ADVANCED MEDICAL OPTICS INC
Form 10-K
March 01, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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x Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year Ended December 31, 2006

or

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File No. 001-31257

ADVANCED MEDICAL OPTICS, INC.

(Exact name of Registrant as Specified in its Charter)

Delaware	**33-0986820**
(State of Incorporation)	(I.R.S. Employer Identification No.)
1700 E. St. Andrew Place, Santa Ana, California	**92705**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number: (714) 247-8200

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

Title of each class	**Name of each exchange on which each class registered**
Common Stock, $0.01 par value	New York Stock Exchange
Preferred Stock Purchase Rights	

Securities registered pursuant to Section 12(g) of the Act: None

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Exchange Act. Yeso No x

Note: Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15 (d) of the Exchange Act from their obligations under those Sections.

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 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. x

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

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

The aggregate market value of the registrant s voting and non-voting common equity held by non-affiliates is approximately $1.9 billion based upon the closing price on the New York Stock Exchange as of June 30, 2006.

Common Stock outstanding as of February 26, 2007: 59,691,248 shares (including 1,397 shares held in treasury).

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates certain information by reference from the registrant s proxy statement for the 2007 annual meeting of stockholders, which proxy statement will be filed no later than 120 days after the close of the registrant s fiscal year ended December 31, 2006.

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PART I

Item 1. Business

AMO was incorporated in Delaware in October 2001 as a subsidiary of Allergan, Inc. (Allergan). Allergan spun-off our company to its stockholders by way of a distribution of all of our shares of common stock on June 29, 2002. As a result of our spin-off from Allergan, we are an independent public company, and Allergan has no continuing stock ownership in us. Unless the context requires otherwise, references to AMO, the Company, we, us or our refer to Allergan s optical medical device business for the periods prior to June 29, 2002 and to Advanced Medica Optics, Inc. and its subsidiaries for the periods on or after such date.

Overview

We are a global leader in the development, manufacture and marketing of medical devices for the eye. We have three major product lines: cataract / implant, laser vision correction, and eye care. In the cataract / implant market, we focus on the four key products required for cataract surgery foldable intraocular lenses, or IOLs, implantation systems, phacoemulsification systems and viscoelastics. In the laser vision correction market, we market laser systems, diagnostic devices, treatment cards and microkeratomes for use in laser eye surgery. Our eye care product line provides a full range of contact lens care products for use with most types of contact lenses. These products include single-bottle, multi-purpose cleaning and disinfecting solutions, hydrogen peroxide-based disinfecting solutions, daily cleaners, enzymatic cleaners and contact lens rewetting drops. Our products are sold in approximately 60 countries and we have direct operations in over 20 countries.

In June 2004, we completed our acquisition of Pfizer Inc. s surgical ophthalmic business, which expanded our viscoelastic and IOL product offerings, allowing us to offer a more comprehensive portfolio of products required to perform cataract surgery. We acquired the *Healon* family of viscoelastic products and the *Tecnis* IOL brand. The addition of the *Healon* family, one of the leading viscoelastic brands, significantly expanded our viscoelastic product line. The *Tecnis* IOL brand further strengthened our position in the ophthalmic surgery market with the *Tecnis* Multifocal IOL brand further expanding our refractive IOL portfolio. We also acquired the *Baerveldt* glaucoma shunt, or drainage device, which provided an entry for us into the glaucoma market.

In May 2005, we acquired VISX, Incorporated, the global leader in laser vision correction. As a result of the VISX acquisition, we are a leader in the design and development of proprietary technologies and systems for laser vision correction of refractive vision disorders. Our products include the *VISX STAR* Excimer Laser System, which is a fully integrated ophthalmic medical device incorporating an excimer laser and a computer driven workstation; the *VISX WaveScan* System, which is a diagnostic device that uses laser beam technology to measure comprehensive refractive errors of the eye and derive comprehensive refractive information about a patient s individual optical system; and *VISX* treatment cards, which provide the user with specific access to proprietary software and are required to operate the *VISX STAR* Excimer Laser System.

In January 2007, we entered into an agreement with IntraLase Corp., a leader in femtosecond lasers used in LASIK surgery, to acquire all fully diluted shares of the company for approximately $808 million in cash. Under the terms of the definitive merger agreement, IntraLase stockholders are expected to receive $25.00 in cash for every share of IntraLase common stock they own. We expect to complete the acquisition during the second quarter of 2007. For a description of the risks related to this transaction, see Risks Relating to the Pending IntraLase Corp. Acquisition beginning on page 24.

Industry

Vision and Vision Impairment.

- *How Vision Works.* Vision is enabled by the cornea and the lens, which work together to focus light, and the iris, which regulates the amount of light that passes through the cornea onto the retina. The retina contains light-sensitive receptors that transmit the image through the optic nerve to the brain.

- *Cataracts.* Cataracts are an irreversible progressive ophthalmic condition in which the eye s natural lens loses its usual transparency and becomes clouded and opaque. This clouding obstructs the passage of light to the retina and can eventually lead to blindness.

- *Refractive Disorders.* Refractive disorders, such as myopia, hyperopia, astigmatism and presbyopia, occur when the lens system is unable to properly focus images on the retina. For example, with myopia (nearsightedness), light rays focus in front of the retina because the curvature of the cornea is too steep. With hyperopia (farsightedness), light rays focus

behind the retina because the curvature of the cornea is too flat. Astigmatism makes it difficult for a person to focus on any object because the otherwise uniform curvature of the cornea or lens is somehow disrupted or becomes uneven. Presbyopia is the progressive loss of flexibility of the lens and its ability to change shape to focus on near or far objects, and is presumably caused by aging of the eye s lens and the muscles that control the shape of the lens.

Ophthalmic Surgical Products Market. Ophthalmic surgical products generally are designed to correct impaired vision through minimally invasive surgical procedures. As the eye ages, the prevalence of cataracts and refractive disorders generally increases. We believe that an aging population, introduction of new technologies and increasing market acceptance present opportunities for growth in the ophthalmic surgical market.

Cataract Treatment. The largest segment of the ophthalmic surgical products market is the treatment of cataracts. Cataract extraction followed by IOL implantation is one of the most common surgical procedures performed in the United States and most other developed nations. As estimated by MarketScope, approximately 2.9 million cataract procedures were performed in the United States and over 14.1 million cataract procedures were performed worldwide in 2006. MarketScope estimates that the global cataract surgery market, which includes sales of IOLs, phacoemulsification equipment, viscoelastics and other related products, was approximately $3.4 billion in 2006 and is projected to grow at a compound annual growth rate of approximately 10% from 2006 to 2011. The data in this report attributed to MarketScope is used with the permission of MarketScope.

During cataract surgery, patients are often treated using phacoemulsification, a process that uses ultrasound waves to break the natural lens into tiny fragments that can be removed from the eye. Viscoelastics are used during cataract surgery to protect the inner layer of the cornea, provide lubrication and maintain space in the anterior chamber of the eye and the capsular bag in the posterior chamber (which houses the lens), allowing the eye to maintain its shape.

The following table sets forth the estimated revenues for each component of the global cataract surgery market in its various components for the year 2006 according to MarketScope (in millions):

IOLs	$ 1,439
Viscoelastics	515
Phacoemulsification machines and accessories	604
Other	870
Total	$ 3,428

Refractive Vision Correction. Another segment of the ophthalmic surgical market is the surgical treatment of refractive disorders.

LASIK. The most common refractive surgery procedure is laser surgery, and the most common surgical technique for treating refractive disorders is laser assisted in-situ keratomileusis, or LASIK. LASIK involves the use of an automated cutting device to cut a thin corneal flap, which is then pulled back to expose the underlying tissue, which is treated using an excimer laser to achieve vision correction. The most common cutting device is called a microkeratome.

As a result of the VISX acquisition, we are a leader in the design and development of proprietary technologies and systems for laser vision correction of refractive vision disorders. Laser vision correction (LVC) eliminates or reduces reliance on eyeglasses or contact lenses. It employs a computerized laser that ablates, or removes, sub-micron layers of tissue from the cornea, reshaping the eye and thereby improving vision.

Standard LASIK was introduced in the mid 1990 s. In performing Standard LASIK, an ophthalmologist conducts a traditional eye examination to determine the prescription required to correct the patient s vision. The prescription is then programmed into the laser system, which calculates the ablation needed to make a precise corneal correction to treat nearsightedness, farsightedness, and astigmatism. Unlike Custom LASIK (see below), Standard LASIK cannot correct higher order aberrations.

The most advanced method of performing laser vision correction is Custom LASIK. Custom LASIK employs a diagnostic evaluation of the eye that measures refractive errors in the patient s vision more precisely than previously available technology. The diagnostic device obtains comprehensive information about the imperfections, or refractive errors, of each patient s vision. Refractive errors are displayed by the diagnostic device in the form of an aberration map that offers a unique pattern for each patient s eye, similar to a fingerprint. The map displays information about refractive errors that result in nearsightedness,

farsightedness, and astigmatism, as well as information about higher order aberrations that were not previously measurable by any other instrument. The information from the diagnostic device is used to generate a personalized treatment plan that is digitally transferred to the laser system. The ablation derived from this information is therefore customized to the individual s eye.

Laser vision correction can also be performed by photorefractive keratectomy (PRK). PRK does not require the use of a microkeratome, and the epithelial layer (or outer layer) of the cornea is removed before ablation. Patients may experience discomfort for approximately 24 hours and blurred vision for approximately 48 to 72 hours after the procedure. Drops to promote corneal healing and alleviate discomfort may be prescribed. Although most patients experience significant improvement in uncorrected vision (vision without the aid of eyeglasses or contact lenses) within a few days of the procedure, unlike LASIK it generally takes several months for the final correction to stabilize and for the full benefit of the procedure to be realized.

IOLs. Surgical implantation of IOLs also may be used to treat patients with refractive disorders. Phakic IOLs can be implanted in front or in back of the iris and work in conjunction with the patient s natural lens to treat refractive disorders. Multifocal IOLs address near, intermediate and distance vision and are approved for non-cataract procedures outside of the United States. Other procedures, such as replacing the patient s natural lens with an accommodating IOL for refractive vision correction, are also being developed.

Eye Care Market. As the use of contact lenses has become increasingly popular, the demand for disinfecting solutions, daily cleaners, enzymatic cleaners and contact lens rewetting drops has increased. We believe that the contact lens market growth is driven by technological advancements in lens materials and designs and broader adoption among younger wearers. In response to increasing popularity of more frequently replaceable lenses and consumer interest in more convenient lens care regimens, we believe the contact lens care market continues to evolve towards greater use of single-bottle, multi-purpose solutions and away from hydrogen peroxide-based solutions. This evolution has had an unfavorable impact on the global hydrogen peroxide market, which is concentrated in Japan and parts of Europe.

Overall, we believe that strong demographic trends, new lens materials and specialty lenses are fueling global increases in the number of contact lens wearers, especially in China and other Asia Pacific countries. We believe that this is contributing to overall growth in multi-purpose solutions. The exception to this positive dynamic is in Japan, where a higher than average percent of the market has moved to daily disposable contact lenses that use cleaning solutions only occasionally or not at all.

Finally, the eye care market includes artificial tear and contact lens rewetter products designed to relieve dryness associated with contact lens wear, environmental conditions and dry eye disease. We believe the global market for artificial tear products exceeds $400 million per year.

Our Products

Cataract / Implant Business

Cataract Surgery

We focus on the four key devices for the cataract surgery market:

- *Foldable IOLs* Foldable IOLs are artificial lenses used to replace the human lens.

- *Implantation systems* Implantation systems are designed and used specifically to implant IOLs during cataract surgery.

- *Phacoemulsification systems* Phacoemulsification systems use ultrasound during small incision cataract surgery to break apart and remove the cloudy human lens prior to its replacement with an IOL.

- *Viscoelastics* Viscoelastics provide a barrier of protection for the cornea during phacoemulsification and maintain the shape of the eye during IOL insertion.

Intraocular Lenses. As a leading provider of IOLs, we offer surgeons a choice of high quality, innovative foldable IOLs in both acrylic and silicone, together with our proprietary implantation systems, for use in minimally invasive cataract surgical procedures. We offer a selection of IOLs in both silicone and acrylic materials, and we offer both monofocal and multifocal designs. Sales of our IOLs represented approximately 29%, 28% and 32% of our net sales in 2006, 2005 and 2004, respectively. Our IOLs primarily include:

Monofocal Lenses

- *Tecnis* a foldable IOL with an aspheric surface and the only IOL to receive FDA approval for claims of improved functional vision, which results in quicker recognition of objects in lower-light conditions. The *Tecnis* lens was the first aspheric lens designated as a new technology intraocular lens by the U.S. Center for Medicare and Medicaid Services (CMS). With this designation, ambulatory surgery centers can receive $50 in additional reimbursement when implanting the *Tecnis* IOL. The *Tecnis* lens is available in silicone and acrylic.

- *Sensar* an acrylic monofocal IOL, with the patented *OptiEdge* design, intended to reduce post-surgical posterior capsular opacification, in order to lessen the need for subsequent corrective laser procedures, and to reduce the potential for unwanted glare and reflections following implantation.

- *ClariFlex* a silicone monofocal IOL, also with the *OptiEdge* design.

Multifocal and Refractive Lenses

- *ReZoom* an acrylic multifocal IOL with optical zones that provide near, intermediate and distance vision, reducing that patient s dependence on eyeglasses. This lens received approval from CMS to allow patients in the U.S. to pay the difference between the $150 reimbursement rate for IOLs and the amount that is charged. The *ReZoom* IOL is also approved in Europe for the treatment of presbyopia.

- *Tecnis Multifocal* a silicone multifocal IOL with a diffractive, aspheric lens surface is approved in Europe for treatment of presbyopia.

- *Verisyse* a phakic IOL that works in conjunction with the human lens to treat high myopia.

Implantation Systems. As a companion to our foldable IOLs, we market insertion systems for each of our foldable IOL models. The *Unfolder,* our proprietary series of implantation systems, which includes the *Emerald*, *SilverT* and *Silver* implantation systems, is used for insertion of our foldable IOLs. These systems assist the surgeon in achieving controlled release of the intraocular lens into the capsular bag through a small incision in the eye.

Phacoemulsification Systems. We are a leading provider of phacoemulsification systems, and have a range of systems to meet market needs. Phacoemulsification systems use disposable or reusable packs that are necessary to operate the equipment. The majority of our phacoemulsification product sales are from sales of these packs and related accessories. Sales of our phacoemulsification products represented approximately 9% of our net sales in 2006 and 2005 and 10% of our net sales in 2004.

We currently market the following phacoemulsification systems:

- *Sovereign* our premier phacoemulsification system is designed to reduce procedure times and provide the surgeon with increased control. The *Sovereign* system is available with our proprietary *Occlusion Mode* and *WhiteStar* technology, which creates less heat and turbulence in the ocular environment, giving rise to the term cold phaco and enabling better patient outcomes. Our *WhiteStar* technology also permits the system to offer bimanual, micro-incision phaco, a procedure which gives surgeons more operating flexibility over traditional techniques.

- *Sovereign Compact* -is a mid-sized phacoemulsification system designed to meet surgeons needs for an advanced phacoemulsification system, with the similar functionality of the *Sovereign* system, in a smaller, more portable size. The *Sovereign Compact* system is also available with *Occlusion Mode* and *WhiteStar* technology.

- *Diplomax II* is a small-sized phacoemulsification system designed for surgeons who need a less expensive and more portable machine. These systems do not include *WhiteStar* technology, but do employ *Occlusion Mode* technology.

Viscoelastics. We are a leading provider of viscoelastic products with the *Healon* family of viscoelastics. The different characteristics associated with each *Healon* product, *Healon, Healon GV* and *Healon5,* provide surgeons with a range of viscoelastic choices that combine the familiarity of the *Healon* line with advanced technologies to satisfy different surgical needs. *Healon* was the first viscoelastic introduced into the ophthalmic surgical product market and is known for its purity and ease of use. *Healon GV* is of a greater viscosity than the original *Healon* solution. *Healon5* is the first viscoadaptive agent to exhibit properties of both cohesive and dispersive viscoelastics and has the highest viscosity. Sales of our viscoelastic products represented approximately 12%, 14% and 10% of our net sales in 2006, 2005 and 2004, respectively.

Other Cataract Surgical Related Products. In addition to our IOLs, phacoemulsification equipment and viscoelastics, we also provide several ancillary products related to the cataract surgery market, including:

- *Irrigating Solutions.* We offer irrigating solutions for use in cataract surgery to help maintain space in the eye and to aid in removing residual tissue during phacoemulsification. Irrigating solutions are balanced saline solutions that are compatible with the natural fluid of the anterior segment of the eye.

- *Custom Eye Trays.* We work with partners in our local markets to offer custom eye trays to our customers. These custom eye trays typically consist of all of the ancillary items that a surgeon needs to use in a single cataract surgery, such as surgical knives, drapes, gloves and gowns. Our partners typically handle assembly, distribution and billing for the product and in most cases we receive a fee per tray from our partners.

- *Capsular Tension Rings.* In the United States, we sell the *StabilEyes* capsular tension ring, which is inserted into the capsular bag during cataract surgery and functions to stabilize the capsular bag during placement of an IOL. We also market and distribute the *Inject-o-Ring* capsular tension ring in Europe. We distribute these products under arrangements with Ophtec B.V. in the United States and Corneal in Europe, respectively.

Other Surgical Products

Glaucoma Implant. The *Baerveldt* glaucoma implant is indicated for use in patients with medically uncontrollable glaucoma and a poor surgical prognosis due to severe preexisting conditions. This can include: neovascular glaucoma, aphakic/pseudophakic glaucoma, failed conventional surgery, congenital glaucoma, and secondary glaucoma due to uveitis or epithelial down growth. *Baerveldt* glaucoma implants are available in three models, all of which feature a larger surface area plate than competing single-quadrant devices.

Laser Vision Correction Business

Our laser vision correction products include the following:

- *VISX STAR Excimer Laser System* The *VISX STAR* System is a fully integrated ophthalmic medical device incorporating an excimer laser and a computer-driven workstation.

- *VISX WaveScan System* The *WaveScan* System is a diagnostic device that uses laser beam technology to measure comprehensive refractive errors of the eye and complex mathematical algorithms to derive comprehensive refractive information about the patient s individual optical system.

- *VISX Treatment Cards* Our proprietary treatment cards control the use of the *VISX STAR* System.

- *Microkeratomes* Surgeons use microkeratomes in LASIK procedures to cut a flap of corneal tissue before treatment with an excimer laser.

VISX STAR Excimer Laser System. The laser ablations produced by the *VISX STAR* System are the product of a variable diameter excimer laser beam scanning system. Seven beams that range in size from 0.65 to 6.5 millimeters are homogenized as they converge, scan, and rotate to produce a smooth ablation area on the eye. The *VISX STAR* System centers on the eye and tracks eye movements in three dimensions during the procedure. Our Iris Registration technology is the first fully automated method of aligning and registering wavefront corrections for *CustomVue* treatment. Iris Registration is designed to replace the current means of registration, which involves manual marking of the eye to assess rotational movement.

The *VISX STAR* System performs Standard LASIK, *CustomVue* laser vision correction, and PRK. It also performs specialized procedures known as Custom-CAP, which treats patients who previously had LVC surgery resulting in symptomatic decentered ablations (a condition that affects fewer than 4,000 patients per year) and PhotoTherapeutic Keratectomy, or PTK, which treats corneas that are scarred or have irregularities from prior infection, trauma or underlying corneal disease.

VISX WaveScan System. The *WaveScan* system displays refractive information about the patient s individual optical system in the form of an aberration map. This unique map, similar to a fingerprint for each patient s eye, offers objective information about refractive errors associated with nearsightedness, farsightedness and astigmatism, as well as information about higher order aberrations that were previously unmeasurable by any other instrument.

VISX Treatment Cards. Each treatment card provides the user with specific access to proprietary software and is required to operate the *VISX STAR* System. Because treatment cards are required to perform procedures, there is a strong correlation between treatment card sales and the number of procedures performed on *VISX STAR* Systems. Types of VISX treatment cards include: *VisionKey* Cards for performing standard LASIK procedures, which in the United States carries a license fee for each procedure that is purchased; *CustomVue* Cards for performing Custom LASIK, which carry a worldwide license fee for each procedure that is purchased; Custom-CAP Cards for performing laser vision correction with a previously decentered ablation, which carry a worldwide license fee for each procedure that is purchased; and the PTK Card, which is offered to physicians at a nominal charge to treat certain types of corneal pathologies. Sales of our treatment cards and associated procedure fees represented approximately 15%, 8% and 0% of our net sales in 2006, 2005 and 2004, respectively.

Microkeratomes. In the refractive surgery market, we are a worldwide distributor of the *Amadeus II* microkeratome system and *SurePass* microkeratome blades.

Eye Care Product Line

In the eye care market, we focus on creating products that make contact lenses more comfortable, simplify contact lens care and promote ocular health. Our eye care business develops, manufactures and markets a full range of contact lens care products for use with most types of contact lenses. Our comprehensive product offering includes single-bottle multi-purpose cleaning and disinfecting solutions and hydrogen peroxide-based disinfecting solutions to destroy harmful microorganisms in and on the surface of contact lenses; daily cleaners to remove undesirable film and deposits from contact lenses; enzymatic cleaners to remove protein deposits from contact lenses; and lens rewetting drops to provide added wearing comfort.

Multi-Purpose Solutions. We market our *Complete* brand single-bottle multi-purpose solutions, a convenient, one bottle chemical disinfecting system for soft contact lenses, on a worldwide basis. *Complete MoisturePLUS* is the first single-bottle, multi-purpose solution with dual demulcents to help prevent contact lens dryness and discomfort and promote ocular health. Sales of our multi-purpose solutions represented approximately 14.8%, 17% and 21% of our net sales in 2006, 2005 and 2004, respectively. We also offer *Complete Blink-N-Clean,* a unique in-the-eye lens cleaning solution.

Hydrogen Peroxide-Based Solutions. We offer products that use hydrogen peroxide-based disinfection systems. Our leading hydrogen peroxide brands are the *Oxysept 1 Step, Ultracare, Consept 1 Step and Consept F* solutions. Sales of our hydrogen peroxide-based solutions represented approximately 6%, 9%, and 14% of our net sales in 2006, 2005 and 2004, respectively.

Lens Rewetting Solutions. We believe that dryness and discomfort are the reasons most often cited for discontinuing contact lens wear. We have introduced contact lens rewetting drops designed to provide prolonged lubrication and improved protection against dryness. Our products in this category include *Complete* and *blink* rewetting solutions.

Research and Development

Our long-term success is dependent on the introduction of new and innovative products in both the ophthalmic surgical and eye care businesses. Our research and development strategy is to develop proprietary products for vision correction that are safe and effective and address unmet needs. As we implement this strategy, we will seek to develop new products with measurable benefits such as increased practitioner productivity, better patient outcomes and reduced costs to health care payors and providers.

Research and development activities for our cataract / implant business are focused on expanding our product portfolio. We have focused on six areas of opportunity to provide superior outcomes:

- *Small incision surgery* work with a variety of advanced lens materials to enable small incision surgery which results in less induced astigmatism, rapid stabilization of the wound and faster visual rehabilitation.

- *Advances in phacoemulsification* technology providing surgeons with high levels of cutting efficiency but with less heat and turbulence directed into the ocular environment enabling potential for more effective and safer cataract extraction procedures.

- *Restoring accommodation following cataract surgery* following cataract surgery, the eye loses its ability to accommodate, or shift its field of focus. Through the development of multifocal and accommodating IOLs, we can provide for the full range of vision following cataract surgery.

- *Improving quality of vision* advancements in optics and optical surface designs.

- *Reducing posterior capsular opacification, or PCO, following cataract surgery* PCO is a clouding of the posterior portion of the capsular bag that occurs in some patients following cataract surgery. Currently, treatment of moderate to severe PCO typically requires a laser procedure.

- *Greater ease of use for practitioners* development of intraocular lens designs and advanced insertion devices, which allow for easier handling in the operating room and greater surgeon control.

In the area of laser vision correction, our research and development efforts are focused on advancements in LASIK and adjunctive technologies. Current projects include expanded treatment applications for custom wavefront guided LASIK, including wavefront guided treatment of presbyopia. Further new product development includes advances in ablation technology, accuracy and reliability in wavefront capture and intraoperative monitoring.

Our research and development efforts in the eye care business are aimed at developing proprietary systems that are effective and more convenient for customers to use, which we believe will result in longer, more comfortable lens wear and a higher rate of compliance with recommended lens care procedures. Our efforts include seeking formulations that provide prolonged lubrication, improved ocular health and protection against dryness, and enhanced cleaning and disinfection without irritation. Our research and development efforts have resulted in the continued development of our flagship *Complete* brand multi-purpose solution and *blink* rewetter solutions, with further advancements currently in development. We are also working to develop over-the-counter artificial tear products.

We plan to supplement our research and development activities with a commitment to identifying and obtaining new technologies through in-licensing, technological collaborations and joint ventures, including the establishment of research relationships with academic institutions and individual researchers.

We spent approximately $66.1 million in 2006, $61.6 million in 2005 and $45.6 million in 2004 on research and development. Total research and development expense in 2005 was $552.4 million, including a non-cash in-process research and development charge of $490.8 million, and in 2004 was $73.7 million, including a non-cash in-process research and development charge of $28.1 million. Research and development spending represented 6.6%, 6.7%, and 6.1% of total net sales in 2006, 2005, and 2004, respectively. We believe that the continuing introduction of new products supplied by our research and development efforts and in-licensing opportunities are critical to our success. There are, however, inherent uncertainties associated with the research and development efforts and the regulatory process and we cannot assure you that any of our research projects will result in new products that we can commercialize.

Customers, Sales and Marketing

Customers. Our primary customers for our cataract / implant and laser vision correction products include surgeons who perform eye surgeries, hospitals and ambulatory surgical centers. The primary customers for our eye care products include optometrists, opticians, ophthalmologists, retailers and clinics that sell directly to consumers. These retailers include mass merchandisers such as Wal-Mart, drug store chains such as Walgreen, hospitals, commercial optical chains and food stores. During 2006, 2005 and 2004, no customer accounted for over 10% of our net sales.

Sales and Marketing. Our sales efforts and promotional activities with respect to our cataract / implant and laser vision correction products are primarily aimed at eye care professionals such as ophthalmologists who use our products. Similarly, our sales and promotional efforts in contact lens care are primarily directed towards optometrists, opticians, optical shops, ophthalmologists and consumers. We often provide samples of our eye care products to practitioners to distribute to their patients to encourage trial use of our solutions. In addition, we advertise in professional journals and have a direct mail program of descriptive product literature and scientific information that we provide to specialists in the eye care field. We have also developed training modules and seminars to update physicians regarding evolving technology. A number of our marketing programs include peer-to-peer marketing with practitioners educating other practitioners about the benefits of our products.

Recognizing the importance of our sales force s expertise, we invest significant time and expense to provide training in such areas as product features and benefits. Training for our ophthalmic surgical products sales force focuses on providing sales personnel with technical knowledge regarding the scope and characteristics of the products they are selling and developing skills in presenting and demonstrating those products. In addition to providing product knowledge for communication to eye care practitioners, our eye care products sales force focuses on developing

the necessary skills to sell to buyers for mass merchandisers and large drug store chains. This sales force also seeks to develop relationships with eye care professionals who may purchase our products and recommend them to their patients.

Each of our products is marketed under its brand name and our corporate name. We have a worldwide marketing organization which helps us to set overall marketing direction, promote consistent global brand positioning and allocate marketing resources to products and regions offering the greatest return. In order to remain sensitive to cultural differences and varying health care systems throughout the world, tactical execution of marketing programs and all sales activities are carried out at the regional level.

We also use third-party distributors for the distribution of our products in smaller geographic markets. No individual agent or distributor accounted for more than 10% of our net sales for the years ended December 31, 2006, 2005 and 2004.

Traditionally, we have realized a seasonal trend in our sales, with the smallest portion of our cataract / implant business sales being realized in the first quarter and with sales gradually increasing from the second to fourth quarter. This has been driven predominantly by seasonality in the sales of capital equipment when customers increase spending as they reach their year end and are able to spend the remainder of their annual budgeted amounts. In the laser vision correction business, the seasonal trend favors the highest portion of sales in the first quarter.

Manufacturing, Operations and Facilities

We manufacture eye care products at our facilities in Hangzhou, China, and Madrid, Spain, and we manufacture surgical products at our facilities in Santa Clara, California, Añasco, Puerto Rico, Groningen, Netherlands and Uppsala, Sweden.

In November 2003, we entered into an agreement with Nicholas Piramal India Limited for the supply of neutralizing tablets primarily used with our hydrogen-peroxide lens care products and unit dose solutions. Nicholas Piramal is a sole-source supplier of these products. If supply of these products were interrupted, we cannot assure you that we would be able to obtain replacement products, and our eye care product sales may be negatively impacted in a material manner.

We have historically outsourced the manufacture of our phacoemulsification equipment to third parties, and we depend on single and limited sources for several key components. Our *Sovereign* system is manufactured by Carl Zeiss Ophthalmic Systems, the manufacturing and supply arrangement for which will terminate at the end of May 2007. Our *Sovereign Compact* system is manufactured by Sanmina-SCI under a manufacturing and supply agreement, which terminates in December 2007. If Sanmina-SCI were to cease manufacturing for any reason, we cannot assure you that we would be able to replace them on terms favorable to us, or at all.

The manufacture of *VISX STAR* Systems and *WaveScan* Systems is a complex operation involving numerous procedures, and the completed systems must pass a series of quality control and reliability tests before shipment. We buy from various independent suppliers many components that are either standard or built to our proprietary specifications, and which are then assembled at our California facility. We also contract with third parties for the manufacture or assembly of certain components. We depend on single and limited sources for several key components. Please see our risk factors for discussion of the risks related to our reliance on single and limited source vendors.

Governmental Regulation

United States. Our products and operations are subject to extensive and rigorous regulation by the FDA. The FDA regulates the research, testing, manufacturing, safety, labeling, storage, recordkeeping, promotion, distribution and production of medical devices in the United States to provide reasonable assurance that medical products distributed domestically are safe and effective for their intended uses. The Federal Trade Commission also regulates the advertising of our products.

Under the Federal Food, Drug, and Cosmetic Act, medical devices are classified into one of three classes Class I, Class II or Class III depending on the degree of risk associated with each medical device and the extent of control needed to provide reasonable assurances with respect to safety and effectiveness. Our current products are Class I, II and III medical devices, with most being classified as Class II devices and our IOLs being classified as Class III devices in the United States, subject to certain exceptions.

Class I devices are those for which safety and effectiveness can be reasonably assured by adherence to a set of guidelines, which include compliance with the applicable portions of the FDA s Quality System Regulation, facility registration and product listing, reporting of adverse medical events, and appropriate, truthful and non-misleading labeling, advertising, and promotional materials, referred to as the general controls. Some Class I, also called Class I reserved, devices also require premarket clearance by the FDA through the 510(k) premarket notification process described below. Many Class I products are exempt from the premarket notification requirements.

Class II devices are those which are subject to the general controls and may require adherence to certain performance standards or other special controls (as specified by the FDA) and clearance by the FDA: Premarket review and clearance by the FDA for these devices is accomplished through the 510(k) premarket notification procedure. For most Class II devices, the manufacturer must submit to the FDA a premarket notification, demonstrating that the device is substantially equivalent to a legally marketed device.

If the FDA agrees that the device is substantially equivalent, it will grant clearance to commercially market the device. By regulation, the FDA is required to complete its review of a 510(k) within 90 days of submission of the notification. As a practical matter, clearance often takes longer. The FDA may require further information, including clinical data, to make a determination regarding substantial equivalence. If the FDA determines that the device, or its intended use, is not substantially equivalent, the FDA will place the device, or the particular use of the device, into Class III, and the device sponsor must then fulfill much more rigorous premarketing requirements, known as premarket approval.

A Class III product is a product that has a new intended use or uses advanced technology that is not substantially equivalent to a use or technology with respect to a legally marketed device, or for which there is not sufficient information to establish performance standards or special controls to provide reasonable assurance of the device s safety and effectiveness and the product is represented to be for use in supporting or sustaining human life or for a use that is of substantial importance in preventing impairment of human health or presents a potential unreasonable risk of illness or injury. The safety and effectiveness of Class III devices cannot be reasonably assured solely by the general controls and the other requirements described above. Therefore, these devices almost always require formal clinical studies to demonstrate safety and effectiveness.

FDA approval of a premarket approval application is required before marketing a Class III product. The premarket approval application process is much more demanding than the 510(k) premarket notification process. A premarket approval application, which is intended to provide reasonable assurance that the device is safe and effective, must be supported by extensive data, including data from preclinical studies and human clinical trials and existing research material, and must contain a full description of the device and its components, a full description of the methods, facilities and controls used for manufacturing, and proposed labeling. Following receipt of a premarket approval application, once the FDA determines that the application is sufficiently complete to permit a substantive review, the FDA will accept the application for review. The FDA, by statute and by regulation, has 180 days to review a filed premarket approval application, although the review of an application more often occurs over a significantly longer period of time. A maximum time of 360 days is allowed to respond to deficiencies.

In approving a premarket approval application or clearing a 510(k) notification, the FDA may also require some form of postmarket surveillance, whereby the manufacturer follows certain patient groups for a number of years and makes periodic reports to the FDA on the clinical status of those patients when necessary to protect the public health or to provide additional safety and effectiveness data for the device.

When FDA approval of a device requires human clinical trials, and if the clinical trial presents a significant risk (as defined by the FDA) to human health, the device sponsor is required to file an investigational device exemption, or IDE, application with the FDA and obtain investigational device exemption approval prior to commencing the human clinical trial. If the clinical trial is considered a nonsignificant risk, investigational device exemption submission to the FDA is not required. Instead, only approval from the Institutional Review Board overseeing the clinical trial is required, although the study is still subject to FDA oversight under other provisions of the IDE regulation. Human clinical studies are generally required in connection with approval of Class III devices and to a much lesser extent for Class I and II devices. Clinical trials conducted abroad for FDA approval must comply with both local regulations and FDA guidance.

Continuing Food and Drug Administration Regulation. After the FDA permits a device to enter commercial distribution, numerous regulatory requirements apply. These include:

- the registration and listing regulation, which requires manufacturers to register all manufacturing facilities and list all medical devices placed into commercial distribution;

- the Quality System Regulation, which requires manufacturers to follow elaborate design, testing, control, documentation and other quality assurance procedures during the manufacturing process;

- labeling regulations;

- the FDA s general prohibition against promoting products for unapproved or off-label uses; and the Medical Device Reporting regulation, which requires that manufacturers report to the FDA if their device may have caused or contributed to a death or serious injury or malfunctioned in a way that would likely cause or contribute to a death or serious injury if it were to reoccur;

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- Medical Device Reporting and recall requirements;
- Device tracking requirements; and
- Post market surveillance requirements.

Failure to comply with the applicable U.S. medical device regulatory requirements could result in, among other things, warning letters, fines, injunctions, civil penalties, repairs, replacements, refunds, recalls or seizures of products, total or partial suspension of production, the FDA s refusal to grant future premarket clearances or approvals, withdrawals or suspensions of current product applications, and criminal prosecution.

Governmental Reimbursement. In the United States, a significant percentage of the patients who receive our IOLs are covered by the federal Medicare program. When a cataract extraction with IOL implantation is performed in an ambulatory surgical center, Medicare provides the ambulatory surgical center with a fixed facility fee that includes a recommended $150 allowance to cover the cost of the IOL. After the Centers for Medicare and Medicaid Services (CMS) (formerly the Health Care Financing Administration), awarded new technology intraocular lens status to our *Tecnis* IOL in 2006, the reimbursement rate for *Tecnis* IOLs implanted in ambulatory surgical centers increased an additional $50 until February 2011. When the procedure is performed in a hospital outpatient department, the hospital s reimbursement is based on a prospective payment that includes payment for the IOL. The allowance is the same for all IOLs.

At the end of 2003, Congress enacted the Medicare Prescription Drug Improvement and Modernization Act of 2003. Among other things, this 1egislation requires CMS to establish a new Medicare payment system for services performed in ambulatory surgical centers. This new payment system is expected to be effective January 1, 2008. At this time, it is not possible to determine how this new payment system could affect our revenues or financial condition.

In addition, if implemented, price controls or other cost-containment measures could materially and adversely affect our revenues and financial condition.

We cannot predict the likelihood or pace of any other significant legislative or regulatory action in these areas, nor can we predict whether or in what form health care legislation being formulated by various governments will be passed. Medicare reimbursement rates are subject to change at any time. We also cannot predict with precision what effect such governmental measures would have if they were ultimately enacted into law. In general, however, we believe that legislative and regulatory initiatives will likely continue, and the adoption of new payment or coverage policies can have some impact on our business.

International Regulation. Internationally, the regulation of medical devices is also complex. In Europe, our products are subject to extensive regulatory requirements. The regulatory regime in the European Union for medical devices became mandatory in June 1998. It requires that medical devices may only be placed on the market if they do not compromise safety and health when properly installed, maintained and used in accordance with their intended purpose. National laws conforming to the European Union s legislation regulate our IOLs and eye care products under the medical devices regulatory system, rather than the more variable national requirements under which they were formerly regulated. The European Union medical device laws require manufacturers to declare that their products conform to the essential regulatory requirements after which the products may be placed on the market bearing the CE marking. The manufacturers quality systems for products in all but the lowest risk classification are also subject to certification and audit by an independent notified body. In Europe, particular emphasis is being placed on more sophisticated and faster procedures for the reporting of adverse events to the competent authorities.

In Japan, premarket approval and clinical studies are required, as is governmental pricing approval for medical devices. Clinical studies are subject to a stringent Good Clinical Practices standard. Approval time frames from the Japanese Ministry, Health, Labor and Welfare (MHLW) vary from simple notifications to review periods of one or more years, depending on the complexity and risk level of the device. In addition, importation into Japan of medical devices is subject to Good Import Practices regulations. As with any highly regulated market, significant changes in the regulatory environment could adversely affect future sales.

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In many of the other foreign countries in which we market our products, we may be subject to regulations affecting, among other things:

- product standards;
- packaging requirements;
- labeling requirements;
- quality system requirements;
- import restrictions;
- tariff regulations;
- duties; and
- tax requirements.

Many of the regulations applicable to our devices and products in these countries are similar to those of the FDA. In many countries, the national health or social security organizations require our products to be qualified before they can be marketed with the benefit of reimbursement eligibility.

Fraud and Abuse. We are subject to various federal and state laws pertaining to health care fraud and abuse, including anti-kickback laws, physician self-referral laws, and false claims laws. Violations of these laws are punishable by criminal and/or civil sanctions, including, in some instances, imprisonment and exclusion from participation in federal and state health care programs, including Medicare, Medicaid, Veterans Administration (VA) health programs and TRICARE. Although we believe that our operations are in material compliance with such laws, we can give no assurances as these laws are far-reaching and their interpretation is subject to change. As a result, we could be required to alter one or more of our practices to remain in compliance with these laws. The occurrence of one or more violations of these laws could result in a material adverse effect on our financial condition and results of operations.

Anti-Kickback Laws. Our operations are subject to federal and state anti-kickback laws. Provisions of the Social Security Act, commonly known as the Anti-Kickback Law, prohibit entities, such as our company, from knowingly and willfully offering, paying, soliciting or receiving any form of remuneration in return for, or to induce:

- the referral of persons eligible for benefits under a federal health care program, including Medicare, Medicaid, the VA health programs and TRICARE, or a state health program; or
- the recommendation, purchase, lease or order of items or services that are covered, in whole or in part, by a federal health care program or state health programs.

The Anti-Kickback Law may be violated when even one purpose, as opposed to a primary or sole purpose, of a payment is to induce referrals or other business. Federal regulations create a small number of safe harbors. Practices which meet all the criteria of an applicable safe harbor will not be deemed to violate the statute; practices that do not satisfy all elements of a safe harbor do not necessarily violate the statute, although such practices may be subject to scrutiny by enforcement agencies.

Violation of the Anti-Kickback Law is a felony, punishable by substantial fines and (for individuals) imprisonment. In addition, the Department of Health and Human Services may impose civil penalties and exclude violators from participation in federal or state health care programs (including Medicare, Medicaid, VA health programs, and TRICARE); if a manufacturer is excluded, its products are not eligible for reimbursement by these programs. Many states have adopted similar anti-kickback laws, which vary in scope and may extend to payments intended to induce the recommendation, purchase, or order of products reimbursed by private payors as well as federal or state health care

programs.

Employee Relations

At December 31, 2006, we employed approximately 3,800 persons throughout the world, including approximately 1,000 in the United States. None of our U.S.-based employees are represented by unions. We consider our relations with our employees to be, in general, very good.

Global Sales

Net sales in the United States were approximately $415.3 million, $302.5 million and $186.9 million for the years ended December 31, 2006, 2005 and 2004, respectively. Our international sales represented approximately $582.2 million, $618.2 million and $555.2 million for the years ended December 31, 2006, 2005 and 2004, respectively, or 58%, 67%, and 75% of total sales, respectively. Sales in Japan were approximately $138.7 million, $174.3 million and $191.5 million for the years ended December 31, 2006, 2005 and 2004, respectively. Our products are sold in over 60 countries. Sales are attributed to the country where the customer resides. Marketing activities are coordinated on a worldwide basis, and resident management teams provide leadership and infrastructure for introduction of new products in the local markets. For additional information relating to our geographic operating segments, see Note 14 of Notes to Consolidated Financial Statements.

Raw Materials

We use a diverse and broad range of raw materials in the design, development and manufacture of our products. While we do fabricate or formulate some of our materials at our manufacturing facilities, we purchase most of the materials and components used in manufacturing our products from external suppliers. In addition, we purchase some supplies from single sources for reasons of quality assurance, sole source availability, cost effectiveness or constraints resulting from regulatory requirements. Several of our materials are sole sourced, including the source of hyaluronic acid used in manufacturing our *Healon* family of products. However, we work closely with our suppliers to assure continuity of supply while maintaining high quality and reliability. Where we buy a material from one source and other sources are available, alternative supplier options are generally considered and identified, although we do not typically pursue regulatory qualification of alternative sources due to the strength of our existing supplier relationships and the time and expense associated with the regulatory process. A change in suppliers could require significant effort or investment by us in circumstances where the items supplied are integral to the performance of our products or incorporate unique technology.

Environmental Matters

Our facilities and operations are subject to federal, state and local environmental and occupational health and safety requirements of the United States and foreign countries, including those relating to discharges of substances to the air, water and land, the handling, storage and disposal of hazardous materials and wastes and the cleanup of properties affected by pollutants. We believe we are currently in material compliance with such requirements and do not currently anticipate any material adverse effect on our business or financial condition as a result of our efforts to comply with such requirements.

In the future, federal, state or local governments in the United States or foreign countries could enact new or more stringent laws or issue new or more stringent regulations concerning environmental and worker health and safety matters that could affect our operations. Also, in the future, contamination may be found to exist at our current or former facilities or off-site locations where we have sent wastes. We could be held liable for such newly-discovered contamination which could have a material adverse effect on our business or financial condition. In addition, changes in environmental and worker health and safety requirements could have a material effect on our business or financial condition.

Competition

The markets for our products are intensely competitive and are subject to significant technological change. Companies within the cataract / implant and laser vision correction markets compete on technological leadership and innovation, quality and efficacy of products, relationships with eye care professionals and health care providers, breadth and depth of product offering and pricing. We believe we have the second largest cataract / implant business on a global basis behind Alcon, Inc., a subsidiary of Nestle S.A. Other competitors in the cataract / implant business include Bausch & Lomb, Staar Surgical, Eyeonics, Hoya, Santen, Zeiss-Meditec and Corneal. We believe we have the world s largest laser vision correction business. Other competitors include Alcon, Bausch & Lomb, Zeiss-Meditec, Moria and Nidek. We believe our competitive position is enhanced by our global distribution network, our focus on technology and customer relationships and product quality. Our ability to compete against larger companies may be impeded by having fewer resources to devote to research and development, sales and marketing.

Companies within the eye care market compete primarily on recommendations from eye care professionals, customer brand loyalty, product quality and pricing. We believe we have one of the top three largest contact lens care businesses on a global basis along with Alcon and Bausch & Lomb. Other competitors include CIBA Vision Corporation, a unit of Novartis, and, within the Japan region, Rohto and Menicon. Our competitive position in the eye care business is enhanced by our strong presence outside the United States and our knowledge of these foreign markets, as well as technological advancement. Our larger competitors have more resources to devote to advertising and promotion, and this may negatively impact our competitive position.

Our competitors may develop technologies and products that are more effective or less costly than any of our current or future products or that could render our products obsolete or noncompetitive. Some of these competitors have substantially more resources and marketing capabilities than we do. Among other things, these consolidated companies can spread their research and development costs over much broader revenue bases than we can and can influence customer and distributor buying decisions. Our inability to produce and develop products that compete effectively against those of our competitors could result in a material reduction in sales.

Patents, Trademarks and Other Intellectual Property

Patents and other proprietary rights are important to the success of our business. We likewise utilize trade secrets, know-how, continuing technological innovations and licensing opportunities to develop and maintain our competitive position. We protect our proprietary rights through a variety of methods, including confidentiality agreements and proprietary information agreements with vendors, employees, consultants and others who have access to our proprietary information.

We have rights to over 1,270 granted and issued patents and over 1,000 pending patent applications relating to aspects of the technology incorporated in many of our products. The scope and duration of our proprietary protection varies throughout the world by jurisdiction and by individual product. In particular, patents for individual products extend for varying periods of time according to the date a patent application is filed, the date a patent is granted and the term of patent protection available in the jurisdiction granting the patent. Our proprietary protection often affords us the opportunity to enhance our position in the marketplace by precluding our competitors from using or otherwise exploiting our technology.

We believe trademark protection is particularly important to the maintenance of the recognized brand names under which we market our products. The scope and duration of our trademark protection varies throughout the world, with some countries protecting trademarks only as long as the mark is used, and others requiring registration of the mark and the payment of registration fees. We own or have rights to material trademarks or trade names that we use in conjunction with the sale of our products, which include, among others, *Advanced Medical Optics®*, *Amadeus*, *AMO®*, *Baerveldt®*, *blink*, *Blink-n-Clean®*, *ClariFlex®*, *Complete®*, *Complete MoisturePLUS*, *Complete Revitalize®*, *Consept®*, *Consept 1 Step*, *Custom Vue®*, *Healon®*, *Healon5®*, *Healon GV®*, *OptiEdge*, *Oxysept®*, *Oxysept 1 Step*, *ReZoom®*, *Sensar®*, *Sovereign®*, *Sovereign Compact*, *Stabileyes®*, *Star S4 IR*, *Tecnis®*, *The Unfolder®*, *UltraCare®*, *Ultrazyme®*, *Verisyse*, *VISX®*, *WaveScan®*, and *WhiteStar®*. Generally, our products are marketed under one of these trademarks or brand names. *Amadeus* is a trademark of SIS Ltd.

We are also a party to several license agreements relating to various aspects of our products; however, we do not believe the loss of any one license would materially affect our business.

We believe that our patents, trademarks and other proprietary rights are important to the development and conduct of our business and the marketing of our products. As a result, we aggressively protect our intellectual property. However, we do not believe that any one of our patents or trademarks is currently of material importance in relation to our overall sales.

Information Available on our Website

Our Internet address is www.amo-inc.com. We make available on our website, free of charge, our filings made with the SEC electronically, including those on Form 10-K, Form 10-Q, and Form 8-K, and any amendments to those filings. Copies are available as soon as reasonably practicable after we have filed or furnished these documents to the SEC (www.sec.gov). Our Code of Ethics, which applies to all employees, is available on our website. Our Code of Ethics is also available in print to any stockholder who requests it from our Investor Relations department, (714) 247-8348. Any changes to the Code of Ethics or waivers granted to our chief executive officer, chief financial officer or controller by our board of directors will be publicized on our website.

Item 1A. Risk Factors

You should carefully consider the following risks and other information. These risks and uncertainties are not the only ones we face. Others that we do not know about now, or that we do not now think are important, may also impair our business. The risks described in this section could cause our actual results to differ materially from those anticipated.

Risks Relating to Our Business

We may not successfully make or integrate acquisitions or enter into strategic alliances.

As part of our business strategy, we intend to pursue selected acquisitions and strategic alliances and partnerships. We compete with other ophthalmic surgical products and eye care companies, among others, for these opportunities and we cannot assure you that we will be able to effect strategic alliances, partnerships or acquisitions on commercially reasonable terms or at all. Even if we do enter into these transactions, we may experience:

- delays in realizing the benefits we anticipate, or we may not realize the benefits we anticipate at all;
- difficulties in integrating any acquired companies and products into our existing business;
- attrition of key personnel from acquired businesses;
- costs or charges;
- difficulties or delays in obtaining regulatory approvals;
- higher costs of integration than we anticipated; or
- unforeseen operating difficulties that require significant financial and managerial resources that would otherwise be available for the ongoing development or expansion of our existing operations.

Consummating these transactions could also result in the incurrence of additional debt and related interest expense, as well as unforeseen contingent liabilities, all of which could have a material adverse effect on our business, financial condition and results of operations. We may also issue additional equity in connection with these transactions, which would dilute our existing stockholders.

We conduct a significant amount of our sales and operations outside of the United States, which subjects us to additional business risks that may cause our profitability to decline.

Because we manufacture and sell a significant portion of our products in a number of foreign countries, our business is subject to risks associated with doing business internationally. In particular, our products are sold in over 60 countries, and most of our manufacturing facilities are located outside the continental United States, in Añasco, Puerto Rico; Madrid, Spain; Hangzhou, China, Uppsala, Sweden and Groningen, Netherlands. In 2006, on an historical basis, we derived approximately $582.2 million, or 58%, of our net sales, from sales of our products outside of the United States, including 14% of our net sales in Japan. We intend to continue to pursue growth opportunities in sales internationally, which could expose us to greater risks associated with international sales and operations. Our international operations are, and will continue to be, subject to a number of risks and potential costs, including:

- unexpected changes in foreign regulatory requirements;
- differing local product preferences and product requirements;
- fluctuations in foreign currency exchange rates;
- political and economic instability;
- cultural differences;
- changes in foreign medical reimbursement and coverage policies and programs;
- diminished protection of intellectual property in some countries outside of the United States;

- trade protection measures and import or export licensing requirements;
- difficulty in staffing and managing foreign operations;

- differing labor regulations; and
- potentially negative consequences from changes in tax laws.

Any of these factors may, individually or as a group, have a material adverse effect on our business and results of operations.

As we expand our existing international operations, we may encounter new risks. For example, as we focus on building our international sales and distribution networks in new geographic regions, we must continue to develop relationships with qualified local distributors and trading companies. If we are not successful in developing these relationships, we may not be able to grow sales in these geographic regions. These or other similar risks could adversely affect our revenue and profitability.

We are exposed to foreign currency risks from our international operations that could adversely affect our financial results.

A significant portion of our sales and operating costs are, and from time to time, a portion of our indebtedness may be, denominated in foreign currencies. We are therefore exposed to fluctuations in the exchange rates between the U.S. dollar and the currencies in which our foreign operations receive revenues and pay expenses, including debt service. Our consolidated financial results are denominated in U.S. dollars and therefore, during times of a strengthening U.S. dollar, our reported international sales and earnings will be reduced because the local currency will translate into fewer U.S. dollars. In addition, the assets and liabilities of our non-U.S. subsidiaries are translated into U.S. dollars at the exchange rates in effect at the balance sheet date. Revenues and expenses are translated into U.S. dollars at the weighted average exchange rate for the period. Translation adjustments arising from the use of differing exchange rates from period to period are included in Accumulated other comprehensive income (loss) in Stockholders equity. Gains and losses resulting from foreign currency fluctuations and remeasurements relating to foreign operations deemed to be operating in U.S. dollar functional currency are included in Other, net in our consolidated statements of operations. Accordingly, changes in currency exchange rates will cause our net earnings and stockholders equity to fluctuate. We use hedging methods on a regular basis to manage the foreign exchange risk. This has historically been accomplished through the use of options and forward contracts.

If we do not introduce new commercially successful products in a timely manner, our products may become obsolete over time, customers may not buy our products and our revenue and profitability may decline.

Demand for our products may change in ways we may not anticipate because of:

- evolving customer needs;
- the introduction of new products and technologies;
- evolving surgical practices; and
- evolving industry standards.

Without the timely introduction of new commercially successful products and enhancements, our products may become obsolete over time, in which case our sales and operating results would suffer. The success of our new product offerings will depend on several factors, including our ability to:

- properly identify and anticipate customer needs;
- commercialize new products in a cost-effective and timely manner;
- manufacture and deliver products in sufficient volumes on time;
- obtain regulatory approval for such new products;
- differentiate our offerings from competitors offerings;

- achieve positive clinical outcomes;
- satisfy the increased demands by health care payors, providers and patients for lower-cost procedures;

- innovate and develop new materials, product designs and surgical techniques; and

- provide adequate medical and/or consumer education relating to new products and attract key surgeons to advocate these new products.

Moreover, innovations generally will require a substantial investment in research and development before we can determine the commercial viability of these innovations and we may not have the financial resources necessary to fund these innovations. In addition, even if we are able to successfully develop enhancements or new generations of our products, these enhancements or new generations of products may not produce revenue in excess of the costs of development and they may be quickly rendered obsolete by changing customer preferences or the introduction by our competitors of products embodying new technologies or features.

We rely on certain suppliers and manufacturers for raw materials and other products and are vulnerable to fluctuations in the availability and price of such products and services.

We purchase certain raw materials and other products from third-party suppliers and vendors, sometimes from limited sources. Our suppliers and vendors may not provide the raw materials or other products needed by us in the quantities requested, in a timely manner, or at a price we are willing to pay. In the event any of our third-party suppliers or vendors were to become unable or unwilling to continue to provide important raw materials and third-party products in the required volumes and quality levels or in a timely manner, or if regulations affecting raw materials such as animal-based products were to change, we would be required to identify and obtain acceptable replacement supply sources. We may not be able to obtain alternative suppliers and vendors on a timely basis, or at all, which could result in lost sales because of our inability to manufacture products containing such raw materials or deliver products we sell from certain suppliers. In addition, we also rely on certain manufacturers for some of our products. We have historically outsourced the manufacture of our phacoemulsification equipment to third parties. If we were unable to renew our third-party manufacturing agreements, or if the manufacturers were to cease manufacturing any of these products for us for any reason, we may not be able to find alternative manufacturers on terms favorable to us, in a timely manner, or at all. If any of these events should occur, our business, financial condition and results of operations could be materially adversely affected.

We face intense competition, and our failure to compete effectively could have a material adverse effect on our profitability and results of operations.

We face intense competition in the markets for our ophthalmic surgical and eye care products and these markets are subject to rapid and significant technological change. We have numerous competitors in the United States and abroad, including, among others, large companies such as Alcon, Inc., a publicly traded subsidiary of Nestle S.A.; Bausch & Lomb; CIBA Vision Corporation, a unit of Novartis, among others. Many of our competitors have substantially more resources and a greater marketing scale than we do. We may not be able to sustain our current levels of profitability and growth as competitive pressures, including pricing pressure from competitors, increase. In addition, if we are unable to develop and produce or market our products to effectively compete against our competitors, our operating results will materially suffer. We also compete against a large number of providers of alternative vision correction solutions, some of which may have greater financial resources than us. New or different methods of vision correction are continually being introduced. Any of these competitive pressures could result in decreased demand for our products.

Because of our leading market position in the laser vision correction business, all of our competitors target our market share in order to grow their own revenues. We can give no assurance that we will be able to maintain or grow our existing market share and it may, in fact, be required to incur considerable expenditures in order to maintain or increase that market share. Should our procedure market share decline, it could have a material adverse effect on our business, financial position, and results of operations.

Trends in the contact lens care market may negatively impact our eye care business.

Our eye care business is impacted by trends in the contact lens care market such as more simplified disinfection systems and technological and medical advances in surgical techniques for the correction of vision impairment. Less expensive one-bottle chemical disinfection systems have gained popularity among soft contact lens wearers instead of peroxide-based lens care products. Also, the growing use and acceptance of daily, frequent replacement and extended wear contact lenses and laser correction procedures, along with the other factors above, could have the effect of continuing to reduce demand for lens care products generally. Our marketing and sales plans may not be appropriate or sufficient to mitigate the effect of these trends on our eye care business and, as a result, our eye care business may suffer.

If we are unable to protect our intellectual property rights, our business and prospects may be harmed.

Our ability to compete effectively is dependent upon our ability to protect and preserve the proprietary aspects of the designs, processes, technologies and materials owned by, used by or licensed to us. We have numerous U.S. patents and corresponding foreign patents that are expected to expire by their own terms at various dates and have additional patent applications pending that may not result in issued patents. Our failure to secure these patents may limit our ability to protect the intellectual property rights that these applications were intended to cover. Although we have attempted to protect our proprietary property, technologies and processes both in the United States and in foreign countries through a combination of patent law, trade secrets and non-disclosure agreements, these may be insufficient. Competitors may be able to design around our patents to compete effectively with our products. We also may not be able to prevent third parties from using our technology without our authorization, breaching any non-disclosure agreements with us, or independently developing technology that is similar to ours. The use of our technology or similar technology by others could reduce or eliminate any competitive advantage we have developed, cause us to lose sales or otherwise harm our business. If it became necessary for us to resort to litigation to protect these rights, any proceedings could be costly and we may not prevail. Further, we may not be able to obtain patents or other protections on our future innovations. In addition, because of the differences in foreign patent and other laws concerning proprietary rights, our products may not receive the same degree of protection in foreign countries as they would in the United States. We cannot assure you that:

- pending patent applications will result in issued patents;
- patents issued to or licensed by us will not be challenged by third parties; or
- our patents will be found to be valid or sufficiently broad to protect our technology or provide us with a competitive advantage.

We may be subject to intellectual property litigation and infringement claims, which could cause us to incur significant expenses or prevent us from selling our products.

There is a substantial amount of litigation over patent and other intellectual property rights in the ophthalmic industry. The fact that we have patents issued to us for our products does not mean that we will always be able to successfully defend our patents and proprietary rights against challenges or claims of infringement by our competitors. A successful claim of patent or other intellectual property infringement or misappropriation against us could adversely affect our growth and profitability, in some cases materially. We cannot assure you that our products do not and will not infringe issued patents or other intellectual property rights of third parties. From time to time, in the ordinary course of business, we receive notices from third parties alleging infringement or misappropriation of the patent, trademark and other intellectual property rights of third parties by us or our consumers in connection with the use of our products. We may be unaware of intellectual property rights of others that may cover some of our technology. If someone claims that our products infringe their intellectual property rights, whether or not such claims are meritorious, any resulting litigation could be costly and time consuming and would divert the attention of our management and personnel from other business issues. The complexity of the technology involved and the uncertainty of intellectual property litigation increase these risks. Claims of intellectual property infringement also might require us to enter into costly royalty or license agreements (if available on acceptable terms or at all). We also may be subject to significant damages or an injunction preventing us from manufacturing, selling or using some or some aspect of our products. We may also need to redesign some of our products or processes to avoid future infringement liability. Any of these adverse consequences could have a material adverse effect on our business and profitability.

Our manufacturing capacity may not be adequate to meet the demands of our business.

If our sales increase substantially, we may need to increase our production capacity. Any prolonged disruption in the operation of our manufacturing facilities or those of our third-party manufacturers could materially harm our business. We cannot assure you that if we choose to scale-up our manufacturing operations, we will be able to obtain regulatory approvals in a timely fashion, which could affect our ability to meet product demand or result in additional costs.

We could experience losses due to product liability claims, product recalls or corrections.

We have in the past been, and continue to be, subject to product liability claims. In connection with our spin-off from Allergan, we assumed the defense of any litigation involving claims related to our business and agreed to indemnify Allergan for all related losses, costs and expenses. As part of our risk management policy, we have obtained third-party product liability insurance coverage. Product liability claims against us may exceed the coverage limits of our insurance policies or cause us to record a self-insured loss. A product liability claim in excess of applicable insurance could have a material adverse effect on our

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business, financial condition and results of operations. Even if any product liability loss is covered by an insurance policy, these policies have substantial retentions or deductibles that provide that we will not receive insurance proceeds until the losses incurred exceed the amount of those retentions or deductibles. To the extent that any losses are below these retentions or deductibles, we will be responsible for paying these losses. The payment of retentions or deductibles for a significant amount of claims could have a material adverse effect on our business, financial condition and results of operations.

In addition, we are subject to medical device reporting regulations that require us to report to the FDA or similar governmental authorities in other countries if our products cause or contribute to a death or serious injury or malfunction in a way that would be reasonably likely to contribute to death or serious injury if the malfunction were to recur. The FDA and similar governmental authorities in other countries have the authority to require the recall of our products in the event of material deficiencies or defects in design or manufacturing. A government mandated or voluntary recall by us could occur as a result of manufacturing errors or design defects, including defects in labeling. We have undertaken voluntary recalls of our products in the past.

Any product liability claim or recall would divert managerial and financial resources and could harm our reputation with customers. We cannot assure you that we will not have product liability claims or recalls in the future or that such claims or recalls would not have a material adverse effect on our business.

In November 2006, we commenced a voluntary recall of eye care solutions, which resulted in a material decrease in eye care sales and increased costs associated with the recall and the necessary corrective measures, including temporary shutdown of production lines in China. We cannot assure you that we have fully anticipated the impact of this recall on our eye care business or that we will be able to regain our market position, particularly in Asia. We also cannot assure you that we will be able to address all associated manufacturing issues on a timely basis.

If we fail to maintain our relationships with health care providers, customers may not buy our products and our revenue and profitability may decline.

We market our products to numerous health care providers, including eye care professionals, hospitals, ambulatory surgical centers, corporate optometry chains and group purchasing organizations. We have developed and strive to maintain close relationships with members of each of these groups who assist in product research and development and advise us on how to satisfy the full range of surgeon and patient needs. We rely on these groups to recommend our products to their patients and to other members of their organizations. The failure of our existing products and any new products we may introduce to retain the support of these various groups could have a material adverse effect on our business, financial condition and results of operations.

We generally do not have long-term contracts with our customers.

We generally do not enter into long-term contracts with our customers. As a result, we are exposed to volatility in the market for our products and loss of our customers. As a result, we may not be able to maintain our level of profitability. If we are unable to market our products on terms we find acceptable, our financial condition and results of operations could suffer materially.

Our business is subject to extensive government regulation.

Our products and operations are subject to extensive regulation in the United States by the FDA and various other federal and state regulatory agencies, including with respect to regulatory clearance or approval of our products, clinical and pre-clinical testing, product marketing, sales and distributions, adverse event reporting, prohibitions on fraud and abuse, submission of false claims, kickbacks and rebates, and relationships with physicians and other referral sources. Additionally, in many foreign countries in which we market our products, we are subject to similar regulations.

Before a new medical device or new use of, or claim for, or modification to an existing product can be marketed in the United States, a company may have to apply for and receive either 510(k) clearance or premarket approval. Either process can be expensive, lengthy and unpredictable. Also, the identification or increased frequency of safety or efficacy concerns could result in product recall or withdrawal or revocation of our FDA clearance or premarket approval. Compliance with these regulations is expensive and time-consuming. We, our subcontractors, and third party manufacturers are subject to periodic and unannounced inspections by FDA and governmental authorities to assess compliance. If we fail to comply, the FDA and state or other regulatory agencies have broad enforcement powers, including any of the following sanctions:

- warning letters, fines, injunctions, consent decrees, civil penalties and exclusion from participation in federal and state health care programs;

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- repair, replacement, recall or seizure of our products;
- operating restrictions, partial suspension or total shutdown of production;
- refusing our requests for 510(k) clearance or premarket approval of new products, new intended uses or modifications to existing products;
- withdrawing 510(k) clearance or premarket approvals that have already been granted; and
- criminal prosecution and penalties.

Product sales, introductions or modifications may be delayed or canceled as a result of U.S. or foreign regulatory processes, which could cause our sales to decline. Failure to obtain regulatory clearance or approvals of new products or product modifications we develop, any limitations imposed by regulatory agencies on new product uses or the costs of obtaining regulatory clearance or approvals could have a material adverse effect on our business, financial condition and results of operations.

We, our subcontractors, and third-party manufacturers are also subject to similar state requirements and licenses. We, our subcontractors, and third-party manufacturers must comply with extensive recordkeeping and reporting requirements and must make available our manufacturing facilities and records for unannounced and periodic inspections by governmental agencies, including FDA, state authorities and comparable agencies in other countries.

Health care initiatives and other cost-containment pressures could cause us to sell our products at lower prices, resulting in less revenue to us. In the United States, a significant percentage of the patients who receive our intraocular lenses are covered by the federal Medicare program. Changes in coverage or coding policies or reductions in Medicare reimbursement rates and the implementation of other price controls could adversely affect our revenues and financial condition. In addition, changes in existing regulatory requirements or adoption of new requirements could hurt our business, financial condition and results of operations.

The clinical trial process required to obtain regulatory approvals is costly and uncertain, and could result in delays in new product introductions or even an inability to release a product.

The clinical trials required to obtain regulatory approvals for our products are complex and expensive and their outcomes are uncertain. We incur substantial expense for, and devote significant time to, clinical trials but cannot be certain that the trials will ever result in the commercial sale of a product. We may suffer significant setbacks in clinical trials, even after earlier clinical trials showed promising results. Any of our products may produce undesirable side effects that could cause us or regulatory authorities to interrupt, delay or halt clinical trials of a product candidate. We, the FDA, or another regulatory authority may suspend or terminate clinical trials at any time if they or we believe the trial participants face unacceptable health risks.

Our business is subject to environmental regulations.

Our facilities and operations are subject to federal, state and local environmental and occupational health and safety requirements of the United States and foreign countries, including those relating to discharges of substances to the air, water and land, the handling, storage and disposal of hazardous materials and wastes and the cleanup of properties affected by pollutants. Failure to maintain compliance with these regulations could have a material adverse effect on our business or financial condition.

In the future, federal, state or local governments in the United States or foreign countries could enact new or more stringent laws or issue new or more stringent regulations concerning environmental and worker health and safety matters that could affect our operations. Also, in the future, contamination may be found to exist at our current or former facilities or off-site locations where we have sent wastes. We could be held liable for such newly discovered contamination which could have a material adverse effect on our business or financial condition. In addition, changes in environmental and worker health and safety requirements could have a material adverse effect on our business or financial condition.

If we fail to attract, hire and retain qualified personnel, we may not be able to design, develop, market or sell our products or successfully manage our business.

Our ability to attract new customers, retain existing customers and pursue our strategic objectives depends on the continued services of our current management, sales, product development and technical personnel and our ability to identify, attract, train and retain similar personnel.

Competition for top management personnel is intense and we may not be able to recruit and retain the personnel we need. The loss of any one of our management personnel, or our inability to identify, attract, retain and integrate

additional qualified management personnel, could make it difficult for us to manage our business successfully and pursue our strategic objectives. Similarly, competition for skilled sales, product development and technical personnel is intense and we may not be able to recruit and retain the personnel we need. The loss of services of a number of key sales, product development and technical personnel, or our inability to hire new personnel with the requisite skills, could restrict our ability to develop new products or enhance existing products in a timely manner, sell products to our customers or manage our business effectively.

We may not be able to hire or retain qualified personnel if we are unable to offer competitive salaries and benefits. If our stock does not perform well, we may have to increase our salaries and benefits, which would increase our expenses and reduce our profitability.

We may be required to satisfy certain indemnification obligations to Allergan, and we may not be able to collect on indemnification rights from Allergan.

Under the terms of our contribution and distribution agreement with Allergan, we and Allergan have each agreed to indemnify each other from and after our spin-off with respect to the debt, liabilities and obligations retained by our respective companies. These indemnification obligations could be significant. The ability to satisfy these indemnities, if called upon to do so, will depend upon the future financial strength of each of our respective companies. We cannot determine whether we will have to indemnify Allergan for any substantial obligations, and we may not have control over the settlement of certain claims and lawsuits that may require partial indemnification by us. We also cannot assure you that, if Allergan is required to indemnify us for any substantial obligations, Allergan will have the ability to satisfy those obligations.

We may be responsible for federal income tax liabilities that relate to the distribution of our common stock by Allergan.

Allergan has received a ruling from the Internal Revenue Service to the effect that the spin-off qualified as a tax-free transaction. If either us or Allergan breach representations to each other or to the Internal Revenue Service, or if we or Allergan take or fail to take, as the case may be, actions that result in the spin-off failing to meet the requirements of a tax-free spin-off pursuant to Section 355 of the Internal Revenue Code, the party in breach will indemnify the other party for any and all resulting taxes. If we were required to pay any of the potential taxes described above, the payment would have a material adverse effect on our financial position.

If laser vision correction is not broadly accepted by both doctors and patients, our business, financial position and results of operations would be materially and adversely impacted.

Our business depends upon broad market acceptance of laser vision correction by both doctors and patients in the United States and key international markets. Our profitability and growth will be largely dependent on increasing levels of market acceptance and procedure growth, especially with regard to our higher-priced *CustomVue* procedure. Potential complications and side effects of laser vision correction include: post-operative discomfort, corneal haze (an increase in the light scattering properties of the cornea) during healing, glare/halos (undesirable visual sensations produced by bright lights), decreases in contrast sensitivity, temporary increases in intraocular pressure in reaction to procedure medication, modest fluctuations in refractive capabilities during healing, modest decrease in best corrected vision (i.e., with corrective eyewear), unintended over- or under-corrections, regression of effect, disorders of corneal healing, corneal scars, corneal ulcers, and induced astigmatism (which may result in blurred or double vision and/or shadow images). Some consumers may choose not to undergo laser vision correction because of these complications or more general concerns relating to its safety and efficacy or a resistance to surgery in general. Alternatively, some consumers may elect to delay undergoing laser vision correction surgery because they believe improved technology or methods of treatment will be available in the near future. Should either the ophthalmic community or the general population turn away from laser vision correction as an alternative to existing methods of treating refractive vision disorders, or if future technologies replaced laser vision correction, these developments could delay or prevent market acceptance of laser vision correction, which could have a material adverse effect on our business, financial position and results of operations.

The possibility of long-term side effects and adverse publicity regarding laser correction surgery could seriously harm our business.

Laser vision correction is a relatively new procedure. Consequently, there is no long-term follow-up data beyond ten years that might reveal additional complications or unknown side effects. Any future reported side effects, other adverse events or unfavorable publicity involving patient outcomes resulting from the use of laser vision correction systems manufactured by us or any participant in the laser vision correction market, may have a material adverse effect on our business, financial position, and results of operations.

General economic conditions could have a negative impact on our business, financial position, and results of operations.

Because laser vision correction is not subject to reimbursement from third-party payors such as insurance companies or government programs, the cost of laser vision correction is typically borne by individuals directly. Accordingly, weak or uncertain economic conditions may cause individuals to be less willing to incur the procedure cost associated with laser vision correction as was evidenced by VISX s decline in revenues from 2002 compared to 2001 and from 2001 compared to 2000. A decline in economic conditions, especially in the United States, could result in a decline in the number of laser vision correction procedures performed and could have a material adverse effect on our business, financial position, and results of operations.

While we devote significant resources to research and development, our research and development may not lead to new products that achieve commercial success.

Our research and development process is expensive, prolonged, and entails considerable uncertainty. Because of the complexities and uncertainties associated with ophthalmic research and development, products we are currently developing may not complete the development process or obtain the regulatory approvals required to market such products successfully. The products currently in our development pipeline may not be approved by regulatory entities and may not be commercially successful, and our current and planned products could be surpassed by more effective or advanced products.

Any failure by third party financing entities to satisfy their obligations to us would negatively impact our financial condition.

We have relationships with third party financing entities that purchase our products directly and subsequently lease and/or sell these products to end-user customers, or provide financing directly to customers who purchase products directly from us. Should any third party financing entity or entities fail or refuse to pay us in a timely manner or at all, it could negatively affect our cash flows and could have a material adverse effect on our business, financial position and results of operations.

If any of our employees, consultants or others breach their proprietary information agreements, our competitive position could be harmed.

We protect our proprietary technology, in part, through proprietary information and inventions agreements with employees, consultants and other parties. These agreements with employees and consultants generally contain standard provisions requiring those individuals to assign to us, without additional consideration, inventions conceived or reduced to practice by them while employed or retained by us, subject to customary exceptions. If any of our employees, consultants or others breach these agreements our competitors may learn of our trade secrets.

Risks Relating to Our Indebtedness and Our Common Stock

We have a significant amount of debt. Our substantial indebtedness could adversely affect our business, financial condition and results of operations and our ability to meet our payment obligations under our debt.

We have a significant amount of debt and substantial debt service requirements. As of December 31, 2006, we had $851.1 million of outstanding debt. Approximately $8.4 million of our revolving credit facility was reserved to support letters of credit issued on our behalf and $291.6 million, exclusive of letters of credit, was available for future borrowings. In addition, we anticipate funding up to $900 million of new debt in connection with our proposed acquisition of IntraLase Corp. See Risks Relating to the Pending IntraLase Corp. Acquisition beginning on page 24.

This level of debt could have significant consequences on our future operations, including:

- making it more difficult for us to meet our payment and other obligations under our outstanding debt;

- resulting in an event of default if we fail to comply with the financial and other restrictive covenants contained in our debt agreements, which event of default could result in all of our debt becoming immediately due and payable;

- reducing the availability of our cash flow to fund working capital, capital expenditures, acquisitions and other general corporate purposes, and limiting our ability to obtain additional financing for these

purposes;

- subjecting us to the risk of increased sensitivity to interest rate increases on our indebtedness with variable interest rates, including borrowings under our senior credit facility;

- limiting our flexibility in planning for, or reacting to, and increasing our vulnerability to, changes in our business, the industry in which we operate and the general economy; and

- placing us at a competitive disadvantage compared to our competitors that have less debt or are less leveraged.

Any of the above-listed factors could have an adverse effect on our business, financial condition and results of operations and our ability to meet our payment obligations under the notes and our other debt.

To service our indebtedness, we will require a significant amount of cash. Our ability to generate cash flow depends on many factors beyond our control.

Our ability to meet our payment and other obligations under our debt depends on our ability to generate significant cash flow in the future. This, to some extent, is subject to general economic, financial, competitive, legislative and regulatory factors as well as other factors that are beyond our control. We cannot assure holders that our business will generate cash flow from operations, or that future borrowings will be available to us under our senior credit facility or otherwise, in an amount sufficient to enable us to meet our payment obligations under our debt and to fund other liquidity needs. We made an irrevocable election to satisfy in cash our conversion obligation with respect to the principal amount of any of our 2.50% convertible senior subordinated notes due 2024 (the Existing 2.50% Convertible Notes) converted after December 15, 2004, with any remaining amount of the conversion obligation to be satisfied in shares of our common stock, in each case, calculated as set forth in the indenture governing the Existing 2.50% Convertible Notes. In addition, because we made this election, the indenture provides that we must satisfy in cash our obligations to repurchase any Existing 2.50% Convertible Notes that holders put to us on January 15, 2010, July 15, 2014 and July 15, 2019.

If the Existing 2.50% Convertible Notes become convertible pursuant to their terms and the holders elect to convert or if holders elect to put their notes to us on the specified repurchase dates, we may not have sufficient cash to satisfy our obligations. In addition, our 1.375% and 3.25% convertible senior subordinated notes due 2025 and 2026, respectively, contain similar provisions. We may be unable to repurchase the notes for cash when required by the holders, including following a fundamental change, or to pay the portion of the conversion value upon conversion of any notes by the holders. Our repurchase of any such notes may be prohibited by our other debt instruments, which could cause defaults and cross-defaults under our other debt agreements. If we are not able to generate sufficient cash flow to service our debt obligations, we may need to refinance or restructure our, sell assets, reduce or delay capital investments, or seek to raise additional capital. If we are unable to implement one or more of these alternatives, we may not be able to meet our payment obligations under the notes and our other debt.

A significant amount of our debt agreements contain covenant restrictions that may limit our ability to operate our business.

The agreements governing our senior credit facility contain covenant restrictions that limit our ability to operate our business, including restrictions on our ability to:

- incur additional debt or issue guarantees;

- create liens;

- make certain investments;

- enter into transactions with our affiliates;

- sell certain assets;

- redeem capital stock or make other restricted payments;

- declare or pay dividends or make other distributions to stockholders; and

- consolidate, merge or transfer all or substantially all of our assets and the assets of our subsidiaries on a consolidated basis.

Our senior credit facility requires us to maintain specific leverage, fixed charge coverage and interest coverage ratios. Our ability to comply with these covenants is dependent on our future performance, which will be subject to many factors, some of which are beyond our control, including prevailing economic conditions. Our failure to comply with these obligations would

prevent us from borrowing additional money under the facility and could result in a default under it. If a default occurs under any of our senior indebtedness, the relevant lenders could elect to declare the indebtedness, together with accrued interest and other fees, to be immediately due and payable and proceed against substantially all of our assets, which will serve as collateral securing the indebtedness. Moreover, if the lenders under a facility or other agreement in default were to accelerate the indebtedness outstanding under that facility, it could result in a default under other indebtedness. If all or any part of our indebtedness were to be accelerated, we may not have or be able to obtain sufficient funds to repay it. In addition, we may incur other indebtedness in the future that may contain financial or other covenants that are more restrictive than those contained in our current indentures.

As a result of these covenants, our ability to respond to changes in business and economic conditions and to obtain additional financing, if needed, may be significantly restricted, and we may be prevented from engaging in transactions that might otherwise be beneficial to us. In addition, our failure to comply with these covenants could result in a default under our debt, which could permit the holders to accelerate such debt. If any of our debt is accelerated, we may not have sufficient funds available to repay such debt. As of December 31, 2006, we were in compliance with our financial and other covenants.

Despite our and our subsidiaries current levels of indebtedness, we may incur substantially more debt, which could further exacerbate the risks associated with our substantial indebtedness.

Although certain of our debt agreements contain restrictions on the incurrence of additional indebtedness, these restrictions are subject to a number of qualifications and exceptions, and the indebtedness incurred in compliance with these restrictions could be substantial. Also, these restrictions do not prevent us from incurring obligations that do not constitute indebtedness as defined in the relevant agreement. If new debt is added to our current debt levels, the related risks that we now face could intensify.

Our stock price may fluctuate as a result of a variety of factors, many of which are beyond our control. These factors include:

- quarterly variations in our operating results;
- operating results that vary from the expectations of management, securities analysts and investors;
- changes in expectations as to our future financial performance;
- announcements of innovations, new products, strategic developments, significant contracts, acquisitions and other material events by us or our competitors;
- the operating and securities price performance of other companies that investors believe are comparable to us;
- future sales of our equity or equity-related securities;
- changes in general conditions in our industry and in the economy, the financial markets and the domestic or international political situation;
- developments or disputes (including lawsuits) concerning proprietary rights;
- developments in the insurance market, which may limit the amount of insurance coverage available to us;
- departures of key personnel; and
- regulatory considerations.

In addition, in recent years, the stock market in general has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market price of securities issued by many companies for reasons often unrelated to their operating performance. These broad market fluctuations may adversely affect our stock price, regardless of our operating results.

Our stockholder rights plan, amended and restated certificate of incorporation and bylaws, as well as provisions of Delaware law, could make it difficult for a third party to acquire our company.

We have a stockholder rights plan that may have the effect of discouraging unsolicited takeover proposals. The rights issued under the stockholder rights plan would cause substantial dilution to a person or group that attempts to acquire us on terms not

approved in advance by our board of directors. In addition, Delaware corporate law and our amended and restated certificate of incorporation and bylaws contain provisions that could delay, deter or prevent a change in control of our company or our management. These provisions could also discourage proxy contests and make it more difficult for our stockholders to elect directors and take other corporate actions without the concurrence of our management or board of directors. These provisions:

- authorize our board of directors to issue blank check preferred stock, which is preferred stock that can be created and issued by our board of directors, without stockholder approval, with rights senior to those of common stock;

- provide for a staggered board of directors and three-year terms for directors, so that no more than one-third of our directors could be replaced at any annual meeting;

- provide that directors may be removed only for cause;

- provide that stockholder action may be taken only at a special or regular meeting and not by written consent;

- provide for super-majority voting requirements for some provisions of our charter; and

- establish advance notice requirements for submitting nominations for election to the board of directors and for proposing matters that can be acted upon by stockholders at a meeting.

We are also subject to anti-takeover provisions under Delaware law, which could also delay or prevent a change of control. Together, these provisions of our amended and restated certificate of incorporation and bylaws, Delaware law and our stockholder rights plan may discourage transactions that otherwise could provide for the payment of a premium over prevailing market prices of our common stock and, possibly, the notes, and also could limit the price that investors are willing to pay in the future for shares of our common stock and the notes.

Risks Relating to the Pending IntraLase Corp. Acquisition

Even though we and IntraLase have obtained the regulatory approvals required to complete the merger, governmental authorities could still seek to block or challenge the merger.

The merger is subject to review by the Antitrust Division of the Department of Justice and the FTC under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act). Under the HSR Act, we and IntraLase are required to make pre-merger notification filings and to await the expiration or early termination of the statutory waiting period prior to completing the merger. The merger is also subject to review by certain other governmental authorities under the antitrust laws of various other jurisdictions where IntraLase conducts business. We have made all required regulatory filings, the applicable waiting periods have expired and we have therefore obtained all regulatory clearances, consents and approvals required to complete the merger with the exception of one review pending in Germany. However, after the statutory waiting periods have expired, and even after completion of the merger, governmental authorities could seek to block or challenge the merger as they deem necessary or desirable in the public interest. In addition, in some jurisdictions, a competitor, customer or other third party could initiate a private action under the antitrust laws challenging or seeking to enjoin the merger, before or after it is completed. We, IntraLase or the combined company may not prevail, or may incur significant costs, in defending or settling any action under the antitrust laws.

We will have more indebtedness after the acquisition of IntraLase, which could adversely affect our cash flows and business.

In order to complete the acquisition, we anticipate arranging for and funding up to $900 million of new financing. Proceeds from the financing will be used to fund the cash consideration paid to IntraLase stockholders. Our debt outstanding as of December 31, 2006 was $851.1 million. As a result of the increase in debt, demands on our cash resources may increase after the completion of the acquisition. The increased levels of debt could, among other things:

- require us to dedicate a substantial portion of our cash flow from operations to payments on our debt, thereby reducing funds available for working capital, capital expenditures, acquisitions and other purposes;

- increase our vulnerability to, and limit our flexibility in planning for, adverse economic and industry conditions;

- affect our credit rating;

- limit our ability to obtain additional financing to fund future working capital, capital expenditures, additional acquisitions and other general corporate requirements;
- create competitive disadvantages compared to other companies with less indebtedness; and
- limit our ability to apply proceeds from an offering or asset sale to purposes other than the repayment of debt.

Although we expect that the acquisition will result in benefits to the combined company, the combined company may not realize those benefits because of integration and other challenges.

Our ability to realize the anticipated benefits of the acquisition will depend, in part, on our ability to integrate the business of IntraLase with our business. The combination of two independent companies is a complex, costly and time-consuming process. This process may disrupt the business of either or both of the companies, and may not result in the full benefits expected by us. The difficulties of combining the operations of the companies include, among others:

- coordinating marketing functions;
- unanticipated issues in integrating information, communications and other systems;
- unanticipated incompatibility of purchasing, logistics, marketing and administration methods;
- retaining key employees;
- consolidating corporate and administrative infrastructures;
- the diversion of management s attention from ongoing business concerns; and
- coordinating geographically separate organizations.

We cannot assure you that the combination of IntraLase with us will result in the realization of the full benefits anticipated from the acquisition.

If the proposed acquisition of IntraLase is not completed, we will have incurred substantial costs that may adversely affect our financial results and operations and the market price of our common stock.

We have incurred and will incur substantial costs in connection with the proposed acquisition of IntraLase. These costs are primarily associated with the fees of attorneys, accountants and our financial advisors. In addition, we have diverted significant management resources in an effort to complete the acquisition and we are subject to restrictions contained in the definitive agreement on the conduct of our business. If the acquisition is not completed, we will have incurred significant costs, including the diversion of management resources, for which we will have received little or no benefit. Also, if the acquisition is not completed under certain circumstances specified in the definitive agreement, we may be required to pay IntraLase expenses in the amount of $7 million.

In addition, if the acquisition is not completed, we may experience negative reactions from the financial markets and our collaborative partners, customers and employees. Each of these factors may adversely affect the trading price of our common stock and our financial results and operations.

Item 1B. Unresolved Staff Comments

We have no unresolved written comments from the Commission.

Item 2. Properties

Our principal executive offices and research facilities are located in Santa Ana, California, in a facility subleased by us through July 2015. We also have an administrative, research and development and manufacturing facility in Santa Clara, California, the lease for which expires in May 2008. We conduct our global operations in facilities that we own or lease. Material facilities include administrative facilities in Australia, Canada, France, Germany, Hong Kong, Ireland, Italy, Spain and the United Kingdom. We also have two facilities in Japan, one used for administration and research and development and the other used for warehousing. We lease all of these facilities. In addition, we operate five manufacturing facilities: one in Añasco, Puerto Rico, where we lease the land and the facility, one in Madrid, Spain, where we own the land and the facility, one in Hangzhou, China, where we own the facility but lease the land, one in Uppsala, Sweden, where we own the land and the facility, and one in Groningen, Netherlands, where we own the land and the facility. We believe these facilities are adequate for the current needs of our business.

Item 3. Legal Proceedings

On January 4, 2005, Dr. James Nielsen filed a complaint against us and Allergan, Inc. in the U.S. District Court of the Northern District of Texas, Dallas Division, for infringement of U.S. Patent No. 5,158,572. Dr. Nielsen alleges that our *Array* multifocal intraocular lens infringes the patent. He is seeking damages and a permanent injunction. The trial in this matter was scheduled to begin on November 6, 2006, but this date has been vacated. A new trial date has not yet been scheduled.

We do not believe, based on current knowledge, that the foregoing legal proceeding is likely to have a material adverse effect on our financial position, results of operations or cash flows. However, we may incur substantial expenses in defending against third party claims. In the event of a determination adverse to us or our subsidiaries, we may incur substantial monetary liability, and be required to change our business practices. Either of these could have a material adverse effect on our financial position, results of operations or cash flows.

While we are involved from time to time in litigation arising in the ordinary course of business, including product liability claims, we are not currently aware of any other actions against us or Allergan relating to the optical medical device business that we believe would have a material adverse effect on our business, financial condition, results of operations or cash flows. We may be subject to future litigation and infringement claims, which could cause us to incur significant expenses or prevent us from selling our products. We operate in an industry susceptible to significant product liability claims. Product liability claims may be asserted against us in the future arising out of events not known to us at the present time. Under the terms of the contribution and distribution agreement effecting our spin-off, Allergan agreed to assume responsibility for, and to indemnify us against, all current and future litigation relating to its retained businesses and we agreed to assume responsibility for, and to indemnify Allergan against, all current and future litigation related to the optical medical device business.

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

We did not submit any matter during the fourth quarter of the fiscal year covered by this report to a vote of security holders, through the solicitation of proxies or otherwise.

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Dividends. We have never declared or paid any cash dividends on our common stock or any of our securities. We do not expect to pay cash dividends on our capital stock in the foreseeable future. We intend to retain our future earnings to continue to fund the development and growth of our business as well as repay long-term debt. In addition, our amended and restated senior credit facility prohibits us from paying cash dividends.

Market Information. The following table shows the quarterly price range of our common stock during the periods listed.

	2006		2005	
Calendar Quarter	**Low**	**High**	**Low**	**High**
First	$ 41.11	$ 47.23	$ 35.91	$ 44.53
Second	43.97	50.70	35.00	40.90
Third	38.75	52.04	37.25	43.30
Fourth	34.77	41.94	32.04	44.00

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Our common stock is listed on the New York Stock Exchange and is traded under the symbol EYE. The closing price of our common stock was $38.94 on February 26, 2007.

The approximate number of stockholders of record was 4,600 as of February 26, 2007.

Item 6. Selected Financial Data

The following table sets forth selected financial data as of and for each of the years in the five-year period ended December 31, 2006, which has been derived from our audited consolidated financial statements.

The selected financial data may not be indicative of the results of operations or financial position that we would have obtained if we had been an independent company during the pre-spin-off period of 2002 presented.

No earnings per share data is presented for the year ended December 31, 2002 as our earnings were a part of Allergan s earnings through the close of business on June 28, 2002.

	For the Year Ended December 31,				
	2006(c)	2005(b)	2004(a)	2003	2002
	(in thousands, except per share data)				
Statement of Operations:					
Net sales	$ 997,496	$ 920,673	$ 742,099	$ 601,453	$ 538,087
Cost of sales	379,325	353,325	306,164	227,811	204,338
Gross profit	618,171	567,348	435,935	373,642	333,749
Selling, general and administrative	404,802	396,599	329,197	276,695	235,977
Research and development	66,099	61,646	45,616	37,413	29,917
In-process research and development		490,750	28,100		
Business repositioning	46,417	29,680			
Net gain on legal contingencies	(96,896)				
Operating income (loss)	197,749	(411,327)	33,022	59,534	67,855
Interest expense	30,272	29,332	26,933	24,224	13,764
Loss on investments, net					3,935
Unrealized loss (gain) on derivative instruments	1,290	(2,563)	403	246	3,199
Loss due to early retirement of Convertible Senior Subordinated Notes	18,783	1,885	116,282		
Other, net	2,588	316	10,620	17,802	2,385
Earnings (loss) before income taxes	144,816	(440,297)	(121,216)	17,262	44,572
Provision for income taxes	65,345	12,900	8,154	6,905	18,662
Net earnings (loss)	$ 79,471	$ (453,197)	$ (129,370)	$ 10,357	$ 25,910
Basic earnings (loss) per share	$ 1.25	$ (8.28)	$ (3.89)	$ 0.36	
Diluted earnings (loss) per share	$ 1.21	$ (8.28)	$ (3.89)	$ 0.35	

(a) Includes results of the acquired Pfizer Inc. Surgical Ophthalmic Business since June 26, 2004 (date of acquisition).

(b) Includes results of the acquired VISX business since May 27, 2005 (date of acquisition).

(c) In 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment.

	As of December 31,				
	2006	2005	2004	2003	2002
	(in thousands)				
Balance Sheet Data:					
Cash and equivalents	$ 34,522	$ 40,826	$ 49,455	$ 46,104	$ 80,578
Current assets	478,143	479,005	376,825	252,492	274,494
Total assets	2,013,897	1,980,722	1,076,534	461,345	463,206
Current liabilities	217,453	260,116	193,923	115,301	108,204
Long term debt, net of current portion and short-term borrowings	851,105	500,000	550,643	233,611	277,559

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

The following discussion and analysis presents the factors that had a material effect on AMO s results of operations and cash flows during each of the three years in the period ended December 31, 2006, and the Company s financial position at that date. Except for the historical information contained herein, the following discussion contains forward-looking statements that involve risk and uncertainties. Our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in the section entitled Risk Factors. This discussion and analysis should be read in conjunction with the historical consolidated financial statements of AMO and related notes thereto included elsewhere in this Form 10-K.

Overview

We are a global leader in the development, manufacture and marketing of medical devices for the eye. Effective January 1, 2006, our reportable segments are represented by our three business units: cataract/implant, laser vision correction (LVC) and eye care. Previously, our reportable segments were based on geographic regions which comprised the Americas, which included North and South America, Europe/Africa/Middle East, Japan and Asia Pacific, which excluded Japan and included New Zealand and Australia. Sales and operating results for 2005 and 2004 have been conformed to reflect the change in presentation of reportable segments. Our cataract/implant business focuses on the four key products required for cataract surgery foldable intraocular lenses, or IOLs, implantation systems, phacoemulsification systems and viscoelastics. Our LVC business markets laser systems, diagnostic devices, treatment cards and microkeratomes for use in laser eye surgery. Our eye care business provides a full range of contact lens care products for use with most types of contact lenses. These products include single-bottle, multi-purpose cleaning and disinfecting solutions, hydrogen peroxide-based disinfecting solutions, daily cleaners, enzymatic cleaners and contact lens rewetting drops.

We have operations in approximately 20 countries and sell our products in approximately 60 countries in the following four regions:

- Americas (North and South America);
- Europe, Africa and Middle East;
- Japan; and
- Asia Pacific (excluding Japan, but including Australia and New Zealand).

Eye Care Recall

In November 2006, we announced the anticipated financial impact associated with the voluntary recall of certain eye care product lots and the related manufacturing capacity constraints caused by a production-line issue at our manufacturing plant in China. The recall negatively impacted sales in the fourth quarter of 2006 due to sales returns of $9.5 million. We also estimated approximately $15.0 million in lost sales in 2006 as a result of the recall. The total of $24.5 million was slightly higher than our original estimate due to higher returns. We incurred approximately $15.4 million in recall-related costs, of which approximately $9.5 million was recorded in cost of goods sold and $5.9 million was recorded in selling, general and administrative expenses. In 2007, we expect to lose approximately $20 million to $25 million in sales and incur about $20 million to $25 million in costs. The costs are due to start-up related expenses and unabsorbed overhead as production ramps up in the first and second quarters of 2007 and to spending on marketing programs to re-launch products and recapture market share.

We commenced the voluntary recall as a result of a production-line issue at our manufacturing plant in China, which could affect the sterility of the product. This issue was limited to two of the four production lines in the China facility. In all, we recalled 2.9 million units, most from Asia Pacific, with about 360,000 units retrieved from Japan and the U.S. In addition, we destroyed about 5 million units that were still in our control.

To correct the sterility issue, we temporarily closed the China plant to conduct a special cleaning and sanitization, and complete an already-planned expansion. We began production on two of the plant s four lines in January 2007 and expect the third also to be operational in the first quarter of 2007. We have commenced product shipments to Japan distribution centers, and are scheduled to begin shipping to the Asia Pacific markets before the end of the first quarter of 2007. The remaining line has been completely replaced and is being expanded to provide automated packaging capabilities that are expected to provide greater flexibility. As per our original schedule, the fourth line is expected to be operational in the late May/early June 2007 timeframe. Our Spain facility supplies the Americas and European markets so there have been no supply disruptions to these regions as a result of the recall.

Product Rationalization and Repositioning Plan

On October 31, 2005, our Board of Directors approved a product rationalization and repositioning plan covering the discontinuation of non-strategic cataract surgical and eye care products and the elimination or redeployment of resources that support these product lines. The plan also included organizational changes and potential reductions in force in manufacturing, sales and marketing associated with these product lines, as well as organizational changes in research and development and other corporate functions designed to align the organization with our strategy and strategic business unit organization.

The plan further called for increasing our investment in key growth opportunities, specifically our refractive implant product line and international laser vision correction business, and accelerating the implementation of productivity initiatives.

In 2006, we incurred $62.7 million of pre-tax charges, which included $16.3 million for inventory, manufacturing related and other charges included in cost of sales and $46.4 million included in operating expenses for severance, relocation and other one-time termination benefits of $13.7 million, productivity and brand repositioning costs of $37.6 million, offset by net asset disposal gains of $2.8 million and a net credit from settlement of contractual obligations of $2.1 million. In 2005, we incurred $42.3 million in pre-tax charges which included $12.6 million for inventory related charges included in cost of sales and $29.7 million included in operating expenses for severance, relocation and other one-time termination benefits of $14.0 million, asset write-downs of $9.2 million, contractual obligations of $2.7 million and accelerated productivity and brand repositioning costs of $3.8 million. We do not expect to incur additional charges associated with this plan. The cumulative charges incurred of $105.0 million were within the range previously announced.

Pending Acquisition of IntraLase Corp.

On January 5, 2007, we entered into an agreement with IntraLase Corp. (IntraLase) to acquire IntraLase for approximately $808 million in cash. IntraLase manufactures femtosecond laser systems utilized in LASIK surgery. Under terms of the agreement, approved by the boards of directors of both companies, after they received fairness opinions from their respective financial advisors, we will pay $25 in cash per share of IntraLase stock and the individually determined cash value per share of outstanding stock options. We have arranged committed financing from a consortium of banks to complete the transaction. We expect the transaction to be completed early in the second quarter of 2007. The transaction is subject to IntraLase stockholder approval as well as regulatory approvals and other customary closing conditions. For a description of the risks related to this transaction, see Risks Relating to the Pending IntraLase Corp. Acquisition beginning on page 24.

Acquisition of VISX, Incorporated

On May 27, 2005, pursuant to the Agreement and Plan of Merger (Merger Agreement), dated as of November 9, 2004, as amended, by and among Advanced Medical Optics, Inc. (AMO), Vault Merger Corporation, a wholly owned subsidiary of AMO, and VISX, Incorporated (VISX), we completed our acquisition of VISX, for total consideration of approximately $1.38 billion, consisting of approximately 27.8 million shares of AMO common stock, the fair value of VISX stock options converted to AMO stock options and approximately $176.2 million in cash (VISX Acquisition). *VISX* products include the *VISX STAR* Excimer Laser System, the *VISX WaveScan* System and *VISX* treatment cards.

The VISX Acquisition has been accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed were recorded at the date of acquisition at their respective fair values. Our reported financial position and results of operations after May 27, 2005 include VISX and the impact of purchase accounting. Purchase accounting applied to the VISX Acquisition resulted in a non-cash in-process research and development charge of $488.5 million in the year ended December 31, 2005.

Acquisition of Pfizer Inc. Surgical Ophthalmic Business

On June 26, 2004, we completed the acquisition of the Pfizer Inc. surgical ophthalmic business for $450 million in cash (Pfizer Acquisition). We acquired ophthalmic surgical products and certain manufacturing and research and development facilities located in Uppsala, Sweden, Groningen, Netherlands and Bangalore, India. The products acquired include the *Healon* line of viscoelastic products used in ocular surgery, the *Tecnis* intraocular lenses and the *Baerveldt* glaucoma shunt.

The Pfizer Acquisition has been accounted for as a purchase business combination. Our reported financial position and results of operations after June 26, 2004 include Pfizer and the impact of purchase accounting. Purchase accounting applied to the Pfizer Acquisition resulted in charges in the year ended December 31, 2004, including an in-process research and development charge of $28.1 million and incremental cost of sales of $28.1 million from the sale of acquired inventory adjusted to fair value.

During 2004, we also incurred other acquisition-related charges totaling approximately $11.6 million as we integrated the Pfizer surgical ophthalmic business and eliminated duplicative functions.

Separation from Allergan

Allergan spun-off its existing optical medical device business by contributing all of the assets related to the two business lines that comprise the optical medical device business to us and distributing all of our outstanding shares of common stock to its stockholders. We had no material assets, liabilities or activities as a separate corporate entity until Allergan s contribution to us of the optical medical device business. The contribution of assets and distribution to Allergan stockholders was completed on June 29, 2002. As a result of the spin-off, we are an independent public company and Allergan no longer maintains any stock ownership in us.

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

Under the manufacturing agreement, which ended on June 29, 2005, Allergan manufactured certain of our eye care products and *VITRAX* viscoelastics from the date of the spin-off. We purchased these products from Allergan at a price equal to Allergan s fully allocated costs plus 10%. During 2005 and 2004, we purchased $41.9 million and $89.3 million, respectively, of product from Allergan. On an annual basis, a pricing true up calculation was performed during the first calendar quarter after the end of each year. This true up calculation was based on the actual volume of products shipped by Allergan to us during the preceding year versus the forecasted volume submitted by us that was used to calculate the invoiced prices. During the year, we periodically reviewed the volume of purchases and accrued for estimated shortfalls, if any. In October 2005, we received $0.8 million from Allergan for the final true up calculation for the last six months of the agreement. In March 2005, we made a payment of $0.2 million to Allergan based upon the true up calculation for the year ended December 31, 2004. These payments have been recorded as an increase/decrease to cost of sales in the accompanying consolidated statements of operations.

The tax sharing agreement governs Allergan s and our respective rights, responsibilities and obligations with respect to taxes for any tax period ending before, on or after the spin-off. Generally, Allergan is liable for all pre-spin-off taxes except for pre-spin-off taxes attributable to our business for 2002. In addition, the tax sharing agreement provides that Allergan is liable for taxes that are incurred as a result of restructuring activities undertaken to effectuate the spin-off. During 2005, we realized final adjustments to accrued, pre-spin-off taxes attributable to our business and payable to Allergan pursuant to this agreement. These adjustments included a $1.4 million benefit from the resolution of a discrete item in the third quarter of 2005, which was recorded in the income tax provision.

Critical Accounting Policies and Estimates

Revenue Recognition and Accounts Receivable

Revenue is realized or realizable and earned when persuasive evidence of an arrangement exists, delivery has occurred, the price to the buyer is fixed or determinable and collectibility is reasonably assured. We record revenue from product sales when title and risk of ownership have been transferred to the customer, which is typically upon delivery to the customer, with the exception of intraocular lenses distributed on a consignment basis, which is upon notification of implantation in a patient. We recognize procedural revenues and revenues from the sale of treatment cards to direct customers when we ship the treatment cards as we have no continuing obligations or involvement subsequent to shipment.

Some customers finance the purchase or rental of their VISX equipment directly from us over periods ranging from one to three years. These financing agreements are classified as either rental or operating leases or sales type leases as prescribed by Statement of Financial Accounting Standards No. 13, Accounting for Leases. Under sales type leases, system revenues are recognized based on the net present value of the expected cash flow after installation to direct customers in the United States and Japan or after shipment to international distributors. Under rental or operating lease arrangements, rental revenue is recognized over the term of the agreement.

We generally permit returns of product if such product is returned in a timely matter, in good condition, and through the normal channels of distribution. However, we do not accept returns of treatment cards and we do not provide rights of return or exchange, price protection or stock rotation rights to any of our VISX product distributors. Return policies in certain international markets can be more stringent and are based on the terms of contractual agreements with the customers. Allowances for returns are provided for based upon an analysis of our historical patterns of returns matched against the sales from which they originated. To date, historical product returns have been within our estimates.

When we recognize revenue from the sale of our products, certain allowances known and estimable at time of sale are recorded as a reduction to sales. These items include cash discounts, allowances and rebates. These items are reflected as a reduction to accounts receivable to the extent the customer will or is expected to reduce its payment on the related invoice amounts. In addition, certain items such as rebates provided to customers that meet certain buying targets are paid to the customer subsequent to customer payment. Thus, such amounts are recorded as accrued liabilities. These provisions are estimated based on historical payment experience, historical relationship to revenues and estimated customer inventory levels. If the historical data and inventory estimates used to calculate these provisions do not properly reflect future activity, our financial position, results of operations and cash flows could be impacted. To date, historical sales allowances have been within our estimates.

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

Inventories

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

Goodwill and Long-Lived Assets

On January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets , whereby goodwill is no longer amortized, but instead is subject to a periodic impairment review performed during the second quarter of each fiscal year. In a business combination, goodwill is allocated to our various reporting units based on relative fair value of the assets acquired and liabilities assumed. We review the recoverability of goodwill by comparing each unit s fair value to the net book value of its assets. If the book value of the reporting unit s assets exceeds its fair value, the goodwill is written down to its implied fair value.

Additionally, we review the carrying amount of goodwill whenever events and circumstances indicate that the carrying amount of goodwill may not be recoverable. Impairment indicators include, among other conditions, cash flow deficits, historic or anticipated declines in revenue or operating profit and adverse legal or regulatory developments. If it is determined such indicators are present and the review indicates goodwill will not be fully recoverable, based upon discounted estimated cash flows, the carrying value is reduced to implied fair value.

In the second quarters of 2006, 2005 and 2004, we performed the annual impairment tests of goodwill and non-amortizable intangible assets, and no impairment was indicated based on these tests. Effective January 1, 2006, our operating segments consist of three businesses: Cataract/Implant, Laser Vision Correction and Eye Care. Accordingly, the annual impairment review in the second quarter of 2006 was based on reporting units that are aligned with the current operating segments.

In accordance with Statement of Financial Accounting Standards No. 144 Accounting for the Impairment or Disposal of Long-lived Assets , we assess potential impairment to our long-lived assets when events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. If required, an impairment loss is recognized as the difference between the carrying value and the fair value of the assets.

Income Taxes

We account for income taxes under the asset and liability method, whereby deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. We evaluate the need to establish a valuation allowance for deferred tax assets based upon the amount of existing temporary differences, the period in which they are expected to be recovered and expected levels of taxable income. A valuation allowance to reduce deferred tax assets is established when it is more likely than not that some or all of the deferred tax assets will not be realized.

We record a liability for potential tax assessments based on our estimate of the potential exposure. New laws and new interpretations of laws and rulings by tax authorities may affect the liability for potential tax assessments. Due to the subjectivity and complex nature of the underlying issues, actual payments or assessments may differ from estimates. To the extent our estimates differ from actual payments or assessments, income tax expense is adjusted. Our income tax returns in several locations

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are being examined by the local taxation authorities. Management believes that adequate amounts of tax and related interest, if any, have been provided for any adjustments that may result from these examinations.

Stock-Based Compensation

Effective January 1, 2006, we began accounting for stock options and employee stock purchase plan (ESPP) shares under the provisions of Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R). SFAS 123R requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. The fair value of stock options and ESPP purchase rights are estimated using a Black-Scholes option valuation model. This model requires the input of subjective assumptions, including expected stock price volatility, estimated life and estimated forfeitures of each award. The fair value of equity-based awards is amortized over the vesting period of the award, and we have elected to use the straight-line method. We make quarterly assessments of the adequacy of the tax credit pool to determine if there are any deficiencies which require recognition in the consolidated statement of operations. Prior to the implementation of SFAS 123R, we accounted for stock options and ESPP shares under the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and made pro forma disclosures as required by SFAS No. 148, Accounting For Stock-Based Compensation Transition and Disclosure, which amended SFAS No. 123, Accounting For Stock-Based Compensation. Pro forma net loss and pro forma net loss per share disclosed in the footnotes to the consolidated financial statements were estimated using a Black-Scholes option valuation model. The fair value of restricted stock and restricted stock units was calculated based upon the fair market value of our common stock at the date of grant.

We also have an annual performance stock incentive program which provides the opportunity for certain executives to earn long-term incentive compensation awards based upon specified market performance measures. Awards are to be settled in a number of restricted stock shares or units equal to the value of the award amount divided by the fair market value of our common stock on the date the performance criteria is deemed to have been met. The fair value of the awards on the grant date is estimated using a lattice-based valuation model. The associated expense, if any, is recognized on a straight-line basis over the period which starts from the date the annual program is approved by the Board of Directors through the end of the expected vesting period of the restricted stock awards.

Acquired In-Process Research and Development

Costs to acquire in-process research and development (IPR&D) projects and technologies which have no alternative future use and which have not reached technological feasibility at the date of acquisition are expensed as incurred. The fair value of IPR&D projects and technologies is estimated based upon management s assumptions such as projected regulatory approval dates, estimated future revenues and cost of goods sold of the products under development and expected sales and marketing costs. The major risks and uncertainties associated with the timely and successful completion of these projects consist of the ability to confirm the safety and efficacy of the technology based on the data from clinical trials and obtaining necessary regulatory approvals. In addition, no assurance can be given that the underlying assumptions used to forecast the cash flows or the timely and successful completion of such projects will materialize, as estimated. For these reasons, among others, actual results may vary from the estimated results.

Comparing Fiscal Years Ended December 31, 2006, 2005 and 2004

The following table presents net sales and operating income by operating segment for 2006, 2005 and 2004, respectively:

	Net Sales			Operating Income		
(In thousands)	**2006**	**2005**	**2004**	**2006**	**2005**	**2004**
Cataract/Implant	$ 519,025	$ 497,191	$ 413,422	$ 266,729	$ 212,879	$ 122,267
Laser Vision Correction	216,876	122,615		130,848	66,375	
Eye Care	261,595	300,867	328,677	104,187	106,023	130,008
Total operating segments	$ 997,496	$ 920,673	$ 742,099	$ 501,764	$ 385,277	$ 252,275

Net sales for 2006 increased by $76.8 million, or 8.3%, to $997.5 million in 2006 from $920.7 million in 2005. The increase in 2006 was primarily the result of full year sales of products acquired in the VISX Acquisition in May 2005, subsequent international expansion of our LVC business, as well as increased sales of technologically advanced products due to continued market acceptance of the products offset by the negative impact of the eye care recall and our business rationalization efforts. The unfavorable impact from foreign currency fluctuations on net sales was $2.2 million in 2006. Our net sales and earnings in future periods may be negatively impacted during times of a strengthening U.S. dollar.

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Net sales from our cataract/implant segment increased by 4.4% in 2006 compared with 2005. This increase was driven largely by increased sales of our branded promoted products, including the *Tecnis* and *ReZoom* intraocular lenses and increased sales of phacoemulsification products. Net sales were negatively impacted by decreased sales of non-promoted older-technology intraocular lenses and non-promoted viscoelastics. We believe that global sales of cataract/implant products will continue to grow due to increased sales of the *Tecnis* and *ReZoom* intraocular lenses. We expect the growth to be partially offset by decreased sales of our older intraocular lenses as we continue our strategy of promoting our higher-technology intraocular lenses, *Tecnis* and *ReZoom*.

Net sales from our LVC segment increased 76.9% in 2006 compared with 2005, reflecting the full year benefit of the May 2005 VISX acquisition, growth in *CustomVue* procedures and strong international system sales. Net sales of acquired VISX products approximated $206.2 million in 2006 compared with approximately $111.1 million in 2005.

Net sales from our eye care segment decreased by 13.1% in 2006 compared with 2005 primarily due to the impact of the recall, decreased sales of hydrogen peroxide-based products, principally in Europe and Japan, where the migration to single-bottle cleaning regimens continues, and decreased sales of multipurpose solutions in Japan due to an increase in the market for daily disposable lenses. As previously discussed, sales in 2006 were negatively impacted by the recall.

As part of our product rationalization and repositioning plan to maximize our competitive advantage as the global refractive leader and improve the global penetration of our core cataract, refractive and eye care brands, we have discontinued a variety of non-strategic cataract surgical and eye care products that lack critical revenue mass, have experienced steadily declining sales trends and/or have generated relatively unattractive margins. We expect the growth of our promoted products to offset the revenue decline related to these discontinued products.

The net unfavorable impact on net sales from foreign currency fluctuations in all geographic regions was $2.2 million in 2006. Our net sales and earnings in future periods may be negatively impacted during times of a strengthening U.S. dollar. Net sales in the Americas include the favorable impact of foreign currency fluctuations of $2.7 million in 2006 primarily due to currencies in Canada and Latin America. Net sales in Europe/Africa/Middle East include the favorable impact of foreign currency fluctuations of $3.2 million primarily due to changes in the U.S. dollar versus the euro in 2006. Net sales in Japan include the unfavorable impact of foreign currency fluctuations of $7.7 million resulting from changes in the U.S. dollar versus the Japanese yen in 2006. Net sales in Asia Pacific include the unfavorable impact of foreign currency fluctuations of $0.4 million in 2006.

Net sales in the U.S. represented 41.6%, 32.9%, and 25.2% of total net sales in 2006, 2005 and 2004, respectively. Additionally, sales in Japan represented 13.9%, 18.9%, and 25.8% of total net sales in 2006, 2005 and 2004, respectively. No other country, or any single customer, generated over 10% of total net sales in any of these years.

Net sales for 2005 increased by $178.6 million, or 24.1%, to $920.7 million in 2005 from $742.1 million in 2004. The increase in 2005 was primarily the result of sales of products acquired in the VISX Acquisition in May 2005 and the full year impact of the purchase of the Pfizer ophthalmic surgical business in June 2004, as well as increased sales of technologically advanced products due to continued market acceptance. Net sales of acquired *VISX* products, included in the LVC segment, approximated $111.1 million in 2005. Net sales of acquired Pfizer ophthalmic surgical products, included in the cataract/implant segment, were $168.4 million in 2005 and $75.8 million in 2004. These increases were partially offset by declines in our older non-promoted and discontinued products and eye care sales in Japan and Europe.

Net sales from our cataract/implant segment increased by 20.2% in 2005 compared with 2004. This increase was driven largely by net sales of acquired Pfizer ophthalmic surgical products described above and increased sales of our branded promoted products, including the *Healon* family of viscoelastics, *Tecnis* and *ReZoom* intraocular lenses, and increased sales of *Sensar* intraocular lenses and phacoemulsification products. Net sales were negatively impacted by decreased sales of non-promoted older-technology intraocular lenses and non-promoted viscoelastics.

Net sales from our LVC segment in 2005 primarily comprised products from the VISX acquisition. Microkeratomes comprised the remaining portion of LVC net sales in 2005. Sales of microkeratomes were included in the cataract/implant segment in 2004 and were not significant.

Net sales from our eye care segment decreased by 8.5% in 2005 compared with 2004 primarily due to decreased sales of hydrogen peroxide-based products, principally in Europe and Japan, where the migration to single-bottle cleaning regimens

continued, and decreased sales of multipurpose solutions in Japan due to an increase in the market for daily disposable lenses. The favorable impact from foreign currency fluctuations during the first nine months of 2005 were offset by a negative impact in the fourth quarter of 2005.

The net unfavorable impact on net sales from foreign currency fluctuations in all geographic regions was $0.2 million in 2005. The favorable impact from foreign currency fluctuations during the first nine months of 2005 were offset by a negative impact in the fourth quarter of 2005. Net sales in the Americas include the favorable impact of foreign currency fluctuations of $2.3 million in 2005 primarily due to currencies in Canada and Latin America. Net sales in Europe/Africa/Middle East include the unfavorable impact of foreign currency fluctuations of $1.0 million primarily due to the strengthening of the U.S. dollar versus the euro in 2005. Net sales in Japan include the unfavorable impact of foreign currency fluctuations of $3.2 million resulting from the strengthening of the U.S. dollar versus the Japanese yen in 2005. Net sales in Asia Pacific include the favorable impact of foreign currency fluctuations of $1.7 million in 2005.

Income and expenses. The following table sets forth certain statement of operations items as a percentage of net sales:

	Year Ended December 31,		
	2006	**2005**	**2004**
Net sales	100.0%	100.0%	100.0%
Cost of sales	38.0	38.4	41.3
Gross margin	62.0	61.6	58.7
Other operating costs and expenses:			
Selling, general and administrative	40.6	43.1	44.4
Research and development	6.6	6.7	6.1
In-process research and development		53.3	3.8
Business repositioning	4.7	3.2	
Net gain on legal contingencies	(9.7)		
Operating income (loss)	19.8	(44.7)	4.4
Interest expense	3.0	3.2	3.6
Unrealized loss (gain) on derivative instruments	0.1	(0.3)	
Loss due to early retirement of convertible senior subordinated notes	1.9	0.2	15.7
Other non-operating expense, net	0.3		1.4
Earnings (loss) before income taxes	14.5%	(47.8)%	(16.3)%
Net earnings (loss)	8.0%	(49.2)%	(17.4)%

Gross margin. Our gross margin percentage increased as a percentage of net sales by 0.4 percentage points to 62.0% in 2006 from 61.6% in 2005. The increase in gross margin was largely driven by sales growth in the higher margin *Healon* family of viscoelastics and sales of acquired *VISX* products. Gross profit for 2006 included a charge of $16.3 million, or a 1.6 percentage point impact on gross margin, for inventory provisions associated with our product rationalization and business repositioning plan. The eye care recall also had a negative impact of $19.0 million from sales returns, inventory provisions and other charges, or a 1.9 percentage point impact on gross margin. Our gross margin percentage increased as a percent of net sales by 2.9 percentage points to 61.6% in 2005 from 58.7% in 2004. Gross profit for 2005 included a charge of $12.6 million, or a 1.4 percentage point impact on gross margin, for inventory provisions associated with our product rationalization and business repositioning plan.

Selling, general and administrative. Selling, general and administrative expenses as a percentage of net sales was 40.6% in 2006, compared to 43.1% in 2005. Selling, general and administrative expenses in 2006 include approximately $1.8 million in acquisition and integration-related charges, amortization expense of $40.0 million related to acquired intangible assets and $5.9 million related to the eye care recall. Selling, general and administrative expenses in 2006 also include a $1.5 million charge associated with the termination of a distributor agreement in India that we had with our former parent, Allergan. Stock-based compensation expense under SFAS 123R included in selling, general and administrative expenses was $14.8 million in 2006. Selling, general and administrative expenses decreased as a percent of net sales by 1.3 percentage points to 43.1% in 2005 from 44.4% in 2004. Selling, general and administrative expenses in 2005 include approximately $14.6 million in acquisition and integration-related charges and amortization expense of $26.7 million related to acquired intangible assets. Selling, general and administrative expenses in 2005 also include an $8.6 million charge associated with the termination of a distributor agreement in India that we had with our former parent, Allergan. In addition, selling, general and administrative expenses in 2005 were impacted by selling costs associated with acquired *VISX* products of $16.2 million.

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Research and development. Research and development expenditures as a percentage of net sales in 2006 remained relatively constant as compared to 2005 and as a percentage of net sales increased slightly in 2005 as compared to 2004. Our research and development strategy is to develop proprietary products for vision correction that are safe and effective and address unmet needs. We are currently focusing on new advancements that build on our *Tecnis, Healon* and *Sovereign* technologies, corneal and lens-based solutions to presbyopia and dry eye products.

In-process research and development. In 2005, we incurred an in-process research and development (IPR&D) charge of $488.5 million related to the VISX Acquisition. This charge represented the estimated fair value of projects that, as of the acquisition date, had not reached technological feasibility and had no alternative future use. The Company recorded $449.2 million of this amount in the second quarter of 2005 and $39.3 million in the third quarter of 2005. The additional charge in the third quarter of 2005 resulted primarily from the completion of the IPR&D valuation. The fair value assigned to IPR&D comprised the following projects: High Myopia for *CustomVue* - $14.7 million, Excimer Laser Improvements - $56.2 million and Presbyopia - $417.6 million. The fair value of these projects was determined by performing a discounted cash flow analysis using the income approach. Net cash flows attributable to these projects were discounted to their present values at a rate commensurate with the perceived risk, which for these projects ranged from 19.0 to 21.0 percent. High myopia for *CustomVue* was forecasted to be approved for sale in the U.S. in late 2005. FDA approval was received in September 2005. A procedure to treat presbyopia is forecasted to be approved for sale in the U.S. in mid-2007. Management s best estimate of additional research and development expenses needed prior to expected FDA approval for these procedures ranges from $4 million to $6 million. Additional research and development expenses in the range of $8 million to $10 million represent management s best estimate as to the additional R&D expenses to bring excimer laser system improvements to market. Forecasted discounted cash flows for each product once launched include estimates for normal sustaining engineering and maintenance R&D. These projects are currently on track for the expected approval dates. However, the major risks and uncertainties associated with the timely and successful completion of these projects consist of the ability to confirm the safety and efficacy of the technology based on the data from clinical trials and obtaining the necessary approvals. We can provide no assurance that the approvals will be received on this schedule or at all.

Business repositioning costs. On October 31, 2005, our Board of Directors approved a product rationalization and repositioning plan covering the discontinuation of non-strategic cataract surgical and eye care products and the elimination or redeployment of resources that support these product lines. The plan also includes organizational changes and potential reductions in force in manufacturing, sales and marketing associated with these product lines, as well as organizational changes in research and development and other corporate functions designed to align the organization with our strategy and strategic business unit organization. The plan further calls for increasing our investment in key growth opportunities, specifically our refractive implant product line and international laser vision correction business, and accelerating the implementation of productivity initiatives. In 2006, we incurred $62.7 million of pre-tax charges, which included $16.3 million for inventory, manufacturing related and other charges included in cost of sales and $46.4 million included in operating expenses for severance, relocation and other one-time termination benefits of $13.7 million, productivity and brand repositioning costs of $37.6 million, offset by net asset disposal gains of $2.8 million and a net credit from settlement of contractual obligations of $2.1 million. We incurred $42.3 million in pre-tax charges during the fourth quarter of 2005 which included $12.6 million for inventory, manufacturing related and other charges included in cost of sales and $29.7 million included in operating expenses for severance, relocation and other one-time termination benefits of $14.0 million, asset write-downs of $9.2 million, contractual obligations of $2.7 million and accelerated productivity and brand repositioning costs of $3.8 million. The cumulative charges incurred of $105.0 million were within the range previously announced. We do not expect to incur additional charges associated with this plan.

Net gain on legal contingencies. We recognized a net gain on legal contingencies of $96.9 million in 2006, primarily from settlement of pending patent litigation, net of costs incurred. On July 7, 2006, we entered into a settlement agreement with Alcon, Inc., Alcon Laboratories, Inc., and Alcon Manufacturing Ltd. (collectively, Alcon) regarding all pending patent litigation between us and Alcon. The settlement required Alcon to pay us a lump-sum payment of $121 million which was received in July 2006 and was accounted for in the third quarter. The parties agreed to dismiss all pending patent litigation in Delaware and Texas, agreed not to sue each other regarding the patents at issue in those cases, and cross-licensed patents covering existing features of commercially available phacoemulsification products.

Operating income. Operating income (loss) was $197.7 million, $(411.3) million and $33.0 million in 2006, 2005 and 2004, respectively. Operating income as a percentage of net sales, or operating margin, was 19.8% in the year ended December 31, 2006. Our 2006 operating income was impacted by a $96.9 million net gain related to the settlement of legal matters discussed above, an aggregate $66.0 million in net charges associated with rationalization and repositioning initiatives, acquisitions, integrations, and termination of a distributor contract. Operating income was impacted by a $19.2 million charge for stock-based compensation expense under SFAS 123R. Operating income was also negatively impacted by $24.9 million related to the eye care recall. The $411.3 million operating loss in 2005 reflected the impact of $536.9 million in charges related primarily to acquisitions, recapitalizations, and product rationalizations and repositioning actions.

Operating income from our Cataract/Implant business increased by $53.9 million in the year ended December 31, 2006, due to the increase in net sales and favorable mix of higher margin products discussed above, along with the favorable impact of cost containment measures taken in connection with our business repositioning plan. Operating income from our LVC business increased by $64.5 million in the year ended December 31, 2006, due to sales of products acquired from VISX in May 2005. Operating income from our Eye Care business decreased by $1.8 million in the year ended December 31, 2006, primarily due to the recall and continued softness in the market for hydrogen peroxide based products, partially offset by lower selling and promotional costs attributable to discontinued products and cost savings from business repositioning actions.

Operating income from our cataract/implant segment increased by $90.6 million in 2005 compared with 2004 due to the increase in net sales and favorable mix of higher margin products discussed above, along with the favorable impact of cost containment measures taken in connection with our business repositioning plan. Operating income from our cataract/implant segment for 2004 included a charge of $28.1 million for manufacturing profit capitalized in inventory and expensed related to the Pfizer Acquisition. Operating income from our LVC business of $66.4 million resulted from the impact of products acquired from VISX in May 2005. Operating income from our eye care segment decreased by $24.0 million in 2005 compared with 2004 primarily due to the unfavorable impact from continued softness in the market for hydrogen peroxide based products, primarily in Japan.

Non-operating expense. Interest expense was $30.3 million, $29.3 million and $26.9 million in 2006, 2005 and 2004, respectively. Interest expense in 2006 includes a pro-rata write-off of debt issuance costs of $3.3 million primarily associated with the termination of the term loan. Interest expense in 2005 includes a pro-rata write-off of debt issuance costs of $5.8 million primarily associated with the termination of the term loan, partially offset by the recognition of a realized gain on interest rate swaps of $0.8 million. We anticipate interest expense to increase in 2007 relative to 2006 due to the anticipated additional debt in connection with the pending acquisition of IntraLase and a full year of interest on our 3.25% notes.

We recorded an unrealized loss (gain) on derivative instruments of $1.3 million, $(2.6) million and $0.4 million in 2006, 2005 and 2004, respectively. We record as unrealized loss (gain) on derivative instruments the mark to market adjustments on the outstanding foreign currency options and forward contracts which we entered into to reduce the volatility of expected earnings in currencies other than the U.S. dollar.

During the year ended December 31, 2006, we entered into an accelerated share repurchase arrangement with a third party to use the proceeds from the issuance of the 3.25% Notes to purchase $500.0 million of AMO common stock at a volume weighted price per share over the term of the agreement. During 2006, the third party had delivered to us in the aggregate, 10.5 million shares of AMO common stock. The impact of the shares repurchased under this arrangement in 2006 reduced stockholders equity by $500.0 million, which included $0.1 million for the par value of Common Stock, additional paid-in capital of $247.2 million and accumulated deficit of $252.7 million. Repurchased shares were retired upon delivery to us. In addition, during 2006, we repurchased $148.9 million of aggregate principal amount of convertible senior subordinates notes ($103.9 million of the principal amount of the 2.5% notes and $45.0 million of the principal amount of the 1.375% notes) utilizing borrowings under our senior credit facility. We incurred a loss on debt extinguishment of $18.8 million, and wrote off debt issuance costs of $3.3 million in 2006 in conjunction with the note repurchases.

In 2005, the loss due to exchange of the 3 ½% convertible senior subordinated notes due 2023 of $1.9 million is comprised of a non-cash charge of $1.7 million and a cash charge of $0.2 million. In the second quarter of 2005, we exchanged 160,695 shares of common stock for $3.0 million aggregate principal amount of the 3 ½% convertible senior subordinated notes in a privately negotiated transaction. As a result, a non-cash charge of approximately $0.5 million representing the fair value of shares issued as a premium was recorded. In the fourth quarter of 2005, we exchanged 291,760 shares of common stock and approximately $0.4 million in cash for $5.6 million aggregate principal amount of the 3 ½% convertible senior subordinated notes in privately negotiated transactions. A non-cash charge of approximately $1.2 million and a cash charge of $0.2 million representing the fair value of shares issued as a premium were recorded.

In 2004, the loss due to exchange of the 3 ½% convertible senior subordinated notes of $116.3 million is comprised of a non-cash charge of $111.7 million and a cash charge of $4.6 million. In the second quarter of 2004, we exchanged approximately 5.8 million shares of common stock and $4.6 million of cash for approximately $108.6 million in aggregate principal amount of these notes. Because these notes we not convertible into equity at such time, a non-cash charge of $107.2 million and a cash charge of $4.6 million was recorded. The $107.2 million non-cash charge was comprised of a charge of $89.1 million representing the difference between the fair market value of 5.3 million shares of common stock issued in exchange for the notes and the principal amount of notes exchanged and a charge of $18.1 million representing the fair market value of 0.5 million shares of common stock issued as a premium. The $4.6 million cash charge represented cash issued as a premium. In the remainder of 2004, we exchanged approximately 1.2 million shares of common stock for approximately $22.8 million in aggregate principal amount of these notes. As a result, a non-cash charge of $4.5 million representing the fair value of shares issued as a premium was recorded.

Other net non-operating expense was $2.6 million for 2006. Other non-operating expense of $0.3 million for 2005. Other non-operating expense of $10.6 million for 2004 included $10.8 million paid for the repurchase of the 9 ¼% senior subordinated notes and early debt extinguishment costs and fees of $0.1 million aggregating $10.9 million partially offset by foreign exchange gains and interest income.

Income taxes. In 2006, we recorded a provision for income taxes of $65.3 million on pre-tax income of $144.8 million. The pre-tax income in 2006 included a net gain on legal contingencies of $96.9 million, for which we recorded income tax expense of $39.9 million, and charges of $18.8 million associated with the repurchase of convertible notes, which resulted in the recognition of partial deferred tax benefit of $3.9 million. Additionally, we recorded a deferred tax benefit of $6.3 million from stock-based compensation of $19.2 million under SFAS 123R. We have provided a tax provision at 41.5% on the remaining pre-tax income. The increase in the tax rate on remaining pre-tax income is due to the impact of the recall, repositioning and the related impact on realization of foreign tax credits. Income taxes are provided on taxable income at the statutory rates applicable to such income and we have provided for U.S. federal income taxes and anticipated foreign withholding taxes on the undistributed earnings of non-U.S. subsidiaries.

In 2005, we recorded a provision for income taxes of $12.9 million on a pre-tax loss of $440.3 million. The pre-tax loss in 2005 included an in-process research and development charge of $490.8 million, a non-cash charge of $1.7 million and a cash charge of $0.2 million related to the exchange of the 3 ½% convertible senior subordinated notes and a charge of $8.6 million associated with the termination of a distribution agreement in India with Allergan, for which no tax benefit was provided on these items. We have provided a tax provision at 33% on the remaining income, which was partially offset by tax benefits from the American Jobs Creation Act of 2004 and final adjustments with Allergan, which are discussed below.

The American Jobs Creation Act of 2004 was signed into law in October 2004, which allowed companies to elect to repatriate cash into the United States in 2005 at a special, temporary effective tax rate of 5.25 percent. Based on our evaluation of the amount of foreign earnings that we have elected to treat under this special provision, the income tax benefit of the repatriation was $5.7 million in 2005.

The lower tax rate in 2005 reflected continuing implementation of our long-term tax strategies, as well as final adjustments of previously accrued pre-spin-off taxes attributable to our business in 2002 and payable to Allergan pursuant to a pre-spin tax sharing agreement. These adjustments included a $1.4 million benefit from the resolution of a discrete item in the third quarter of 2005, which was recorded in the income tax provision.

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

In 2004, we recorded a provision for income taxes of $8.2 million even though we had a pre-tax loss of $121.2 million. We recorded such provision as no tax benefit has been recognized for the IPR&D charge of $28.1 million nor for the aggregate charge of $116.3 million related to the exchange of the 3 ½% convertible senior subordinated notes. We provided a tax provision at 35% on the remaining income in 2004. The lower tax rate in 2004 reflected continuing implementation of our long-term tax strategies.

Net earnings (loss). Net earnings (loss) was $79.5 million, $(453.2) million and $(129.4) million in 2006, 2005 and 2004, respectively. Net earnings in 2006 was primarily due to the full year of operating results attributable to the VISX acquisition, the net gain on legal contingencies, partially offset by business repositioning costs, stock-based compensation expense under SFAS 123R and net charges incurred for the early retirement of convertible senior subordinated debt. The net loss in 2005 included an aggregate after-tax charge of $536.9 million, primarily due to the VISX Acquisition, business repositioning costs, integration related costs, and termination of a distributor agreement in India, write-off of debt issuance costs and exchange of the 3 ½% convertible senior subordinated notes, partially offset by tax benefits from the American Jobs Creation Act of 2004 and final adjustments with Allergan.

The net loss in 2004 included an aggregate after-tax charge of $175.5 million related to the following: the manufacturing profit capitalized in inventory and expensed related to the Pfizer Acquisition; the charge to terminate a distributor contract

following the decision to move to a direct sales model in Belgium as a result of the Pfizer Acquisition and severance paid to employees considered redundant upon completion of the Pfizer Acquisition; the in-process research and development charge related to the Pfizer Acquisition; the pro-rata write-off of debt issuance costs and write-off of original issue discount net of a net realized gain on interest rate swaps; and the charges related to the repurchase of the 9 ¼% senior subordinated notes and the exchange of the 3 ½% convertible senior subordinated notes.

Liquidity and Capital Resources

We assess our liquidity by our ability to generate cash to fund operations. Significant factors in the management of liquidity are: funds generated by operations; levels of accounts receivable, inventories, accounts payable and capital expenditures; adequate lines of credit; and financial flexibility to attract long-term capital on satisfactory terms. As of December 31, 2006, we had cash and equivalents of $34.5 million.

Historically, we have generated cash from operations in excess of working capital requirements, and we expect to do so in the future. Net cash provided by operating activities in 2006 was $224.8 million compared to $20.8 million in 2005 and $39.7 million in 2004. Operating cash flow improved in 2006 compared to 2005 largely as a result of settlement of legal contingencies, the non-cash impact of stock-based compensation, depreciation and amortization and loss on exchange of convertible notes. Other improvements included timing of collections on trade receivables and payments for interest on outstanding debt and income taxes, as well as the favorable impact of the VISX acquisition. These improvements were partially offset by an increase in cash payments to finalize business repositioning actions in 2006 and recall costs. Operating cash flow decreased in 2005 compared to 2004 due to increases in cash paid for income taxes, timing of accounts payable payments and inventory buildup, partially offset by the favorable impact of the VISX acquisition and timing of accounts receivable collections. The inventory buildup was due in part to bridging stock related to the recent transfer of eye care manufacturing from Allergan and the increases in the size and scope of our global manufacturing network.

Net cash used in investing activities was $40.4 million, $79.9 million, and $482.2 million in 2006, 2005 and 2004, respectively. The majority of 2006 capital expenditures were for the Uppsala, Sweden manufacturing facility to separate the facility from existing Pfizer operations and related upgrades, and for upgrades to our eye care product manufacturing facility in Madrid, Spain. The 2005 capital expenditures are primarily comprised of expenditures to upgrade our viscoelastics manufacturing facility in Uppsala, Sweden. The 2005 amount includes $36.9 million net cash paid primarily for the acquisition of VISX. The 2004 capital expenditures are primarily comprised of expansion of our manufacturing facilities in preparation for the transition away from the Allergan manufacturing agreement, expenditures at the acquired manufacturing facilities and construction of research and development facilities at our leased headquarters. The 2004 amount also includes the $456.7 million Pfizer Acquisition purchase price, which was financed with a portion of the proceeds from the issuance of $350.0 million of 2 ½% convertible senior subordinated notes and a $250.0 million term loan. Expenditures for property, plant and equipment totaled $29.0 million, $23.1 million, and $17.5 million in 2006, 2005, and 2004, respectively. Expenditures for demonstration (demo) and bundled equipment, primarily phacoemulsification and microkeratome surgical equipment, were $10.8 million, $11.1 million, and $6.8 million in 2006, 2005, and 2004, respectively. We maintain demo and bundled equipment to facilitate future sales of similar equipment and related products to our customers. Expenditures for capitalized internal-use software were $3.2 million, $8.8 million, and $2.4 million in 2006, 2005, and 2004, respectively. The 2005 software expenditures were due to acquisition related integrations and improvements to support common global technology platforms. We capitalize internal-use software costs after technical feasibility has been established. In 2007, we expect to invest approximately $50.0 million to $60.0 million in property, plant and equipment, demo and bundled equipment, and capitalized software as part of the overall expansion of our business.

Net cash used in financing activities was $189.8 million in 2006, which primarily comprised $227.7 million of debt repayments and financing related costs of $11.1 million, offset by $42.2 million from the sale of stock to employees and $6.7 million of excess tax benefits. Proceeds of $500.0 million from the issuance of the 3.25% convertible senior subordinated notes were used to repurchase 10.5 million shares of AMO common stock.

Net cash provided by financing activities was $54.0 million in 2005, which comprised $150.0 million of proceeds from the issuance of the 1.375% convertible senior subordinated notes, $60.0 million of borrowings primarily under the senior revolving credit facility, $45.8 million of proceeds from the sale of stock to employees and $0.8 million proceeds received after settling an interest rate swap agreement, reduced by $194.2 million of debt repayments and $8.4 million of financing related costs.

Net cash provided by financing activities was $442.2 million in 2004, which primarily comprised $350.0 million of proceeds from the issuance of the 2 ½% convertible senior subordinated notes and a $250.0 million term loan, partially offset by repayment of debt of $149.2 million and financing related costs of $16.6 million.

At December 31, 2006, approximately $8.4 million of the revolving credit facility was reserved to support letters of credit issued on our behalf for normal operating purposes and we had approximately $291.6 million undrawn and available revolving loan commitments.

At December 31, 2005, we had $10.0 million of borrowings outstanding under a short-term loan from Bank of Ireland to our subsidiary, AMO Ireland. This loan was supported by a $10.0 million letter of credit and was paid in its entirety on February 21, 2006 and is no longer available for borrowing.

Our senior credit facility provides that we will maintain certain financial and operating covenants which include, among other provisions, maintaining specific leverage and coverage ratios. Certain covenants under the senior credit facility may limit the incurrence of additional indebtedness. The senior credit facility prohibits dividend payments. We were in compliance with these covenants at December 31, 2006. Our senior credit facility is collateralized by a first priority perfected lien on, and pledge of, all of the combined company s present and future property and assets (subject to certain exclusions), 100% of the stock of the domestic subsidiaries, 66% of the stock of the foreign subsidiaries and all present and future intercompany debts.

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

We believe that the net cash provided by our operating activities, supplemented as necessary with borrowings available under our revolving credit facility and existing cash and equivalents, will provide sufficient resources to fund the expected 2007 capital expenditures, and to meet our working capital requirements, debt service and other cash needs over the next year.

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

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

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

Foreign currency fluctuations. Approximately 58%, 67%, and 75% of our revenues in the years ended December 31, 2006, 2005 and 2004, respectively, were derived from operations outside the United States, and a significant portion of our cost structure is denominated in currencies other than the U.S. dollar, primarily the Japanese yen and the euro. Therefore, we are subject to fluctuations in sales and earnings reported in U.S. dollars as a result of changing currency exchange rates.

Contractual obligations. The following represents a list of our material contractual obligations and commitments as of December 31, 2006:

	Payments Due by Period				
	Less Than 1 Year	**1-3 Years**	**3-5 Years**	**More Than 5 Years**	**Total**
	(in millions)				
Long-term debt, principal amount	$	$	$	$ 851.1	$ 851.1
Cash commitments for interest payments	23.8	47.7	47.7	333.6	452.8
Operating lease obligations	16.1	17.0	8.2	21.8	63.1
IT services	3.6				3.6
Other purchase obligations, primarily purchases of inventory and capital equipment	62.0	4.6			66.6

Off-balance sheet arrangements. We had no off-balance sheet arrangements at December 31, 2006.

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New Accounting Standards

In May 2005, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In June 2006, the Emerging Issues Task Force (EITF) issued EITF 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation) to clarify diversity in practice on the presentation of different types of taxes in the financial statements. The Task Force concluded that, for taxes within the scope of the issue, a company may adopt a policy of presenting taxes either gross within revenue or net. That is, it may include charges to customers for taxes within revenues and the charge for the taxes from the taxing authority within cost of sales, or, alternatively, it may net the charge to the customer and the charge from the taxing authority. If taxes subject to EITF 06-3 are significant, a company is required to disclose its accounting policy for presenting taxes and the amounts of such taxes that are recognized on a gross basis. The guidance in this consensus is effective for the first interim reporting period beginning after December 15, 2006 (the first quarter of our fiscal year 2007). We do not expect the adoption of EITF 06-3 will have a material impact on our results of operations, financial position or cash flow.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109 (FIN 48).and is effective for fiscal years beginning after December 15, 2006. FIN 48 clarifies the accounting for uncertainties in income taxes recognized in accordance with SFAS No. 109, Accounting for Income Taxes by prescribing guidance for the recognition, derecognition and measurement in financial statements of income tax positions taken in previously filed tax returns or tax positions expected to be taken in tax returns, including a decision whether to file or not to file in a particular jurisdiction. FIN 48 requires that any liability created for unrecognized tax benefits be disclosed. The application of FIN 48 may also affect the tax bases of assets and liabilities and therefore may change or create deferred tax liabilities or assets. The Company will be required to adopt FIN 48 as of January 1, 2007. If there are changes in the net assets of the Company as a result of the application of FIN 48, the cumulative effects, if any, will be recorded as an adjustment to retained earnings. We are currently evaluating the impact of adoption of FIN 48 and have not yet determined the effect on our earnings or financial position.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurement. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This Statement does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently assessing the impact of SFAS No. 157 on our financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Qualifying Misstatements in Current Year Financial Statements, which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The adoption of SAB No. 108 in 2006 did not have a material impact on our consolidated financial position, results of operations or cash flows.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires an employer to recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status, measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year, and recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income and as a separate component of stockholders equity. We adopted SFAS No. 158 in the fourth quarter of fiscal 2006. The impact of the adoption of this new accounting standard is disclosed in Note 10 to the consolidated financial statements. The effect on the balance sheet as of December 31, 2006 from the adoption of SFAS No. 158 was based on the funded status of the defined benefit plans as of September 30, 2006, the measurement date of the plans assets and obligations. We will be required to change the measurement date to December 31 in fiscal year 2008.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

We routinely monitor the risks associated with fluctuations in currency exchange rates and interest rates. We address these risks through controlled risk management that may include the use of derivative financial instruments to economically hedge or reduce these exposures. We do not expect to enter into financial instruments for trading or speculative purposes.

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

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

Interest rate risk. At December 31, 2006, our debt comprises domestic borrowings of $851.1 million of fixed rate debt.

In July 2004, we entered into an interest rate swap agreement, which effectively converted the interest rate on $125.0 million of term loan borrowings from a floating rate to a fixed rate. This interest rate swap qualified as a cash flow hedge and would have matured in July 2006. In April 2005, we terminated the interest rate swap. Upon termination, we received approximately $0.8 million and included the related gain of approximately $0.5 million, which includes the accrued but unpaid net amount between us and the swap counterparty, as a component of accumulated other comprehensive income in the second quarter of 2005. As a result of the repayment of the term loan in July 2005, the gain on the interest rate swap of $0.8 million was fully recognized as a reduction to the interest expense in the third quarter of 2005.

The tables below present information about our debt obligations and interest rate derivatives for the years ended December 31, 2006 and 2005:

December 31, 2006

	Maturing in							
	2007	2008	2009	2010	2011	Thereafter	Total	Fair Market Value
	(in thousands, except interest rates)							
LIABILITIES								
Debt Obligations:								
Fixed Rate	$	$	$	$	$	$ 246,105	$ 246,105	$ 238,722
Weighted Average Interest Rate						2.50 %	2.50 %	
Fixed Rate	$	$	$	$	$	$ 105,000	$ 105,000	$ 99,554
Weighted Average Interest Rate						1.375 %	1.375 %	
Fixed Rate	$	$	$	$	$	$ 500,000	$ 500,000	$ 455,950
Weighted Average Interest Rate						3.25 %	3.25 %	
Total Debt Obligations	$	$	$	$	$	$ 851,105	$ 851,105	$ 794,226
Weighted Average Interest Rate						2.80 %	2.80 %	

December 31, 2005

	Maturing in							
	2006	2007	2008	2009	2010	Thereafter	Total	Fair Market Value
	(in thousands, except interest rates)							
LIABILITIES								
Debt Obligations:								
Fixed Rate	$	$	$	$	$	$ 350,000	$ 350,000	$ 376,705
Weighted Average Interest Rate						2.50 %	2.50 %	
Fixed Rate	$	$	$	$	$	$ 150,000	$ 150,000	$ 150,948
Weighted Average Interest Rate						1.375 %	1.375 %	
Variable Rate	$ 10,000	$	$	$	$	$	$ 10,000	$ 10,000
Weighted Average Interest Rate	4.61 %						4.61 %	
Variable Rate	$ 50,000	$	$	$	$	$	$ 50,000	$ 50,000
Weighted Average Interest Rate	6.22 %						6.22 %	
Total Debt Obligations	$ 60,000	$	$	$	$	$ 500,000	$ 560,000	$ 587,653
Weighted Average Interest Rate	5.95 %					2.16 %	2.57 %	

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

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

We use foreign currency option contracts, which provide for the sale of foreign currencies to offset foreign currency exposures expected to arise in the normal course of our business. While these instruments are subject to fluctuations in value, such fluctuations are anticipated to offset changes in the value of the underlying exposures. The principal currencies subject to this process are the Japanese yen and the euro. The foreign exchange forward contracts are entered into to protect the value of foreign currency denominated monetary assets and liabilities and the changes in the fair value of the foreign currency forward contracts were economically designed to offset the changes in the revaluation of the foreign currency denominated monetary assets and liabilities. These forward contracts are denominated in currencies which represent material exposures. The changes in the fair value of foreign currency option and forward contracts are recorded through earnings as Unrealized loss (gain) on derivative instruments while any realized gains or losses on expired contracts are recorded through earnings as Other, net in the accompanying consolidated statements of operations. Any premium cost of purchased foreign exchange option contracts are recorded in Other current assets and amortized over the life of the options.

At December 31, 2006, there are no outstanding interest rate swaps.

The following tables provide information about our foreign currency derivative financial instruments outstanding as of December 31, 2006 and 2005. The information is provided in U.S. dollar amounts, as presented in our consolidated financial statements.

	December 31, 2006		**December 31, 2005**	
	Notional Amount (in $ millions)	**Average Contract or Strike Rate**	**Notional Amount (in $ millions)**	**Average Contract or Strike Rate**
Foreign currency forward contracts:				
Receive US$/Pay Foreign Currency:				
Swedish Krona	$ 8.8	6.85	$ 31.5	7.94
U.K. Pound			5.2	1.72
Canadian Dollar	9.5	1.16		
Australia Dollar	7.1	1.27		
Swiss Franc			1.5	1.31
Japanese Yen	7.1	118.8		
Pay US$/Receive Foreign Currency:				
Japanese Yen			3.0	117.45
Euro			5.9	1.19
Swiss Franc	3.7	1.22		
Canadian Dollar			3.4	1.17
Australia Dollar			2.9	0.73
Total Notional	**$ 36.2**		**$ 53.4**	
Estimated Fair Value	**$**		**$**	
Foreign currency purchased put options:				
Japanese Yen	$ 72.0	118.00	$ 66.2	117.83
Euro	50.8	1.24	40.2	1.18
Foreign currency sold call options:				
Japanese Yen	81.3	104.50	60.0	106.60
Euro	53.1	1.29	43.0	1.26
Total Notional	**$ 257.2**		**$ 209.4**	
Estimated Fair Value	**$ (0.6)**		**$ 1.1**	

The notional principal amount provides one measure of the transaction volume outstanding as of the end of the period, and does not represent the amount of our exposure to market loss. The estimate of fair value is based on applicable and commonly used prevailing financial market information as of December 31, 2006 and 2005. The amounts ultimately realized upon settlement of these financial instruments, together with the gains and losses on the underlying exposures, will depend on actual market conditions during the remaining life of the instruments.

The impact of foreign exchange risk management transactions on income was a net realized gain (loss) of $2.3 million, $(2.0) million and $(1.9) million in 2006, 2005 and 2004, respectively, which are recorded in Other, net on the accompanying consolidated statements of operations.

Item 8: Financial Statements and Supplementary Data

Index to Financial Statements

ADVANCED MEDICAL OPTICS, INC.

CONSOLIDATED BALANCE SHEETS

	As of December 31, 2006	2005
	(In thousands, except share data)	
ASSETS		
Current assets		
Cash and equivalents	$ 34,522	$ 40,826
Trade receivables, net	232,408	238,761
Inventories	127,532	104,820
Deferred income taxes	41,698	66,476
Income tax receivable	15,045	
Other current assets	26,938	28,122
Total current assets	478,143	479,005
Property, plant and equipment, net	132,756	115,725
Deferred income taxes	13,260	12,626
Other assets	69,365	52,473
Intangible assets, net	471,664	495,609
Goodwill	848,709	825,284
Total assets	$ 2,013,897	$ 1,980,722
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Current portion of long-term debt and short-term borrowings	$	$ 60,000
Accounts payable	53,897	64,045
Accrued compensation	41,896	43,406
Other accrued expenses	120,384	90,666
Income taxes		1,434
Deferred income taxes	1,276	565
Total current liabilities	217,453	260,116
Long-term debt, net of current portion	851,105	500,000
Deferred income taxes	185,844	182,179
Other liabilities	43,504	28,365
Commitments and contingencies		
Stockholders equity		
Preferred stock, $.01 par value; 5,000,000 shares authorized, none issued		
Common stock, $.01 par value; 240,000,000 shares authorized; 59,512,106 and 67,832,010 shares issued	595	678
Additional paid-in capital	1,409,475	1,586,864
Accumulated deficit	(730,800)	(557,586)
Accumulated other comprehensive income (loss)	36,745	(19,870)
Less treasury stock, at cost (1,397 and 1,397 shares)	(24)	(24)
Total stockholders equity	715,991	1,010,062
Total liabilities and stockholders equity	$ 2,013,897	$ 1,980,722

See accompanying notes to consolidated financial statements.

ADVANCED MEDICAL OPTICS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2006	**2005**	**2004**
	(In thousands, except per share data)		
Net sales	$ 997,496	$ 920,673	$ 742,099
Cost of sales	379,325	353,325	306,164
Gross profit	618,171	567,348	435,935
Selling, general and administrative	404,802	396,599	329,197
Research and development	66,099	61,646	45,616
In-process research and development		490,750	28,100
Business repositioning	46,417	29,680	
Net gain on legal contingencies	(96,896)		
Operating income (loss)	197,749	(411,327)	33,022
Non-operating expense (income):			
Interest expense	30,272	29,332	26,933
Unrealized loss (gain) on derivative instruments	1,290	(2,563)	403
Loss due to early retirement of Convertible Senior Subordinated Notes (note 6)	18,783	1,885	116,282
Other, net	2,588	316	10,620
	52,933	28,970	154,238
Earnings (loss) before income taxes	144,816	(440,297)	(121,216)
Provision for income taxes	65,345	12,900	8,154
Net earnings (loss)	$ 79,471	$ (453,197)	$ (129,370)
Net earnings (loss) per share:			
Basic	$ 1.25	$ (8.28)	$ (3.89)
Diluted	$ 1.21	$ (8.28)	$ (3.89)
Weighted average number of shares outstanding:			
Basic	63,383	54,764	33,284
Diluted	65,571	54,764	33,284

See accompanying notes to consolidated financial statements.

ADVANCED MEDICAL OPTICS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)

	Common Stock		Additional Paid-In	Unearned	Retained Earnings (Accumulated	Accumulated Other Comprehensive	Treasury Stock			Comprehensive
	Shares	Par Value	In Capital	Compensation	Deficit)	Income (Loss)	Shares	Amount	Total	Income (Loss)
	(in thousands)									
Balance at December 31, 2003	29,379	$ 294	$ 54,128	$ (64)	$ 24,981	$ 13,868	(1)	$ (15)	$ 93,192	
Comprehensive loss										
Net loss					(129,370)				(129,370)	$ (129,370)
Foreign currency translation adjustments						55,799			55,799	55,799
Unrealized gain on derivative instrument qualifying as cash flow hedge, net of $112 of tax						207			207	207
Total comprehensive loss										$ (73,364)
Issuance of common stock in connection with convertible note exchanges	7,021	70	243,881						243,951	
Issuance of common stock under stock option plan	490	5	4,934						4,939	
Issuance of common stock under stock purchase plans	171	2	3,051						3,053	
Issuance of restricted stock	8		265	(265)						
Expense of compensation plan				219					219	
Tax benefits from employee stock plans			4,288						4,288	
Purchase of treasury stock, at cost								(8)	(8)	
Balance at December 31, 2004	37,069	$ 371	$ 310,547	$ (110)	$ (104,389)	$ 69,874	(1)	$ (23)	$ 276,270	
Comprehensive loss										
Net loss					(453,197)				(453,197)	$ (453,197)
Foreign currency translation adjustments						(89,537)			(89,537)	(89,537)

Reclassification adjustment for realized gain on derivative instrument qualifying as cash flow hedge, net of $112 of tax						(207)			(207)	(207)	
Total comprehensive loss										$ (542,941)	
Issuance of common stock in connection with convertible note exchanges	453	4	10,126						10,130		
Issuance of common stock under stock option plan	2,305	23	41,388						41,411		
Issuance of common stock under stock purchase plans	144	1	4,429						4,430		
Issuance of restricted stock	74	1	4,008	(4,008)					1		
Cancellation of restricted stock			(49)	49							
Issuance of common stock under VISX acquisition	27,787	278	1,202,907						1,203,185		
Expense of compensation plan				1,245					1,245		
Tax benefits from employee stock plans			16,332						16,332		
Transfer of restricted stock to treasury stock								(1)	(1)		
Balance at December 31, 2005	67,832	$ 678	$ 1,589,688	$ (2,824)	$ (557,586)	$ (19,870)	(1)	$ (24)	$ 1,010,062		
Comprehensive income											
Net earnings					79,471				79,471	$ 79,471	
Foreign currency translation adjustments						58,036			58,036	58,036	
Total comprehensive income										$ 137,507	
Adjustment for initial adoption of FAS 158, net of taxes						(1,421)			(1,421)		
Issuance of common stock under stock option plan	1,799	18	37,276						37,294		
Issuance of common stock under stock purchase plans	154	2	4,927						4,929		

Issuance of restricted stock	225	2	(2)							
Cancellation of restricted stock	(7)									
Stock repurchase	(10,491)	(105)	(247,210)		(252,685)				(500,000)	
Reclassification of unearned compensation balance			(2,824)	2,824						
Tax benefits from employee stock plans			8,386						8,386	
Stock-based compensation expense			19,234						19,234	
Balance at December 31, 2006	59,512	$ 595	$ 1,409,475	$	$ (730,800)	$ 36,745	(1)	$ (24)	$ 715,991	

See accompanying notes to consolidated financial statements.

ADVANCED MEDICAL OPTICS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2006	2005	2004
	(in thousands)		
Cash flows provided by operating activities			
Net earnings (loss):	$ 79,471	$ (453,197)	$ (129,370)
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Amortization and write-off of original issue discount and debt issuance costs	7,051	9,284	11,028
Amortization and write-off of net realized gain on interest rate swaps		(773)	(3,466)
Depreciation and amortization	70,598	51,588	23,616
Deferred income taxes	29,985	(5,104)	(16,737)
Tax benefit from issuance of stock under stock plans			4,288
In-process research and development		490,750	28,100
Loss on exchange of convertible senior subordinated notes	18,783	1,670	111,702
Loss on investments and assets	2,204	13,165	1,047
Unrealized loss (gain) on derivatives	1,290	(2,563)	403
Stock based compensation expense	19,234	1,245	219
Changes in assets and liabilities, net of effect of acquisition:			
Trade receivables	13,918	(27,780)	(48,459)
Inventories	(20,378)	(14,720)	13,198
Other current assets	(6,190)	(7,170)	(1,514)
Accounts payable	(11,823)	(27,328)	39,759
Accrued expenses and other liabilities	27,647	6,684	7,294
Income taxes	(6,880)	(16,802)	5,775
Other non-current assets	(116)	1,887	(7,215)
Net cash provided by operating activities	224,794	20,836	39,668
Cash flows from investing activities			
Acquisition of business, net of cash acquired		(36,867)	(456,709)
Additions to property, plant and equipment	(29,023)	(23,097)	(17,492)
Proceeds from sale of property, plant and equipment	2,609	48	1,172
Additions to capitalized internal-use software	(3,191)	(8,816)	(2,415)
Additions to demonstration and bundled equipment	(10,756)	(11,135)	(6,778)
Net cash used in investing activities	(40,361)	(79,867)	(482,222)
Cash flows from financing activities			
Short-term borrowings (repayments), net	(60,000)	60,000	
Repayment of long-term debt	(167,678)	(194,166)	(149,243)
Financing related costs	(11,063)	(8,459)	(16,553)
Proceeds from issuance of long-term debt	500,000	150,000	600,000
Proceeds from issuance of common stock	42,223	45,841	7,992
Repurchase and retirement of common stock	(500,000)		
Excess tax benefits from stock-based compensation	6,718		
Other		773	(8)
Net cash (used in) provided by financing activities	(189,800)	53,989	442,188

Effect of exchange rates on cash and equivalents	(937)	(3,587)	3,717
Net (decrease) increase in cash and equivalents	(6,304)	(8,629)	3,351
Cash and equivalents at beginning of year	40,826	49,455	46,104
Cash and equivalents at end of year	$ 34,522	$ 40,826	$ 49,455
Supplemental disclosure of cash flow information			
Cash paid during the year for:			
Interest	$ 14,781	$ 22,005	$ 21,472
Income taxes	25,675	34,805	14,225
Supplemental non-cash investing and financing activities:			
Exchange of convertible notes into common stock	$	$ 8,600	$ 131,400
Acquisition of VISX, Incorporated (Note 3)		1,203,185	

See accompanying notes to consolidated financial statements.

ADVANCED MEDICAL OPTICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

Note 1: Description of Business

Advanced Medical Optics, Inc. (AMO or the Company) develops, manufactures and markets medical devices for the eyes. Effective January 1, 2006, the Company s reportable segments are represented by three business units: cataract/implant, laser vision correction (LVC) and eye care. Previously, the Company s reportable segments were based on geographic regions which comprised the Americas, which included North and South America, Europe/Africa/Middle East, Japan and Asia Pacific, which excluded Japan and included New Zealand and Australia. The cataract/implant business focuses on the four key products required for cataract surgery foldable intraocular lenses, or IOL s, implantation systems, phacoemulsification systems and viscoelastics. The LVC business markets laser systems, diagnostic devices, treatment cards and microkeratomes for use in laser eye surgery. The eye care business provides a full range of contact lens care products for use with most types of contact lenses. These products include single-bottle, multi-purpose cleaning and disinfecting solutions, hydrogen peroxide-based disinfecting solutions, daily cleaners, enzymatic cleaners, contact lens rewetting drops, and in Europe and Asia, contact lenses. The Company sells its products in approximately 60 countries and has direct operations in approximately 20 countries.

Note 2: Summary of Significant Accounting Policies

This summary of significant accounting policies is presented to assist the reader in understanding and evaluating the consolidated financial statements. These policies are in conformity with accounting principles generally accepted in the United States of America and have been applied consistently in all material respects. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, the reported amounts of revenues and expenses during the reporting period, and related disclosures. Actual results could differ from those estimates.

Basis of Presentation

The consolidated financial statements include the accounts of AMO and all of its subsidiaries. All significant transactions among the consolidated entities have been eliminated from the consolidated financial statements.

Foreign Currency Translation

The financial position and results of operations of AMO s foreign operations are generally determined using local currency as the functional currency. Assets and liabilities of these operations are translated at the exchange rate in effect at each year-end. Income statement amounts are translated at the average rate of exchange prevailing during the year. Translation adjustments arising from the use of differing exchange rates from period to period are included in accumulated other comprehensive income (loss) in stockholders equity. Gains and losses resulting from foreign currency transactions and remeasurements relating to foreign operations deemed to be operating in U.S. dollar functional currency are included in Other, net in the accompanying consolidated statements of operations.

Cash and Equivalents

The Company considers cash and equivalents to include cash in banks, money market mutual funds and time deposits with financial institutions with original maturities of 90 days or less.

Investments

The Company has non-marketable equity investments in conjunction with its various collaboration arrangements. The non-marketable equity investments are recorded at cost and are evaluated periodically for other than temporary declines in fair value. The Company uses the following criteria to determine if such a decline should be considered other than temporary:

the duration and extent to which the market value has been less than cost;

the financial condition and near-term prospects of the investee;

the reasons for the decline in market value;

the investee s performance against product development milestones; and

the Company s ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value.

If it is determined that a decline of any investment is other than temporary, then the carrying value would be written down to fair value, and the write-down would be included in earnings as a loss.

Inventories

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

Property, Plant and Equipment

Property, plant and equipment are stated at cost. Additions, major renewals and improvements are capitalized, while maintenance and repairs are expensed. For financial reporting purposes, depreciation is generally provided on the straight-line method over the useful lives of the related assets, which are 20 to 40 years for buildings and improvements and from 3 to 15 years for machinery and equipment. Leasehold improvements are amortized over the life of the related facility lease or the asset, whichever is shorter. Accelerated depreciation methods are generally used for income tax purposes.

Goodwill and Long-Lived Assets

Goodwill represents the excess of acquisition costs over the fair value of net assets of purchased businesses. Intangible assets include licensing agreements, customer relationships and technology rights, which are amortized utilizing a straight-line method over their estimated useful lives ranging from 3 to 19 years, and non-amortizable trademarks.

The Company has adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142), whereby goodwill and non-amortizable intangible assets are no longer amortized, but instead is subject to a periodic impairment review performed during the second quarter of each fiscal year. In a business combination, goodwill is allocated to the Company s various reporting units, which are the same as the Company s reportable operating segments, based on relative fair value of the assets acquired and liabilities assumed. The Company reviews the recoverability of its goodwill and non-amortizable intangible assets on an annual basis by comparing each unit s fair value to the net book value of its assets. If the book value of the reporting unit s assets exceeds its fair value, the goodwill is written down to its implied fair value. In the second quarters of 2006, 2005 and 2004, the Company performed its annual impairment tests of its goodwill and non-amortizable intangible assets, and no impairment was indicated based on these tests.

Additionally, the Company reviews the carrying amount of goodwill whenever events and circumstances indicate that the carrying amount of goodwill may not be recoverable. Impairment indicators include, among other conditions, cash flow deficits, historic or anticipated declines in revenue or operating profit and adverse legal or regulatory developments. If it is determined such indicators are present and the review indicates goodwill will not be fully recoverable, based upon discounted estimated cash flows, the carrying value is reduced to implied fair value.

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-lived Assets (SFAS 144), the Company assesses potential impairment to its long-lived assets when events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. If required, an impairment loss is recognized as the difference between the carrying value and the fair value of the assets.

Capitalized Software

The Company capitalizes certain internal-use computer software costs after technological feasibility has been established. These capitalized costs are amortized utilizing the straight-line method over their estimated economic life not to exceed three years.

Demonstration (Demo) and Bundled Equipment

In the normal course of business, the Company maintains demo and bundled equipment, primarily phacoemulsification and microkeratome surgical equipment, for the purpose and intent of selling similar equipment or related products to the customer in the future. Demo and bundled equipment are not held for sale and are recorded as other non-current assets. The assets are amortized utilizing the straight-line method over their estimated economic life not to exceed three years.

Revenue Recognition and Accounts Receivable

Revenue is realized or realizable and earned when persuasive evidence of an arrangement exists, delivery has occurred, the price to the buyer is fixed or determinable and collectibility is reasonably assured. The Company records revenue from product sales when title and risk of ownership have been transferred to the customer, which is typically upon delivery to the customer, with the exception of intraocular lenses distributed on a consignment basis, which is upon notification of implantation in a patient. The Company recognizes license fees and revenues from the sale of treatment cards to direct customers when it ships the treatment cards as it has no continuing obligations or involvement subsequent to shipment.

Some customers finance the purchase or rental of their VISX equipment directly from the Company over periods ranging from one to three years. These financing agreements are classified as either rental or operating leases or sales type leases as prescribed by SFAS No. 13, Accounting for Leases. Under sales type leases, equipment revenues are recognized based on the net present value of the expected cash flow after installation to direct customers in the United States and Japan or after shipment to international distributors. Under rental or operating lease arrangements, rental revenue is recognized over the term of the agreement.

The Company generally permits returns of product if such product is returned in a timely matter, in good condition, and through the normal channels of distribution. However, the Company does not accept returns of treatment cards and does not provide rights of return or exchange, price protection or stock rotation rights to any VISX product distributors. Return policies in certain international markets can be more stringent and are based on the terms of contractual agreements with the customers. Allowances for returns are provided for based upon an analysis of the Company s historical patterns of returns matched against the sales from which they originated. To date, historical product returns have been within the Company s estimates.

When the Company recognizes revenue from the sale of products, certain allowances known and estimable at time of sale are recorded as a reduction to sales. These items include cash discounts, allowances and rebates. These items are reflected as a reduction to accounts receivable to the extent the customer will or is expected to reduce its payment on the related invoice amounts. In addition, certain items such as rebates provided to customers that meet certain buying targets are paid to the customer subsequent to customer payment. Thus, such amounts are recorded as accrued liabilities. These provisions are estimated based on historical payment experience, historical relationship to revenues and estimated customer inventory levels. To date, historical sales allowances have been within the Company s estimates.

The allowance for doubtful accounts is determined by analyzing specific customer accounts and assessing the risk of uncollectibility based on insolvency, disputes or other collection issues. In addition, the Company routinely analyzes the different aging categories and establishes allowances based on the length of time receivables are past due (based on contractual terms). A write-off will occur if the settlement of the account receivable is less than the carrying amount or the Company determines the balance will not be collected.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk principally consist of trade receivables. Wholesale distributors, major retail chains, and managed care organizations account for a substantial portion of trade receivables. This risk is limited due to the large number of customers comprising the Company s customer base, and their geographic dispersion. Ongoing credit evaluations of customers financial condition are performed and, generally, no collateral is required. The Company maintains reserves for potential credit losses and such losses, in the aggregate, have not exceeded management s expectations.

Income Taxes

The Company records income taxes under the asset and liability method, whereby deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and for operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Management evaluates the need to establish a valuation allowance for deferred tax assets based upon the amount of existing temporary differences, the period in which they are expected to be recovered and expected levels of taxable income. A valuation allowance to reduce deferred tax assets is established when it is more likely than not that some or all of the deferred tax assets will not be realized.

In preparing its consolidated financial statements, the Company is required to estimate its income taxes in each jurisdiction in which it operates. This process involves estimating the current liability as well as assessing temporary differences resulting from differing treatment of items for tax and financial accounting purposes. Significant management judgment is required in determining the provision for income taxes and deferred tax assets and liabilities.

Stock Based Compensation

Prior to January 1, 2006, the Company s stock-based compensation plans were accounted for under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and the disclosure only provisions of Statement of Financial Accounting Standards No. 123 (SFAS 123). Accordingly, no compensation expense was recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. The fair value, as determined on the date of grant, of restricted stock awards was recognized as compensation expense ratably over the respective vesting period. Additionally, the ESPP qualified as a non-compensatory plan under APB 25; therefore, no compensation cost was recorded in relation to the discount offered to employees for purchases made under the ESPP.

On January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R, requiring recognition of expenses equivalent to the fair value of stock-based compensation awards. The Company has elected to use the modified prospective application transition method as permitted by SFAS 123R and therefore has not restated the financial results reported in prior periods. Under this transition method, stock-based compensation expense for the year ended December 31, 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, as adjusted for estimated forfeitures. Compensation expense for all stock-based compensation awards granted subsequent to January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. In addition, the Company s unearned compensation balance at January 1, 2006 was reclassified to additional paid-in capital upon the adoption of SFAS 123R.

Additionally, under SFAS 123R, the ESPP is considered a compensatory plan and requires recognition of compensation expense for purchases of common stock made under the ESPP. The Company recognizes compensation expense for stock option and ESPP awards on a straight-line basis over the vesting period. Compensation expense related to the restricted stock and restricted stock units is recognized over the requisite service periods of the awards, consistent with the Company s practices under SFAS 123 prior to January 1, 2006.

Research and Development

Research and development costs are charged to expense when incurred.

Acquired In-Process Research and Development

Costs to acquire in-process research and development (IPR&D) projects and technologies which have no alternative future use and which have not reached technological feasibility at the date of acquisition are expensed as incurred (see Note 3).

Comprehensive Income (Loss)

Comprehensive income (loss) encompasses all changes in equity other than those with stockholders and consists of net earnings (loss), foreign currency translation adjustments, unrealized gains/losses on derivative instruments and pension obligations, if applicable.

The components of accumulated other comprehensive income (loss) were as follows:

(in millions)	Foreign currency translation adjustment	Change in net unrealized holding gains / losses on derivatives	Unrecognized losses and prior service cost, net	Total accumulated other comprehensive income (loss)
Balance as of December 31, 2003	$ 13,868	$	$	$ 13,868
Net change during the year	55,799	207		56,006
Balance as of December 31, 2004	69,667	207		69,874
Net change during the year	(89,537)	(207)		(89,744)
Balance as of December 31, 2005	(19,870)			(19,870)
Net change during the year	58,036			58,036
Adoption of SFAS No. 158			(1,421)	(1,421)
Balance as of December 31, 2006	$ 38,166	$	$ (1,421)	$ 36,745

Recently Adopted and Issued Accounting Standards

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS No. 154). SFAS No. 154 requires retrospective application to prior periods financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS 154 by the Company did not have a material impact on its consolidated financial position, results of operations or cash flows.

In June 2006, the Emerging Issues Task Force (EITF) issued EITF 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation) to clarify diversity in practice on the presentation of different types of taxes in the financial statements. The Task Force concluded that, for taxes within the scope of the issue, a company may adopt a policy of presenting taxes either gross within revenue or net. That is, it may include charges to customers for taxes within revenues and the charge for the taxes from the taxing authority within cost of sales, or, alternatively, it may net the charge to the customer and the charge from the taxing authority. If taxes subject to EITF 06-3 are significant, a company is required to disclose its accounting policy for presenting taxes and the amounts of such taxes that are recognized on a gross basis. The guidance in this consensus is effective for the first interim reporting period beginning after December 15, 2006 (the first quarter of our fiscal year 2007). The Company does not expect the adoption of EITF 06-3 to have a material impact on its results of operations, financial position or cash flow.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement 109 (FIN 48).and is effective for fiscal years beginning after December 15, 2006. FIN 48 clarifies the accounting for uncertainties in income taxes recognized in accordance with SFAS No. 109, Accounting for Income Taxes by prescribing guidance for the recognition, derecognition and measurement in financial statements of income tax positions taken in previously filed tax returns or tax positions expected to be taken in tax returns, including a decision whether to file or not to file in a particular jurisdiction. FIN 48 requires that any liability created for unrecognized tax benefits be disclosed. The application of FIN 48 may also affect the tax bases of assets and liabilities and therefore may change or create deferred tax liabilities or assets. The Company will be required to adopt FIN 48 as of January 1, 2007. If there are changes in the net assets of the Company as a result of the application of FIN 48, the cumulative effects, if any, will be recorded as an adjustment to retained earnings. The Company is currently evaluating the impact of its adoption of FIN 48 and has not yet determined the effect on its earnings or financial position.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurement. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This Statement does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently assessing the impact of SFAS No. 157 on its financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Qualifying Misstatements in Current Year Financial Statements, which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB No. 108 is effective for companies with fiscal years ending after November 15, 2006 and is required to be adopted by the Company in its fiscal year ending December 30, 2006. The adoption of SAB No. 108 did not have a material impact on the Company s financial statements.

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, Employer s Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires an employer to recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status, measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year, and recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income and as a separate component of stockholders equity. We adopted SFAS No. 158 in the fourth quarter of fiscal 2006. The impact of the adoption of this new accounting standard is disclosed in Note 10 to the consolidated financial statements. The effect on the balance sheet as of December 31, 2006 from the adoption of SFAS No. 158 was based on the funded status of the defined benefit plans as of September 30, 2006, the measurement date of the plans assets and obligations. The Company will be required to change the measurement date to December 31 in fiscal year 2008.

Note 3: Acquisitions

VISX, Incorporated (VISX)

On May 27, 2005, pursuant to the Agreement and Plan of Merger (Merger Agreement), dated as of November 9, 2004, as amended, by and among AMO, Vault Merger Corporation, a wholly owned subsidiary of AMO, and VISX, AMO completed its acquisition of VISX, for total consideration of approximately $1.38 billion, consisting of approximately 27.8 million shares of AMO common stock, the fair value of VISX stock options converted to AMO stock options and approximately $176.2 million in cash (VISX Acquisition). VISX products include the *VISX STAR* Excimer Laser System, the *VISX WaveScan* System and *VISX* treatment cards. As a result of the VISX Acquisition, the Company became the leader in the design and development of proprietary technologies and systems for laser vision correction of refractive vision disorders. The VISX Acquisition has been accounted for as a purchase business combination. The results of operations of the VISX Acquisition have been included in the accompanying consolidated statements of operations from the date of the VISX Acquisition.

The total cost of the VISX Acquisition is as follows (in thousands):

Cash consideration to VISX stockholders	$ 176,167
Fair value of AMO shares issued to VISX stockholders	1,136,605
Fair value of vested VISX stock options	66,580
Direct transaction fees and expenses	15,765
Cash and cash equivalents acquired	(156,765)
Total purchase price	$ 1,238,352

The above purchase price has been allocated based on the fair values of assets acquired and liabilities assumed and has been allocated as follows (in thousands):

Inventories	$ 11,918
Accounts receivable, net	39,353
Other current assets	22,129
Property, plant and equipment	3,350
Other non-current assets	8,038
Intangible assets	402,300
In-process research and development	488,500
Goodwill	479,016
Accounts payable	(16,032)
Other current liabilities	(43,957)
Non-current deferred tax liability, primarily related to intangible assets	(156,263)
Net assets acquired	$ 1,238,352

Of the $402.3 million of acquired intangible assets, $239.5 million was assigned to developed technology rights that have a weighted-average useful life of approximately 10.1 years, $22.4 million was assigned to customer relationships with a useful life of 5 years and $140.4 million was assigned to the VISX trade name with an indefinite useful life. The amounts assigned to intangible assets were based on management s estimate of the fair value.

Identification and allocation of value to the identified intangible assets was based on the provisions of SFAS No. 141, Business Combinations, (SFAS No. 141). The fair value of the identified intangible assets was estimated by performing a discounted cash flow analysis using the income approach. This method includes a forecast of direct revenues and costs associated with the respective intangible assets and charges for economic returns on tangible and intangible assets utilized in cash flow generation. Net cash flows attributable to the identified intangible assets are discounted to their present value at a rate commensurate with the perceived risk. The projected cash flow assumptions considered contractual relationships, customer attrition, eventual development of new technologies and market competition.

The estimates of expected useful lives are based on guidance from SFAS No. 141 and take into consideration the effects of competition, regulatory changes and possible obsolescence. The useful lives of technology rights are based on the number of years in which net cash flows have been projected. The useful lives of customer relationships was estimated based upon the length of the contracts currently in place, probability based estimates of contract renewals in the future and natural growth and diversification of other potential customers, which were considered insignificant. Management considers the VISX trade name to be the leading name in excimer laser vision correction procedures. VISX s estimated market share of 60 percent demonstrates its commercial success. Management intends to maintain and continue to market existing and new products under the VISX trade name. As management intends to continue to use the VISX trade name indefinitely, an indefinite life was assigned.

Assumptions used in forecasting cash flows for each of the identified intangible assets included consideration of the following:

- VISX historical operating margins
- Number of procedures and devices VISX has developed and had approved by the FDA
- VISX market share
- Contractual and non-contractual relationships with large groups of surgeons and
- Patents and exclusive licenses held.

A history of operating margins and profitability, a strong scientific, service and manufacturing employee base and a leading presence in the excimer laser market were among the factors that contributed to a purchase price resulting in the recognition of goodwill. The acquired goodwill, which is not deductible for tax purposes, has been allocated to the LVC segment.

In-process research and development (IPR&D)

Approximately $488.5 million of the purchase price represents the estimated fair value of projects that, as of the VISX Acquisition date, had not reached technological feasibility and had no alternative future use. The Company recorded $449.2 million of this amount in the second quarter of 2005 and $39.3 million in the third quarter of 2005. The additional charge in the third quarter of 2005 resulted primarily from the completion of the IPR&D valuation. The fair value assigned to IPR&D comprised the following projects (in thousands):

	Value of IPR&D Acquired
High Myopia for CustomVue	$ 14,700
Excimer Laser Improvements	56,200
Presbyopia	417,600
Total	$ 488,500

The fair value of these projects was determined by performing a discounted cash flow analysis using the income approach. Net cash flows attributable to these projects were discounted to their present values at a rate commensurate with the perceived risk, which for these projects ranged from 19.0 to 21.0 percent. The following assumptions underlie the fair value as of the VISX Acquisition date:

A high myopia procedure for *CustomVue* was forecasted to be approved for sale in the U.S. in late 2005. A procedure to treat presbyopia is forecasted to be approved for sale in the U.S. in mid-2007. Additional research and development expenses will be incurred prior to expected FDA approval for these procedures. Forecasted discounted cash flows for each product once launched include estimates for normal sustaining engineering and maintenance R&D;

Additional research and development expenses will be incurred to bring excimer laser system improvements to market. Like the other IPR&D projects, maintenance R&D and sustaining engineering costs were allocated to the forecasted cash flows once commercialized;

Revenue that is reasonably likely to result from the approved and unapproved potential uses of identifiable intangible assets that includes the estimated number of units to be sold, estimated selling prices, estimated market penetration and estimated market share and year-over-year growth rates over the product cycles. These estimates were based on management s consideration of life cycles for similar products VISX has previously launched, the competitive landscape, and previous success in working with the FDA; and

The cost structure was assumed to be similar to that for existing products.

The major risks and uncertainties associated with the timely and successful completion of these projects consist of the ability to confirm the safety and efficacy of the technology based on the data from clinical trials and obtaining necessary regulatory approvals. In addition, no assurance can be given that the underlying assumptions used to forecast the cash flows or the timely and successful completion of such projects will materialize, as estimated. For these reasons, among others, actual results may vary significantly from the estimated results.

In September 2005, high myopia *CustomVue* was approved by FDA.

Pfizer Inc. Surgical Ophthalmic Business

On June 26, 2004, pursuant to a stock and asset purchase agreement dated as of April 21, 2004, the Company completed the purchase of Pfizer Inc. s surgical ophthalmic business for $450.0 million in cash (Pfizer Acquisition). Pfizer s surgical ophthalmic business manufactured and marketed surgical devices for the eyes. The Company acquired ophthalmic surgical products and certain manufacturing and research and development facilities located in Uppsala, Sweden, Groningen, Netherlands and Bangalore, India. The products acquired include the *Healon* line of viscoelastic products used in ocular surgery, the *CeeOn* and *Tecnis* intraocular lenses and the *Baerveldt* glaucoma shunt. The Pfizer Acquisition has been accounted for as a purchase business combination.

The following unaudited pro forma information assumes the VISX Acquisition and the Pfizer Acquisition occurred on January 1, 2004. These unaudited pro forma results have been prepared for informational purposes only and do not purport to represent what the results of operations would have been had the VISX Acquisition and the Pfizer Acquisition occurred as of the date indicated, nor of future results of operations. The unaudited pro forma results for years ended December 31, 2005 and 2004 are as follows (in thousands, except per share data):

	Year Ended December 31, 2005		Year Ended December 31, 2004	
Net sales	$ 1,000,842		$ 982,834	
Net earnings	37,377	(1)	70,603	(2)
Earnings per share:				
Basic (3)	$ 0.57		$ 1.09	
Diluted (4)	$ 0.54		$ 1.04	

(1) The unaudited pro forma information for the year ended December 31, 2005 excludes the following non-recurring charges related to the VISX Acquisition: a $488.5 million in-process research and development charge and a $2.0 million charge for the amortization and write-off of debt issuance costs. The unaudited pro forma information also reflects an $11.7 million increase in amortization related to management s estimate of the fair value of intangible assets acquired as the result of the VISX Acquisition and a $4.7 million increase in interest expense resulting from additional borrowings incurred to fund the cash portion of the VISX Acquisition and related costs and amortization of deferred financing costs. Approximately $11.0 million of merger charges incurred by VISX are not excluded from the unaudited pro forma information for the year ended December 31, 2005.

(2) The unaudited pro forma information for the year ended December 31, 2004 excludes the following non-recurring charges related to the Pfizer Acquisition: incremental cost of sales of $28.1 million from the sale of acquired inventory adjusted to fair value, a $28.1 million in-process research and development charge, a charge of $6.5 million for the write-off of debt issuance costs, one-time commitment fee and original issue discount, net of the recognition of realized gains

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on interest rate swaps; and early debt extinguishment costs of $127.2 million. The unaudited pro forma information also reflects a $2.3 million decrease in depreciation and amortization related to the fair value of property, plant and equipment and identifiable intangible assets acquired in the Pfizer Acquisition and a $4.1 million increase in interest expense resulting from the recapitalization to fund the Pfizer Acquisition.

The unaudited pro forma information for the year ended December 31, 2004 also includes a $28.2 million increase in amortization related to management s estimate of the fair value of intangible assets acquired as the result of the VISX Acquisition and an $11.4 million increase in interest expense resulting from additional borrowings incurred to fund the cash portion of the VISX Acquisition and related costs and amortization of deferred financing costs.

(3) The weighted average number of shares outstanding used for the computation of basic earnings per share for the year ended December 31, 2005 reflects the issuance of 27.8 million shares of AMO s common stock to VISX stockholders less the 16.6 million weighted average shares related to the VISX Acquisition already included in basic shares outstanding.

The weighted average number of shares outstanding used for the computation of basic earnings per share for the year ended December 31, 2004 reflects the issuance of 7.0 million shares of AMO s common stock in the private exchanges of the 3½% Convertible Senior Subordinated Notes less the 3.6 million weighted average shares related to the private exchanges already included in basic shares outstanding. The weighted average number of shares outstanding used for the computation of basic earnings per share for the year ended December 31, 2004 also includes the 27.8 million shares issued to VISX stockholders as the result of the VISX Acquisition.

(4) The weighted average number of shares outstanding used for the computation of diluted earnings per share for the year ended December 31, 2005 includes the aggregate dilutive effect of approximately 3.3 million shares for stock options and awards, the remaining 3½% Convertible Senior Subordinated Notes and VISX options exchanged for AMO stock options

The weighted average number of shares outstanding used for the computation of diluted earnings per share for the year ended December 31, 2004 includes the aggregate dilutive effect of approximately 3.6 million shares for stock options and awards, the remaining 3½% Convertible Senior Subordinated Notes and VISX options exchanged for AMO stock options.

Note 4: Product Rationalization and Business Repositioning

On October 31, 2005, the Company s Board of Directors approved a product rationalization and repositioning plan covering the discontinuation of non-strategic cataract surgical and eye care products and the elimination or redeployment of resources that support these product lines. The plan also included organizational changes and potential reductions in force in manufacturing, sales and marketing associated with these product lines, as well as organizational changes in research and development and other corporate functions designed to align the organization with our strategy and strategic business unit organization.

The plan further called for increasing the Company s investment in key growth opportunities, specifically the Company s refractive implant product line and international laser vision correction business, and accelerating the implementation of productivity initiatives. Following an analysis of its IOL manufacturing capabilities in the second quarter of 2006, the Company has decided to consolidate certain operations. In addition, the Company expanded the scope of its eye care rationalization initiatives in order to maximize manufacturing capacity and seize growth opportunities. Total cumulative charges of $105.0 million have been incurred through December 31, 2006.

For the year ended December 31, 2006, the Company incurred $62.7 million of pre-tax charges, which included $16.3 million for inventory, manufacturing related and other charges included in cost of sales and $46.4 million included in operating expenses. Charges included in operating expenses comprised productivity and brand repositioning costs of $37.6 million and severance, relocation and other one-time termination benefits of $13.7 million, offset by net asset disposal gains of $2.8 million and a net credit from settlement of contractual obligations of $2.1 million.

The Company incurred $42.3 million in pre-tax charges during the fourth quarter of 2005 which included $12.6 million for inventory, manufacturing related and other charges included in cost of sales and $29.7 million included in operating expenses for severance, relocation and other one-timer termination benefits of $14.0 million, asset write-downs of $9.2 million, contractual obligations of $2.7 million and accelerated productivity and brand repositioning costs of $3.8 million.

Business repositioning charges and related activity in the accrual balances during the year ended December 31, 2006 were as follows (in thousands):

Business Repositioning Costs Reported In:	Balance at December 31, 2005	Costs Incurred	Cash Payments	Non-Cash Adjustments	Balance at December 31, 2006
Cost of sales					
Inventory, manufacturing and other charges	$	$ 16,244	$	$ (16,244)	$
Operating Expenses					
Severance, relocation and related costs	8,779	13,700	(11,080)		11,399
Net gain on asset disposals		(2,777)		2,777	
Contractual obligations	2,641	(2,106)	(287)		248
Productivity initiatives and brand repositioning costs	883	37,600	(37,295)		1,188
	12,303	46,417	(48,662)	2,777	12,835
	$ 12,303	$ 62,661	$ (48,662)	$ (13,467)	$ 12,835

The Company incurred $42.3 million in pre-tax charges during the fourth quarter of 2005 as follows (in thousands);

Business Repositioning Costs Reported In:	Costs Incurred	Cash Payments	Non-Cash Adjustments	Balance at December 31, 2005
Cost of sales				
Inventory, manufacturing and other charges	$ 12,585	$	$ (12,585)	$
Operating Expenses				
Severance, relocation and related costs	14,020	(5,241)		8,779
Asset write-downs	9,172		(9,172)	
Contractual obligations	2,641			2,641
Productivity initiatives and brand repositioning costs	3,847	(2,964)		883
	29,680	(8,205)	(9172)	12,303
	$ 42,265	$ (8,205)	$ (21,757)	$ 12,303

Productivity initiatives and brand repositioning costs resulted from the Company s investment in key growth opportunities, specifically the Company s refractive implant product line, international laser vision correction business and expanded eye care rationalization, and the implementation of productivity improvements in manufacturing operations, distribution, customer service and corporate functions. Severance, relocation and related costs were incurred for worldwide workforce reductions due to the Company s discontinuation of certain non-core products and infrastructure and process improvements associated with the Company s productivity initiatives. The majority of these costs occurred in the United States, Japan and Europe. Net asset gains resulted from disposals of long-lived assets from certain discontinued non-core products and relocation of certain facilities, offset by asset write-downs which resulted from the impairment and disposal of long-lived assets from the reduction in expected future cash flows. The fair values of impaired assets were based on probability weighted expected cash flows as determined in accordance with SFAS 144. The net credit from contractual obligations primarily resulted from the settlement with a vendor during the third quarter of 2006.

Note 5: Composition of Certain Financial Statement Captions

	December 31,	
	2006	2005
	(in thousands)	
Trade receivables, net		
Trade receivables	$ 244,725	$ 247,849
Less allowance for doubtful accounts	12,317	9,088
	$ 232,408	$ 238,761
Inventories		
Finished products, including consignment inventory of $13,958 and $11,890 in 2006 and 2005, respectively	$ 83,358	$ 66,492
Work in process	13,538	13,148
Raw materials	30,636	25,180
	$ 127,532	$ 104,820
Property, plant and equipment, net		
Land	$ 9,566	$ 8,987
Buildings and leasehold improvements	93,575	79,502
Machinery, equipment and furniture	115,447	94,819
	218,588	183,308
Less accumulated depreciation and amortization	85,832	67,583
	$ 132,756	$ 115,725

Intangible assets, net

		December 31, 2006		December 31, 2005	
(In thousands)	Useful Life (Years)	Gross Amount	Accumulated Amortization	Gross Amount	Accumulated Amortization
Amortizing Intangible Assets:					
Licensing	3 - 5	$ 4,590	$ (4,243)	$ 4,590	$ (4,113)
Technology rights	8 - 19	364,219	(61,997)	348,379	(26,128)
Trademarks	13.5	16,933	(3,545)	14,689	(1,995)
Customer relationships	5	22,400	(7,093)	22,400	(2,613)
		408,142	(76,878)	390,058	(34,849)
Nonamortizing Tradename (VISX)	Indefinite	140,400		140,400	
		$ 548,542	$ (76,878)	$ 530,458	