1 800 CONTACTS INC
Form 10-Q
May 14, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended March 30, 2002

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

For the transition period from ___________ to _________.

Commission file number: 0-23633

1-800 CONTACTS, INC.
(Exact name of registrant as specified in its charter)

Delaware	87-0571643
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
66 E. Wadsworth Park Drive, 3rd Floor Draper, UT	84020
(Address of principal executive offices)	(Zip Code)

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

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

/X/ Yes / / No

As of May 7, 2002, the Registrant had 11,382,212 shares of Common Stock, par value $0.01 per share outstanding.

1-800 CONTACTS, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(IN THOUSANDS)

ASSETS

	DECEMBER 29, 2001	MARCH 30, 2002
CURRENT ASSETS:		
Cash and cash equivalents	$ 36	$ 75
Inventories	43,000	44,826
Deferred income taxes	985	1,017
Other current assets	1,019	1,283
Total current assets	45,040	47,201
PROPERTY AND EQUIPMENT, net	3,309	3,477
DEFERRED INCOME TAXES	439	496
INTANGIBLE ASSETS, net	1,544	1,436

OTHER ASSETS	73	88
Total assets	$ 50,405	$ 52,698
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Line of credit	$ 12,526	$ 13,628
Accounts payable	10,251	10,963
Accrued liabilities	3,313	2,787
Income taxes payable	141	1,367
Unearned revenue	421	430
Total current liabilities	26,652	29,175
STOCKHOLDERS' EQUITY:		
Common stock	129	129
Additional paid-in capital	23,998	24,008
Retained earnings	18,276	20,216
Treasury stock at cost	(18,649)	(20,829)
Accumulated other comprehensive loss	(1)	(1)
Total stockholders' equity	23,753	23,523
Total liabilities and stockholders' equity	$ 50,405	$ 52,698

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

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1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	QUARTER ENDED	
	MARCH 31, 2001	MARCH 30, 2002
NET SALES	$ 42,817	$ 41,581
COST OF GOODS SOLD	25,534	28,894
Gross profit	17,283	12,687
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES:		
Advertising expense	8,264	2,719
Legal and professional fees	425	1,260
Other selling, general and administrative expenses	4,542	5,391
Total selling, general and administrative expenses	13,231	9,370
INCOME FROM OPERATIONS	4,052	3,317
OTHER EXPENSE, net	(205)	(130)

INCOME BEFORE PROVISION FOR INCOME TAXES	3,847	3,187
PROVISION FOR INCOME TAXES	(1,517)	(1,247)
NET INCOME	$ 2,330	$ 1,940
PER SHARE INFORMATION:		
Basic net income per common share	$ 0.20	$ 0.17
Diluted net income per common share	$ 0.20	$ 0.17

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE QUARTER ENDED MARCH 30, 2002
(UNAUDITED)
(IN THOUSANDS)

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	TREASURY STOCK		ACCUMUL OTHE COMPREH LOS
	SHARES	AMOUNT			SHARES	AMOUNT	
BALANCE, December 29, 2001	12,861	$ 129	$ 23,998	$ 18,276	(1,285)	$ (18,649)	$
Purchase of treasury shares	-	-	-	-	(200)	(2,213)	
Exercise of common stock options	-	-	-	-	6	33	
Income tax benefit from common stock options exercised	-	-	10	-	-	-	
Net income	-	-	-	1,940	-	-	
Foreign currency translation adjustments	-	-	-	-	-	-	
Comprehensive income							
BALANCE, March 30, 2002	12,861	$ 129	$ 24,008	$ 20,216	(1,479)	$ (20,829)	$

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(IN THOUSANDS)

	QUARTER ENDED	
	MARCH 31, 2001	MARCH 30, 2002
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 2,330	$ 1,940
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	329	422
Gain on sale of property and equipment	(5)	-
Loss on impairment of non-marketable securities	220	-
Deferred income taxes	(174)	(89)
Changes in operating assets and liabilities:		
Inventories	(1,152)	(1,826)
Other current assets	(367)	(264)
Accounts payable	4,732	711
Accrued liabilities	938	(526)
Income taxes payable	691	1,236
Unearned revenue	(177)	9
Net cash provided by operating activities	7,365	1,613
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(517)	(481)
Proceeds from sale of property and equipment	5	10
Purchase of intangible assets	(61)	(12)
Deposits	6	(15)
Net cash used in investing activities	(567)	(498)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Common stock repurchases	-	(2,213)
Proceeds from exercise of common stock options	101	34
Net (repayments) borrowings on line of credit	(3,265)	1,102
Net cash used in financing activities	(3,164)	(1,077)
NET INCREASE IN CASH AND CASH EQUIVALENTS	3,634	38
EFFECT OF FOREIGN EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	3	1
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	42	36
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 3,679	$ 75
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for interest	$ 32	$ 113
Cash paid for income taxes	1,000	100

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

1-800 CONTACTS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1. PRESENTATION OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The accompanying condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments), which in the opinion of management, are necessary to present fairly the results of operations of the Company for the periods presented. It is suggested that these condensed consolidated financial statements be read in conjunction with the audited financial statements and the notes thereto included in the Company's Annual Report to Shareholders on Form 10-K.

The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year.

NOTE 2. NET INCOME PER COMMON SHARE

Basic net income per common share ("Basic EPS") excludes dilution and is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per common share ("Diluted EPS") reflects the potential dilution that could occur if stock options or other common stock equivalents were exercised or converted into common stock. The computation of Diluted EPS does not assume exercise or conversion of securities that would have an antidilutive effect on net income per common share. For the quarters ended March 31, 2001 and March 30, 2002, options to purchase 119,184 and 459,157 shares of common stock, respectively, were not included in the computation of Diluted EPS because the exercise prices of the options were greater than the average market price of the common shares.

The following is a reconciliation of the numerator and denominator used to calculate Basic and Diluted EPS (in thousands, except per share amounts):

	Quarter Ended March 31, 2001			Quarter Ended March	
	Net Income	Shares	Per-Share Amount	Net Income	Shares
Basic EPS	$ 2,330	11,577	$ 0.20	$ 1,940	11,521
Effect of stock options		224			101
Diluted EPS	$ 2,330	11,801	$ 0.20	$ 1,940	11,622

NOTE 3. COMMON STOCK TRANSACTIONS

During the quarter ended March 30, 2002, the Company repurchased 200,000 shares for a total cost of approximately $2.2 million.

The Company's Board of Directors has authorized the repurchase of up to

3,000,000 shares of its common stock. A purchase of the full 3,000,000 shares would equal approximately 23.3 percent of the total shares issued. The repurchase of common stock is subject to market conditions and is accomplished through periodic purchases at prevailing prices on the open market, by block purchases or in privately negotiated transactions. The repurchased

shares are retained as treasury stock to be used for corporate purposes. Through March 30, 2002, the Company had repurchased 1,706,500 shares for a total cost of approximately $22.1 million.

During the quarter ended March 30, 2002, employees exercised stock options to purchase 5,506 shares of common stock for a total of approximately $33,000.

During the quarter ended March 30, 2002 the Company granted nonqualified stock options to purchase 119,926 shares of common stock to employees, directors and consultants of the Company. The exercise prices of the options range from $11.76 to $12.00. The options vest equally over a four-year period and expire in seven to ten years.

On April 12, 2002, the Company's Board of Directors approved and adopted, subject to stockholder approval, certain amendments to the Company's stock option plan to provide for an increase in the number of shares of common stock reserved for issuance under the plan from 620,000 to 1,240,000.

NOTE 4. LINE OF CREDIT

The Company has a revolving credit facility that provides for borrowings equal to the lesser of $20.0 million or 50 percent of eligible inventory. The credit facility bears interest at a floating rate equal to the lender's prime interest rate minus 0.25 percent (4.5 percent at March 30, 2002) or 2.35 percent above the lender's thirty day LIBOR. If at any time, the Company's ratio of liabilities to net worth is more than 1.5, the floating rate will increase by 0.25 percent. The credit facility also includes an unused credit fee equal to one-eighth of one percent, payable quarterly. As of March 30, 2002, the Company's outstanding borrowings on the credit facility, including bank overdrafts, were approximately $13.6 million. The credit facility is secured by substantially all of the Company's assets and contains financial covenants customary for this type of financing. As of March 30, 2002, the Company was in compliance with these covenants. The credit facility expires April 30, 2003.

NOTE 5. LEGAL MATTERS

On April 7, 1999, the Kansas Board of Examiners in Optometry ("KBEO") commenced a civil action against the Company. The action was filed in the District Court of Shawnee County, Kansas, Division 6. The complaint was amended on May 28, 1999. The amended complaint alleges that "on one or more occasions" the Company sold contact lenses in the state of Kansas without receipt of a prescription. The amended complaint seeks an order enjoining the Company from further engaging in the alleged activity. The amended complaint does not seek monetary damages. In response to the amended complaint, the Company has retained counsel, and intends to vigorously defend itself in this action. The Company has filed an answer to the amended complaint and, at the request of the Court, filed a motion for summary judgment. In November 2000, the Court issued an order denying the summary judgment motion, finding that there were factual issues regarding whether the KBEO can meet the requirements necessary to obtain injunctive relief, and whether the Kansas law violates the Commerce Clause of the United States Constitution. The parties are now engaging in fact and expert

discovery in preparation for trial.

On or about November 2, 1999, the Texas Optometry Board filed a civil action against the Company seeking injunctive relief and civil penalties against the Company for alleged violations of the Texas Optometry Act. The Company has entered into a settlement agreement which resolves the complaint. A cash payment of $8,500 was made in connection with the settlement.

The Company entered into a written settlement agreement with the Texas Department of Health ("TDH"), the regulatory authority in Texas for sellers of contact lenses. This settlement agreement became effective on February 29, 2000, and relates to the Company's sales practices in Texas. The agreement began to be implemented in November 2000 and allows for a review of and, if necessary, changes to the Company's practices during an initial six-month period. The TDH issued a Notice of Violation against the Company on or about February 26, 2001,

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alleging that the Company failed to comply with certain provisions of the agreement. The Company is engaged in discussions with the TDH regarding this notice.

On May 22, 2001, the Middle District Court in Jacksonville, Florida announced a preliminary settlement with Johnson & Johnson with respect to the multi-district litigation ("MDL") brought by the attorneys general of 32 states on behalf of a nationwide class of consumers. This suit alleged that consumers overpaid for contact lenses as a result of antitrust violations by Johnson & Johnson, CIBA Vision, Bausch & Lomb, and the American Optometric Association ("AOA"). Specifically, the attorneys general alleged that the manufacturers and the AOA conspired to eliminate competition from alternative distribution channels, including mail order companies, and ensure that contact lenses would only be available from eye care professionals. On or about October 12, 2001 the Company was granted intervener status by the court in the MDL lawsuit. This status allows the Company to become a party to the lawsuit for the limited purpose of enforcing the injunctive relief provisions of the MDL settlement agreement, e.g. requiring Johnson & Johnson's eye care division, Vistakon, to sell its products directly to the Company. The court finalized the MDL settlement agreement on November 1, 2001. The agreement became effective on December 1, 2001. To date, Vistakon has refused to open an account with the Company. The Company filed a motion with the court alleging that Johnson & Johnson is in violation of the settlement agreement because it has refused to open an account for the Company. The court has granted motions for discovery and an evidentiary hearing has been set for the summer of 2002 regarding this motion for contempt.

On October 18, 2001, Vistakon filed an action against the Company concerning certain of the Company's communications with customers informing them of the Company's belief that there are superior products available from other manufacturers with less restrictive distribution policies. The action was filed in the Middle District Court in Jacksonville, Florida. The complaint alleges claims for false advertising, unfair trade practices, tortious interference with prospective economic advantage and defamation and seeks both damages and injunctive relief. Vistakon also filed a motion for preliminary injunction which the Company opposed. The court granted Vistakon's preliminary injunction motion in part. The court ruled that when the Company wishes to rely on a particular study that the Company needs to make clear which lenses the study compares. Also, the court found that some of the Company's statements were inconsistent when it stated that it continues to fill virtually all orders of Vistakon products while also stating that Vistakon has attempted to cut off the Company's sources for Vistakon product. The Company appealed this decision and is

presently waiting for the 11th circuit federal court of appeals to hear the case. The Company believes the complaint lacks merit and plans to vigorously defend the action.

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

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

NOTE 6. RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations," and No. 142, "Goodwill and Other Intangible Assets," effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives. The Company adopted these new rules on accounting for goodwill and other intangible assets effective in the first quarter of fiscal 2002. There was no impact on the financial statements of the Company.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which replaces SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets to Be Disposed Of." The accounting model for long-lived assets to be disposed of by sale applies to all long-lived assets, including discontinued operations, and replaces the provisions of Accounting Principles Board Opinion No. 30, "Reporting Results of Operations--Reporting the Effects of Disposal of a Segment of a Business," for the disposal of segments

of a business. This statement requires that those long-lived assets be measured at the lower of the carrying amount or fair value less costs to sell, whether reported in continuing operations or in discontinued operations. As a result, discontinued operations will no longer be measured at net realizable value or include amounts for operating losses that have not yet occurred. This statement also broadens the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. This statement is effective for fiscal years beginning after December 15, 2001. The Company adopted this statement effective in the first quarter of fiscal 2002. There was no impact on the financial statements of the Company.

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

OVERVIEW

The Company is a leading direct marketer of replacement contact

lenses. The Company was formed in February 1995 and is the successor to the mail order business founded by the Company's Vice President of Sales in March 1991. Historically, the Company's net sales have grown rapidly, from $3.6 million in fiscal 1996 to $169 million in fiscal 2001. During the first quarter of 2002, net sales declined slightly to $41.6 million from $42.8 million in the first quarter of fiscal 2001. Internet sales grew from an insignificant amount in fiscal 1996 to $67.6 million in fiscal 2001 and from $16.3 million in the first quarter of fiscal 2001 to $17.1 million in the first quarter of fiscal 2002.

The Company's fiscal year consists of a 52/53 week period ending on the Saturday nearest to December 31.

The Company expenses all advertising costs when the advertising first takes place. As a result, quarter-to-quarter comparisons are impacted within and between quarters by the timing of television, radio and Internet advertisements and by the mailing of the Company's printed advertisements. The volume of mailings and other advertising may vary in different quarters and from year to year depending on the Company's assessment of prevailing market opportunities.

The sale and delivery of contact lenses are governed by both federal and state laws and regulations. The Company sells to customers in all 50 states, and each sale is likely to be subject to the laws of the state where the customer is located. In some states, the Company operates according to agreements it has entered into with local regulatory authorities or medical boards or agencies. The Company's general operating practice is to attempt to obtain a valid prescription from each of its customers or his/her eye care practitioner. If the customer does not have a copy of his/her prescription but does have the prescription information obtained directly from the customer's eye care practitioner, the Company attempts to contact the customer's eye care practitioner to obtain a copy of or verify the customer's prescription. If the Company is unable to obtain a copy of or verify the customer's prescription, it is the Company's general practice to complete the sale and ship the lenses to the customer based on the prescription information provided by the customer. The Company retains copies of the written prescriptions that it receives and maintains records of its communications with the customer's prescriber.

On May 22, 2001, the Middle District Court in Jacksonville, Florida announced a preliminary settlement with Johnson & Johnson with respect to the multi-district litigation brought by the attorneys general of 32 states on behalf of a nationwide class of consumers. This suit alleged that consumers overpaid for contact lenses as a result of antitrust violations by Johnson & Johnson, CIBA Vision, Bausch & Lomb, and the American Optometric Association ("AOA"). Specifically, the attorneys general alleged that the manufacturers and the AOA conspired to eliminate competition from alternative distribution channels, including mail order companies, and ensure that contact lenses would only be available from eye care professionals. The court finalized the settlement agreement on November 1, 2001. The agreement became effective on December 1, 2001. CIBA Vision settled this lawsuit more than four years ago and Bausch & Lomb settled in the first part of 2001. The Company now purchases lenses directly from these two manufacturers.

Johnson & Johnson's press release announcing the settlement stated that it would begin selling to alternative channels of distribution. To date, Johnson & Johnson's eye care division, Vistakon, has refused to open an account with the Company. In October 2001, the Company was granted intervener status to this multi-district litigation by the court. This status allows the Company to become a party to the lawsuit for the limited purpose of enforcing the injunctive relief provisions of the settlement agreement, e.g. requiring Vistakon to sell its products directly to the Company.

Vistakon's current interpretation of the settlement agreement, and its

subsequent actions, have made its products more difficult for the Company to obtain. As long as this restricted supply and the resulting wholesale price increases continue, the Company's future net sales and gross profit will be negatively impacted. As a result of this

restricted supply, the Company has reduced its planned advertising spending, which will also adversely impact net sales.

The Company is also investing significant resources to ensure that the settlement agreement will allow it to purchase contact lenses directly from Vistakon. As a result, the Company expects to continue to incur significant legal and related expenses during fiscal 2002.

In response to Johnson & Johnson's efforts to make its products more difficult to obtain, the Company tested whether it could successfully transition its customers into new products by assisting them in getting fitted for a new brand of contact lenses. The Company believes that these tests indicate that its customers are receptive to an offer from the Company to try both a new product and a new eye care provider. The Company feels that a more active role in the product/provider decision may help it address the policies of manufacturers that refuse to sell their brands to the Company but seek to sell their brands exclusively to eye doctors.

On October 18, 2001, Vistakon filed an action against the Company concerning certain of its communications with customers informing them of the Company's belief that there are superior products available from other manufacturers with less restrictive distribution policies. See Note 5 to the Company's condensed consolidated financial statements.

RESULTS OF OPERATIONS

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

	QUARTER ENDED	
	MARCH 31, 2001	MARCH 30, 2002
Net sales	100.0%	100.0%
Cost of goods sold	59.6	69.5
Gross profit	40.4	30.5
Advertising expense	19.3	6.5
Legal and professional fees	1.0	3.0
Other selling, general and administrative expenses	10.6	13.0
Total selling, general and administrative expenses	30.9	22.5
Income from operations	9.5	8.0
Other expense, net	(0.5)	(0.3)
Income before provision for income taxes	9.0	7.7
Provision for income taxes	(3.6)	(3.0)

Net income	5.4%	4.7%

NET SALES. Net sales for the quarter ended March 30, 2002 decreased 3% to $41.6 million from $42.8 million for the quarter ended March 31, 2001. This decrease is mainly due to a decline in new sales as a result of spending about $5.5 million less on advertising in the first quarter of fiscal 2002 than was spent on advertising in the first quarter of fiscal 2001. The decline in new sales was partially offset by the increase in repeat sales as the Company continues to realize the benefits of a strong customer base. Repeat sales for the first quarter of fiscal 2002 increased 17% to $32.9 million, or 79% of net sales, from $28.1 million, or 66% of net sales, for the first quarter of fiscal 2001. The Company also believes that its net sales reflect some of the benefits of the more than $100 million it has invested in its national advertising campaign over the last several years and its commitment to customer service. In addition, the Company continues to refine its marketing efforts to its customer base and enhance its website. The Company continues to highlight its website in its advertising. Internet sales for the first quarter of fiscal 2002 were $17.1 million, or 41% of net sales, as compared to $16.3 million, or 38% of net sales, for the first quarter of fiscal 2001. Due to the current environment (higher prices for and reduced supply of Vistakon products), the Company has continued its suspension of quantity discounts on all Vistakon contact lenses

that was implemented in June 2001. During the first quarter of fiscal 2002, the Company also continued with other programs implemented in September 2001 to manage its level of Vistakon inventory, including reducing the standard quantity of Vistakon contact lenses offered to customers. Due to such practices, the Company has been able to fill nearly all requests from customers for Vistakon products, albeit at substantially higher costs to the Company to aquire such product for resale.

GROSS PROFIT. Gross profit as a percentage of net sales decreased to 30.5% for the quarter ended March 30, 2002 from 40.4% for the quarter ended March 31, 2001. Internet sales as a percentage of net sales impacts gross profit as a percentage of net sales since Internet orders generate lower gross profit due to free shipping on those orders. During the first quarter of fiscal 2002, gross profit was impacted by the increase in wholesale prices paid for Vistakon products. To offset some of the increase in wholesale prices paid for Vistakon products, the Company raised its retail prices on Vistakon products during December 2001. During the first quarter of fiscal 2002, Vistakon products accounted for about 40% of the Company's net sales. If supply of Vistakon products remains limited and wholesale prices remain at current levels, gross profit will continue to be adversely impacted in future periods.

ADVERTISING EXPENSE. Advertising expense for the quarter ended March 30, 2002 decreased $5.5 million, or 67%, from the quarter ended March 31, 2001. As a percentage of net sales, advertising expense decreased to 6.5% for the first quarter of fiscal 2002 from 19.3% for the first quarter of fiscal 2001. Until the current environment (higher prices for and reduced supply of Vistakon products) changes, the Company plans on spending about $11 to $12 million on advertising during the remainder of fiscal 2002. However, if opportunities present themselves, the Company may increase advertising spending above currently planned levels.

LEGAL AND PROFESSIONAL FEES. Legal and professional fees for the quarter ended March 30, 2002 increased $0.8 million, or 196%, from the quarter

ended March 31, 2001. As a percentage of net sales, legal and professional fees increased to 3.0% for the first quarter of fiscal 2002 from 1.0% for the first quarter of fiscal 2001. During the first quarter of fiscal 2002, the Company incurred significant legal and professional fees related to its legal matters and its increased efforts to proactively influence the industry on behalf of itself and consumers. The Company expects to continue to incur significant legal and professional fees as it continues this proactive approach, including investing resources to ensure that the multi-district litigation settlement agreement with Johnson & Johnson will allow it to purchase contact lenses directly from Vistakon.

OTHER SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Other selling, general and administrative expenses for the quarter ended March 30, 2002 increased $0.8 million, or 19%, from the quarter ended March 31, 2001. As a percentage of net sales, other selling, general and administrative expenses increased to 13.0% for the first quarter of fiscal 2002 from 10.6% for the first quarter of fiscal 2001. Operating and payroll costs increased as the Company enhanced its operating infrastructure and its management team to meet the demands of the business.

OTHER EXPENSE, NET. Other expense decreased to approximately $130,000 for the quarter ended March 30, 2002 from approximately $205,000 for the quarter ended March 31, 2001. For the first quarter of fiscal 2002, other expense consists mainly of interest expense, resulting from the increased use of the revolving credit facility. During the first quarter of fiscal 2001, the Company recorded a $220,000 loss related to the impairment of non-marketable securities offset partially by interest income.

INCOME TAXES. The Company's effective tax rate for the quarter ended March 30, 2002 was 39.1%. For the quarter ended March 31, 2001, the Company's effective tax rate was 39.4%. As of March 30, 2002, the Company had not provided a valuation allowance on deferred tax assets. The Company's future effective tax rate will depend upon future taxable income. The Company anticipates that its fiscal 2002 effective income tax rate will be approximately 39%.

LIQUIDITY AND CAPITAL RESOURCES

For the quarters ended March 30, 2002 and March 31, 2001, net cash provided by operating activities was approximately $1.6 million and $7.4 million, respectively. In the fiscal 2002 period, cash was provided primarily by net income and increases in accounts payable and income taxes payable partially offset by an increase in inventories. In the fiscal 2001 period, cash was provided primarily by net income and increases in accounts payable, accrued liabilities and income taxes payable partially offset by an increase in inventories. In order to help ensure sufficient

supply of inventory, the Company generally carries a higher level of inventory than if it were able to purchase directly from all contact lens manufacturers.

The Company used approximately $498,000 and $567,000 for investing activities in the quarters ended March 30, 2002 and March 31, 2001, respectively. The majority of these amounts relate to capital expenditures for infrastructure improvements. Capital expenditures for the fiscal 2002 and 2001 periods were approximately $481,000 and $517,000, respectively. The Company anticipates additional capital expenditures for infrastructure as it continues to expand and improve operating facilities, telecommunications systems and management information systems in order to handle future growth.

During the quarters ended March 30, 2002 and March 31, 2001, the

Company used approximately $1.1 million and $3.2 million for financing activities. During the fiscal 2002 period, the Company repurchased a total of 200,000 shares of its common stock for a total cost of approximately $2.2 million and had net borrowings on its credit facility of approximately $1.1 million. During the fiscal 2001 period, the Company repaid the amount owed on its credit facility. The net repayments on the credit facility totaled approximately $3.3 million. In both the fiscal 2002 and 2001 periods, these amounts were offset slightly by proceeds from the exercise of common stock options.

The Company's Board of Directors has authorized the repurchase of up to 3,000,000 shares of its common stock. A purchase of the full 3,000,000 shares would equal approximately 23.3 percent of the total shares issued. The repurchase of common stock is subject to market conditions and is accomplished through periodic purchases at prevailing prices on the open market, by block purchases or in privately negotiated transactions. The repurchased shares are retained as treasury stock to be used for corporate purposes. Through March 30, 2002, the Company had repurchased 1,706,500 shares for a total cost of approximately $22.1 million.

The Company has a revolving credit facility to provide for working capital requirements and other corporate purposes. The credit facility provides for borrowings equal to the lesser of $20.0 million or 50 percent of eligible inventory and bears interest at a floating rate equal to the lender's prime interest rate minus 0.25 percent (4.5 percent at March 30, 2002) or 2.35 percent above the lender's thirty day LIBOR. If at any time, the Company's ratio of liabilities to net worth is more than 1.5, the floating rate will increase by 0.25 percent. The credit facility also includes an unused credit fee equal to one-eighth of one percent, payable quarterly. As of March 30, 2002, the Company's outstanding borrowings on the credit facility, including bank overdrafts, were approximately $13.6 million. The credit facility is secured by substantially all of the Company's assets and contains financial covenants customary for this type of financing. As of March 30, 2002, the Company was in compliance with these covenants. The credit facility expires April 30, 2003.

The Company believes that its cash on hand, together with cash generated from operations and the cash available through the credit facility, will be sufficient to support current operations through the next year. The Company may be required to seek additional sources of funds for accelerated growth or continued growth beyond that point, and there can be no assurance that such funds will be available on satisfactory terms. Failure to obtain such financing could delay or prevent the Company's planned growth, which could adversely affect the Company's business, financial condition and results of operations.

See "Overview" for a discussion regarding the multi-district litigation's potential impact on the Company's results of operations.

As a result of state regulatory requirements, the Company's liquidity, capital resources and results of operations may be negatively impacted in the future if the Company incurs increased costs or fines, is prohibited from selling its products in a particular state(s) or experiences losses of a substantial portion of the Company's customers for whom the Company is unable to obtain or verify a prescription due to the enforcement of requirements by state regulatory agencies.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

The Company has entered into additional commitments to purchase

approximately $5.7 million of inventory through December 2002, bringing the total commitments to purchase inventory to approximately $18.1 million for 2002. The Company has also entered into additional noncancelable commitments with various advertising companies that will require the Company to pay approximately $2.5 million for advertising through December 2002, bringing the total commitments for advertising to approximately $8.8 million for 2002. See the Company's Annual Report to Shareholders on Form 10-K for a summary of the Company's other contractual obligations and commitments.

RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations," and No. 142, "Goodwill and Other Intangible Assets," effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives. The Company adopted these new rules on accounting for goodwill and other intangible assets effective in the first quarter of fiscal 2002. There was no impact on the financial statements of the Company.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which replaces SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets to Be Disposed Of." The accounting model for long-lived assets to be disposed of by sale applies to all long-lived assets, including discontinued operations, and replaces the provisions of Accounting Principles Board Opinion No. 30, "Reporting Results of Operations--Reporting the Effects of Disposal of a Segment of a Business," for the disposal of segments of a business. This statement requires that those long-lived assets be measured at the lower of the carrying amount or fair value less costs to sell, whether reported in continuing operations or in discontinued operations. As a result, discontinued operations will no longer be measured at net realizable value or include amounts for operating losses that have not yet occurred. This statement also broadens the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. This statement is effective for fiscal years beginning after December 15, 2001. The Company adopted this statement effective in the first quarter of fiscal 2002. There was no impact on the financial statements of the Company.

CRITICAL ACCOUNTING POLICIES

See the Company's Annual Report to Shareholders on Form 10-K for a summary of the Company's critical accounting policies.

FORWARD-LOOKING STATEMENTS

Except for the historical information contained herein, the matters discussed in this Form 10-Q are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. These forward-looking statements involve risks and uncertainties and often depend on assumptions, data or methods that may be incorrect or imprecise. The Company's future operating results may differ materially from the results discussed in, or implied by, forward-looking statements made by the Company. Factors that may cause such differences include, but are not limited to, those discussed below and the other risks detailed in the Company's other reports filed with the Securities and Exchange Commission. The words such as "believes," "anticipates," "expects," "future," "intends," "would," "may" and similar expressions are intended to identify forward-looking statements. The Company undertakes no obligation to revise any of these

forward-looking statements to reflect events or circumstances after the date hereof.

FACTORS THAT MAY AFFECT FUTURE RESULTS

- The Company's sales growth will not continue at historical rates and it may encounter unforeseen difficulties in managing its future growth;
- A significant portion of the Company's sales may not comply with applicable state laws and regulations governing the delivery and sale of contact lenses;
- Because the Company doesn't manufacture contact lenses, it cannot ensure that the contact lenses it sells meet all federal regulatory requirements;
- It is possible that the FDA will consider certain of the contact lenses the Company sells to be misbranded;
- The Company currently purchases a substantial portion of its products from unauthorized distributors and is not an authorized distributor for some of the products that it sells;
- The Company obtains a large percentage of its inventory from a limited number of suppliers, with a single distributor accounting for 38%, 35% and 46% of the Company's inventory purchases in fiscal 1999, 2000 and 2001, respectively;
- Historically, Johnson & Johnson's Vistakon products have accounted for about 40% of the Company's net sales; if supply of Vistakon products remains limited and wholesale prices remain at current levels, the Company's future net sales and gross profit will be negatively impacted;
- The Company may continue to incur significant legal and professional fees related to its legal matters and its increased efforts to proactively influence the industry on behalf of itself and consumers;
- The Company's quarterly results are likely to vary based upon the level of sales and marketing activity in any particular quarter;
- The Company is dependent on its telephone, Internet and management information systems for the sale and distribution of contact lenses;
- The retail sale of contact lenses is highly competitive; certain of the Company's competitors are large, national optical chains that have greater resources than the Company has;
- The demand for contact lenses could be substantially reduced if alternative technologies to permanently correct vision gain in popularity;
- The Company does not have any property rights in the 1-800 CONTACTS telephone number or the Internet addresses that it uses;
- Increases in the cost of shipping, postage or credit card processing could harm the Company's business;
- The Company's business could be harmed if it is required to collect state sales tax on the sale of products;

- The Company faces an inherent risk of exposure to product liability claims in the event that the use of the products it sells results in personal injury;

- The Company conducts its operations through a single distribution facility;

- The Company's success is dependent, in part, on continued use of the Internet;

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- Government regulation and legal uncertainties relating to the Internet and online commerce could negatively impact the Company's business operations; and

- Changing technology could adversely affect the operation of the Company's website.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to changes in interest rates primarily related to its revolving credit facility. As of March 30, 2002, the Company's outstanding borrowings on the credit facility, including bank overdrafts, were approximately $13.6 million. The credit facility currently bears interest at a variable rate. The Company is exposed to limited foreign currency risk due to cash held by its foreign subsidiary. As of March 30, 2002, the Company's total cash in foreign currencies was approximately $10,000. In addition, all of the Company's revenue transactions are in U.S. dollars.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See notes to condensed consolidated financial statements.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

From time to time the Company receives notices, inquiries or other correspondence from states or its regulatory bodies charged with overseeing the sale of contact lenses. The Company's practice is to review such notices with legal counsel to determine the appropriate response on a case-by-case basis. It is the opinion of management, after discussion with legal counsel, that the Company is taking the appropriate steps to address the various notices received.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(A) Exhibits

Exhibit No.	Description of Exhibit
10.1	Employment agreement between the Company and Jonathan C. Coon.
10.2	Employment agreement between the Company and John F. Nichols.
10.3	Employment agreement between the Company and Scott S. Tanner.
10.4	Employment agreement between the Company and Robert G. Hunter.

(B) Reports on From 8-K

No reports on Form 8-K were filed by the Registrant during the quarter ended March 30, 2002.

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SIGNATURES

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

1-800 CONTACTS, INC.

Dated: May 14, 2002

By: /s/ Jonathan C. Coon

Name: Jonathan C. Coon
Title: President and Chief Executive Officer

By: /s/ Scott S. Tanner

Name: Scott S. Tanner
Title: Chief Operating Officer and Chief Financial Officer

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