G. Hunter has served as Vice President, Finance of the Company since 2000. Prior to the arrival of Mr. Bethers in 2003, Mr. Hunter served as Interim Chief Financial Officer for six months. Prior to becoming Vice President, Finance, Mr. Hunter served as the Corporate Controller since November 1997. Before joining the Company, Mr. Hunter served as an auditor with Hawkins, Cloward & Simister LC from November 1993 to 1997 and with Arthur Andersen LLP from April 1992 to November 1993. Mr. Hunter is a Certified Public Accountant. Mr. Hunter graduated *summa cum laude* with a Bachelor s Degree from Brigham Young University, where he also earned a Masters of Accountancy Degree.

R. Joe Zeidner has served as Vice President, Legal Affairs and Chief Legal Officer of the Company since 2003. Mr. Zeidner has served as the General Counsel of the Company since September 2000 and as the Corporate Secretary since February 2001. Prior to joining the Company, Mr. Zeidner served as regulatory General Counsel of Pharmanex, Inc., a Utah-based vitamin and supplement manufacturer and distributor, from 1998 to 2000. Prior to that, Mr. Zeidner served as Northeast Asia General Counsel of Nu Skin Japan and Nu Skin Korea and worked at Pfizer pharmaceutical from 1989 to 1991. Mr. Zeidner received a Bachelor s degree in Japanese and Communications from Brigham Young University and a law degree from the J. Reuben Clark School at Brigham Young University.

S. Todd Witzel has served as Chief Information Officer of the Company since 2003. Prior to his current position, Mr. Witzel served as both the Director of Information Technology and the Manager, Management Information Systems since joining the Company in November 1996. Before joining the Company, Mr. Witzel worked as a computer programmer for Access Software from 1992 to 1996.

Graham Mullis has served as President and Managing Director of ClearLab International since 2002. He also serves as Director of Clearlab Pte Ltd. He has more than 10 years experience in leading medical device businesses and 8 years in the contact lens industry. He was the Managing Director of Biocompatibles Hydron, and sold the business to CooperVision for $125 million. He launched the Proclear range of contact lenses at Biocompatibles, which is now a major product line for CooperVision , the fourth largest contact lens manufacturer in the world. He is leading the expansion of 1-800 CONTACTS overseas as well as leading Clearlab International. He has a bachelor s degree in Biochemistry & Physiology from Southampton University and an MBA from Warwick Business School.

David Saylor has served as Vice President of Operations since June 2003. Mr. Saylor joined the Company in 2003 from Sloan Valve Company, a privately held plumbing products manufacturer located in Franklin Park, Illinois, where he was Director of Operations. Previously, Mr. Saylor was Plant Manager for TRW Automotive, Jackson Michigan Plant, where he led a five-year expansion of that brake manufacturing facility, adoption of JIT/Lean Manufacturing and QS9000 quality certification. Prior to this, Mr. Saylor was Director of Program Management for VarityKelsey-Hayes. Mr. Saylor s experience includes 13 years of operations and manufacturing management and nearly 10 years in engineering. He received a Bachelor of Science, Metallurgical Engineering from Michigan Technological University in 1984.

Steve Newman is serving as Chief Technology Officer of Clearlab International. He has more than 25 years experience in the contact lens industry, specifically in the area of manufacturing and lens design. He holds numerous patents in the area of toricidal and spherical contact lens designs and their manufacturing methods. Prior to joining Clearlab International he was R&D Manager for Hydron Pty Ltd Australia, Director of Capricornia Australia, and recently Chief Executive Officer for Igel Visioncare Pte Ltd. He will lead all of the research and development activities for the Company.

There are no family relationships between any executive officer or director of the Company.

PART II

Item 5. **Market for Registrant s Common Equity and Related Stockholder Matters.**

Market Information

The Common Stock is traded on the Nasdaq National Market (Nasdaq) under the symbol CTAC. The Common Stock commenced trading on February 10, 1998. The following table sets forth the high and low closing sale prices per share for the Common Stock as reported by the Nasdaq for the periods presented:

	High	Low
Fiscal Year ended December 28, 2002:		
First Quarter	$ 12.48	$ 10.26
Second Quarter	15.25	10.90
Third Quarter	13.55	7.95
Fourth Quarter	27.28	8.31
Fiscal Year ended January 3, 2004:		
First Quarter	28.56	17.26
Second Quarter	26.58	20.19
Third Quarter	24.61	18.70
Fourth Quarter	23.00	19.67

Holders

As of March 3, 2004, there were approximately 81 holders of record of Common Stock. The Company believes that it has a significantly larger number of beneficial holders of Common Stock.

Dividends

The Company anticipates that all of its future earnings will be retained to finance the expansion of its business. Any future determination to pay dividends will be at the discretion of the Company s Board of Directors and will depend upon, among other factors, the Company s results of operations, financial condition, capital requirements and contractual restrictions. In addition, the Company s revolving credit facility prohibits the Company from paying any cash dividends on its Common Stock.

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Recent Sales of Unregistered Securities

On July 24, 2002, the Company acquired certain net assets and the majority of the business operations of IGEL, a developer and contract manufacturer of contact lenses based in Singapore. The acquisition was effected through a wholly owned subsidiary of the Company, IGEL Acquisition Co. Pte Ltd (subsequently renamed ClearLab International), and included the purchase of assets of Igel C.M. Laboratory Pte Ltd and International Vision Laboratories Pte Ltd, both subsidiaries of Igel Visioncare Pte Ltd, as well as certain other assets from Sinduchajana Sulistyo and Stephen D. Newman. The assets acquired included principally the long-term leasehold interests in the land and building where the manufacturing facility is located, as well as equipment, inventories, and certain intellectual property rights, including patents key to the operation of the acquired business.

The consideration paid by the Company consisted of approximately $6.6 million in cash (which includes $1.2 million in transaction costs), $8.9 million in assumed building and business loans to be paid over 7 years from the acquisition date, $0.7 million in assumed capital lease obligations, a non-interest bearing note payable of $2.1 million to be paid over 5 years from the acquisition date, 700,000 shares of restricted common stock of the Company, and 270,000 common stock options of the Company in three tranches of 90,000 each with exercise prices of $15, $25 and $35 per share, respectively.

The 700,000 shares of restricted common stock were placed in escrow, subject to a performance guarantee, and vest over a two-year schedule with no shares released from escrow for a minimum of one year from the acquisition date. On June 6, 2003, the performance guarantee was met relating to these shares and 175,000 shares were released on July 24, 2003, and 437,500 shares were released on January 24, 2004. The remaining 87,500 shares held in escrow will be released on July 24, 2004.

On January 30, 2003, the Company completed the acquisition of certain assets and the assumption of certain liabilities of Lens Express LLC and Camelot Ventures/CJ, L.L.C. d/b/a Lens 1st (collectively, the Seller), two leading U.S. mail order contact lens retailers. The assets acquired included databases, customer information, web sites and Internet addresses or domain names, telephone numbers, certain specified contracts and intellectual property rights. In addition, acquired assets included certain property, equipment, inventories, receivables and prepaid expenses. With the exception of specifically identified liabilities, the Company did not assume the liabilities of the Seller. The liabilities assumed by the Company included certain of the Seller s identified contracts, accounts payable, accrued liabilities, certain customer program obligations and severance obligations as of January 30, 2003. The consideration paid by the Company consisted of approximately $7.0 million in cash (including $0.5 million in transaction costs), 900,000 shares of restricted common stock of the Company with a fair value of $19.9 million and the assumption of approximately $4.1 million of the aforementioned liabilities. The 900,000 shares of restricted common stock are subject to a lock-up period of 12 months after the acquisition date of January 30, 2003. In connection with the acquisition, the Company entered into a registration rights agreement pursuant to which the Company granted the Seller certain piggyback registration rights with respect to the 900,000 shares of restricted common stock.

The shares and options related to these transactions were issued in reliance upon the exemption from registration provided in Section 4(2) of the Securities Act of 1933, as amended. In that regard, each of the sellers represented to the Company that he/it was an accredited investor as defined in Rule 501(a) of Regulation D promulgated under the Securities Act.

Item 6. **Selected Financial Data.**

The financial data as of and for the years ended January 1, 2000 (fiscal 1999), December 30, 2000 (fiscal 2000), December 29, 2001 (fiscal 2001), December 28, 2002 (fiscal 2002) and January 3, 2004 (fiscal 2003) have been derived from the consolidated financial statements of the Company. The selected financial data should be read in conjunction with the consolidated financial statements and the notes thereto of the Company and Management s Discussion and Analysis of Financial Condition and Results of Operations.

	Fiscal Year				
	1999	2000	2001	2002	2003
	(in thousands, except per share amounts)				
Statement of Operations Data:					
Net sales	$ 98,525	$ 144,971	$ 169,036	$ 168,580	$ 187,303
Cost of goods sold	59,416	86,367	103,093	118,181	116,873
Gross profit	39,109	58,604	65,943	50,399	70,430
Advertising expense	20,238	25,603	26,850	12,642	20,191
Legal and professional fees	454	870	2,838	4,738	6,352
Research and development				247	4,625
Purchased in-process research and development				7,789	
Other operating expenses	11,548	15,251	19,874	23,870	37,615
Total operating expenses	32,240	41,724	49,562	49,286	68,783
Income from operations	6,869	16,880	16,381	1,113	1,647
Other income (expense), net	(41)	198	(252)	(1,186)	(1,167)
Income (loss) before provision for income taxes	6,828	17,078	16,129	(73)	480
Provision for income taxes	(701)	(6,604)	(6,265)	(3,931)	(1,918)
Net income (loss)	$ 6,127	$ 10,474	$ 9,864	$ (4,004)	$ (1,438)
Basic net income (loss) per common share(1)	$ 0.49	$ 0.88	$ 0.85	$ (0.35)	$ (0.11)
Diluted net income (loss) per common share(1)	$ 0.48	$ 0.86	$ 0.84	$ (0.35)	$ (0.11)
Balance Sheet Data (at the end of year):					
Working capital	$ 14,837	$ 9,359	$ 18,388	$ 19,997	$ 12,266
Total assets	25,054	26,108	50,405	62,004	86,931
Total debt (including current portion)	30	3,265	12,526	26,610	18,319
Stockholders equity	18,701	13,964	23,753	17,597	55,207

(1) On July 24, 2000, the Company effected a two-for-one stock split. All share and per share information has been adjusted retroactively to give effect to this stock split.

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

Overview

The Company is a leading direct marketer of replacement contact lenses. The Company was formed in February 1995 and is the successor to the mail order business founded by the Company s Vice President of Trade Relations in March 1991. The Company s net sales have grown rapidly from $3.6 million in fiscal 1996 to $187.3 million in fiscal 2003.

Recent Transactions

Lens Express / Lens 1st. On January 30, 2003, the Company acquired certain assets and assumed certain liabilities of Lens Express LLC and Camelot Ventures/CJ, L.L.C. d/b/a Lens 1st (collectively, the Seller), two leading U.S. mail order contact lens retailers. The assets acquired included databases, customer information, web sites and Internet addresses or domain names, telephone numbers, certain specified contracts and intellectual property rights. In addition, acquired assets included certain property, equipment, inventories, receivables and prepaid expenses. With the exception of specifically identified liabilities, the Company did not assume the liabilities of the Seller. The liabilities assumed by the Company included certain of the Seller s identified contracts, accounts payable, accrued liabilities, certain customer program obligations and severance obligations as of January 30, 2003.

The consideration paid by the Company consisted of approximately $7.0 million in cash (including $0.5 million in transaction costs), 900,000 shares of restricted Common Stock of the Company with a fair value of $19.9 million and the assumption of approximately $4.1 million of the aforementioned liabilities. The 900,000 shares of restricted common stock were subject to a lock-up period of 12 months after the acquisition date of January 30, 2003. In connection with the acquisition, the Company entered into a registration rights agreement granting the Seller certain piggyback registration rights with respect to the 900,000 shares of restricted Common Stock. The Company funded the cash consideration portion of the asset purchase from its revolving credit facility.

Subsequent to fiscal 2003, the Company announced that it will be consolidating the operating facility acquired from Lens 1st into its principal operating facilities in Utah, effective by the end of the first quarter of fiscal 2004.

Cole National Marketing Agreement. On June 30, 2003, the Company and Cole National Corporation (Cole) announced that they had signed an agreement under which the Company s customers can receive discounted eye exams and value pricing on eyeglasses, sunglasses and other vision products that the Company does not sell from a network of doctors contracted with Cole Managed Vision and associated with more than 1,500 Pearle Vision, Pearle VisionCare, Sears Optical and Target Optical stores in the U.S. Cole will offer its network of doctors for at least one year. The Company will retain the contact lens business of customers referred to Cole stores.

As part of the agreement, the Company and Cole are also working together on a variety of cross-marketing programs and promotions of their respective products in select test markets. The goal of these cross-marketing programs is to find other ways that the Company and Cole can help create value together.

Supplier Agreements. During the latter part of 2003, the Company reached agreements with its top three vendors for improved pricing and marketing support. This support will come in the form of cooperative marketing and rebate programs designed to promote the manufacturer s products and build sales. As part of its ongoing relationship with its suppliers, the Company annually reviews its specific marketing plans and negotiates cooperative marketing programs and product pricing.

Letter of Intent (Purchase of VisionTec). On March 13, 2003, the Company signed a letter of intent with VisionTec, a developer and manufacturer of contact lenses based in the United Kingdom, and certain of its shareholders. The Company agreed to pay VisionTec a non-refundable sum equal to $1.5 million to be used by the

entity for research and development activities relating to contact lenses. Of the total, $700,000 was paid on March 14, 2003, and the remaining $800,000 was paid on June 13, 2003. In addition, the Company was granted a six-month option to either: (1) acquire all of the shares of common stock of the entity; or, (2) acquire from the entity a worldwide license to manufacture, market, sell or otherwise use or exploit specific technology developed by the entity. As consideration for this option, the Company paid $100,000 to VisionTec on March 14, 2003. In the event that the Company did not exercise the option to purchase the shares of the VisionTec, the Company agreed to pay the entity an additional $800,000. The Company also reimbursed VisionTec and its shareholders $161,000 for legal and financial expenses incurred by the entity in connection with the agreement.

On September 12, 2003, the Company exercised the option to acquire all of the shares of common stock of VisionTec. During the period between September 12, 2003 and the closing of the acquisition on February 24, 2004, the Company continued to pay certain fees and expenses of the entity related to the entity s research and development activities. The Company paid approximately $2.1 million to VisionTec from September 12, 2003 through January 3, 2004 and $536,000 from January 3, 2004 through February 24, 2004, for such research and development activities.

In connection with the agreement, and the transactions discussed above, the Company has expensed a total of approximately $3.9 million from March 13, 2003 through January 3, 2004 (inclusive of the $161,000 in costs) related to these research and development initiatives.

On February 24, 2004, the Company completed the acquisition of the shares of VisionTec (subsequently renamed ClearLab UK). The transaction was accomplished as a purchase of all of the stock of the entity. The consideration paid included approximately $3.2 million in cash and 155,084 shares of the Company s common stock with a fair value of approximately $3.2 million. In addition, the Company has agreed to pay a per unit royalty to the former shareholders of VisionTec for a period of ten years. The Company financed the cash portion of this acquisition with its revolving credit facility from its U.S. bank.

IGEL (ClearLab International). On July 24, 2002, the Company completed the acquisition of certain net assets and the majority of the business operations of IGEL, a developer and contract manufacturer of contact lenses based in Singapore. The acquisition was effected through a wholly owned subsidiary of the Company, IGEL Acquisition Co. Pte Ltd (subsequently renamed ClearLab International). The results of operations of ClearLab International are included in the consolidated results of the Company from the date of the acquisition.

ClearLab International manufactures injection cast molded soft contacts lenses on a contract basis for various contact lens manufacturers, as well as, manufactures and distributes branded and private label contact lenses via distributors and other sales channels outside the U.S. It produces a wide range of frequent replacement spherical and toric lenses and is focused on developing new lens materials for the future. ClearLab International markets its products principally in Europe and other international markets.

The consideration paid by the Company consisted of approximately $6.6 million in cash (which includes $1.2 million in transaction costs), $8.9 million in assumed building and business loans to be paid over seven years from the acquisition date, $0.7 million in assumed capital lease obligations, a non-interest bearing note payable of $2.1 million to be paid over five years from the acquisition date, 700,000 shares of restricted common stock of the Company, and 270,000 common stock options of the Company in three tranches of 90,000 each with exercise prices of $15, $25 and $35 per share, respectively. The Company obtained a $10 million, five-year term loan from a U.S. bank to provide partial financing for this asset purchase. 1-800 CONTACTS, INC. also executed guarantees for the building and business loans assumed in the transaction.

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The 700,000 shares of restricted common stock were placed in escrow, subject to a performance guarantee, and vest over a two-year schedule with no shares released from escrow for a minimum of one year from the acquisition date. On June 6, 2003, the performance guarantee was met relating to these shares and 175,000 shares were released on July 24, 2003, and an additional 437,500 shares were released on January 24, 2004 in accordance with the vesting provisions. The remaining 87,500 shares held in escrow will be released on July 24, 2004 based on an October 14, 2003 amendment to the escrow agreement. For financial reporting purposes, all shares held in escrow are treated as outstanding as of June 6, 2003, the date the performance guarantee was met, and the Company reflected additional purchase consideration for the estimated fair value of these shares of approximately $17.0 million. The fair value was based upon the closing market price of the Company s common stock on the date the performance guarantee was met, reduced by an approximate 9% discount due to the restrictions associated with the vesting period of the common stock held in escrow. This discount was determined by an independent third party appraisal.

The $17.0 million of additional purchase consideration, net of a contingent consideration liability of $5.4 million recorded at the purchase date in accordance with SFAS No. 141, was recorded as goodwill. At January 3, 2004, goodwill related to this transaction amounted to $11.5 million.

The value of the options to purchase 270,000 shares of common stock will be determined and recorded as additional purchase consideration at the applicable vesting dates. These options vest equally at the end of the third, fourth and fifth years from the acquisition date.

During the second quarter of fiscal 2003, the Company also recorded compensation expense and additional paid-in capital of approximately $0.7 million due to the transfer of 28,000 common shares owned by ClearLab International s chief technology officer to key employees of ClearLab International. The shares transferred represented a portion of the 700,000 shares held in escrow and are subject to the same performance guarantee and vesting provisions. Because the performance conditions were met, and there are no additional contingencies, the fair value of the shares was recorded as compensation expense.

Subsequent to year-end, ClearLab was renamed ClearLab International. ClearLab International will be the principal sales organization for the Company s international wholesale manufacturing business.

Johnson & Johnson Vision Care Agreement. In December 2002, the Company announced that it had reached an agreement with Johnson & Johnson Vision Care to become an authorized retailer of Johnson & Johnson Vision Care contact lenses. The Company modified its operating systems in connection with this agreement. The Company implemented new procedures for Johnson & Johnson Vision Care by geographic region based on time zone. The Company began this implementation in February 2003 and completed it in April 2003. The Company began buying direct from Johnson & Johnson Vision Care during March 2003.

This direct relationship with Johnson & Johnson Vision Care has lowered the Company s product acquisition costs and allowed it to offer rebates and other incentives not previously available to its customers who wear Johnson & Johnson Vision Care lenses. The Company has also been able to reduce its inventory investment by purchasing a more balanced mix of products at lower prices than it has historically been able to obtain through indirect sources. This agreement also resolved long-standing disputes.

Net sales for fiscal 2003 were negatively impacted by canceled orders due to prescription verification procedures including most significantly those implemented as part of the Johnson & Johnson Vision Care agreement. The Company is taking steps to recover these canceled orders,

including creating a doctor network through the Cole agreement and establishing a doctor network department to help customers schedule eye exams in order to obtain prescriptions. The Company is uncertain of the ultimate impact these prescription verification procedures will have on future net sales.

Regulatory Considerations

The sale and delivery of contact lenses are governed by both Federal and state laws and regulations, including the recently enacted federal Fairness to Contact Lens Consumer Act (FCLCA). The FCLCA requires that contact lenses only be sold to consumers based on a valid prescription. Satisfying this prescription requirement obligates the seller either to obtain a copy of the prescription itself or to verify the prescription by direct communication with the customer s prescriber. Consistent with this requirement, the Company s current operating practice is to require all customers to provide either a valid copy of their prescription or the contact information for their prescriber so that the Company can verify their prescription by direct communication with their prescriber. If the Company does not have a valid copy of the customer s prescription, the Company directly communicates to the customer s prescriber the precise prescription information received from the customer and informs the prescriber that it will proceed with the sale based on this prescription information unless the prescriber advises it within eight business hours that such prescription information is expired or otherwise invalid. If the prescriber properly advises the Company within this time period that the customer s prescription is expired or otherwise invalid, the Company s practice is to cancel the customer s order. On the other hand, if the prescriber either advises the Company that the prescription is valid or fails to properly respond within the communicated time period, the Company s practice is to complete the sale based on the prescription information communicated to the prescriber, as expressly permitted by the FCLCA. The Company retains copies of the written prescriptions that it receives and maintains records of its communications with the customer s prescriber. See Government Regulation under Item 1 of Part I of this Form 10-K.

Results of Operations

The Company s fiscal year consists of a 52/53-week period ending on the Saturday nearest to December 31. Fiscal 2001 ended December 29, 2001; fiscal 2002 ended December 28, 2002; and fiscal 2003 ended January 3, 2004. Fiscal 2001 and 2002 were 52-week years. Fiscal 2003 is a 53-week year and ended on January 3, 2004.

The following table presents the Company s results of operations expressed as a percentage of net sales for the periods indicated:

	Fiscal Year		
	2001	**2002**	**2003**
Net sales	100.0%	100.0%	100.0%
Cost of goods sold	61.0	70.1	62.4
Gross profit	39.0	29.9	37.6
Advertising	15.9	7.5	10.8
Legal and professional	1.7	2.8	3.4
Research and development	0.0	0.1	2.5
Purchased in-process research and development	0.0	4.6	0.0
Other operating expenses	11.7	14.2	20.1
Total operating expenses	29.3	29.2	36.8
Income from operations	9.7	0.7	0.8
Other expense, net	(0.2)	(0.8)	(0.6)
Income (loss) before provision for income taxes	9.5	(0.1)	0.2
Provision for income taxes	(3.7)	(2.3)	(1.0)
Net income (loss)	5.8%	(2.4%)	(0.8%)

Fiscal Year 2003 Compared to Fiscal Year 2002

Net sales. Net sales for fiscal 2003 increased 11% to $187.3 million from $168.6 million for fiscal 2002. Net sales (excluding ClearLab International) for fiscal 2003 and 2002 were $181.3 million and $166.5 million, respectively. The increase in net sales is mainly due to the acquisition of Lens Express and Lens 1st on January 30, 2003, although the Company has realized fewer incremental sales from customers of these operations than it had originally expected. ClearLab International net sales for fiscal 2003 and 2002 (for the period subsequent to the acquisition date of July 24, 2004) were $6.0 million and $2.1 million, respectively.

Also, the increase in net sales is partially due to an increase in advertising. The Company plans to spend about $25 to $30 million on advertising during the fiscal 2004, including nearly $9 million in the first quarter of fiscal 2004. During the latter part of 2003, the Company also reached agreements with its top three suppliers for improved pricing and marketing support. The support will come mainly in the form of rebates and cooperative marketing arrangements, which will begin during the first quarter of fiscal 2004 and continue throughout fiscal 2004.

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Net sales for fiscal 2003 were negatively impacted by canceled orders due to prescription verification procedures implemented as part of the Johnson & Johnson Vision Care agreement and in response to changes in some state laws. The Company has taken steps to minimize these canceled orders, including continued development of a doctor network through the Cole agreement and the establishment of a doctor network department to help obtain the necessary prescription information that is required to complete an order. During fiscal 2003, the Company s order cancellation rate increased an estimated ten percentage points from the Company s order cancellation rate in fiscal 2002, due mainly to these verification procedures. Subsequent to the FCLCA taking effect on February 4, 2004, the Company s cancellation rate has increased from the rate which occurred during fiscal 2003 as the Company has extended its verification procedures used in response to the Johnson & Johnson Vision Care agreement and certain state laws nationally. The Company is successfully recovering a portion of these cancelled orders through the implementation of the above noted order recovery procedures. The Company is uncertain of the ultimate long-term impact that these prescription verification procedures required by the Act and the Company s efforts to recover the canceled sales will have on future net sales.

On August 1, 2003, the Company lowered its retail prices to its customers on Johnson & Johnson Vision Care products. The Company had increased its retail prices on select Johnson & Johnson Vision Care products during December 2001. The Company s retail prices for Johnson & Johnson Vision Care products are now at levels similar to those prior to the December 2001 increase. During fiscal 2003, Johnson & Johnson Vision Care products accounted for approximately 40% of the Company s net sales.