1 800 CONTACTS INC
Form 10-Q
May 13, 2003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended March 29, 2003

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

For the transition period from to .
Commission file number: 0-23633

1-800 CONTACTS, INC.

(Exact name of registrant as specified in its charter)

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

(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.

ý Yes o No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange act).

o Yes ý No

As of May 6, 2003, the Registrant had 13,069,112 shares of Common Stock, par value $0.01 per share, outstanding.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

1-800 CONTACTS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)
(unaudited)

	December 28, 2002	March 29, 2003
ASSETS		
CURRENT ASSETS:		
Cash	$ 259	$ 554
Accounts receivable	655	904
Inventories, net	37,785	34,895
Prepaid income taxes	769	644
Deferred income taxes	756	773
Other current assets	1,095	1,700

		December 28, 2002		March 29, 2003
Total current assets		41,319		39,470
PROPERTY AND EQUIPMENT, net		12,862		13,204
DEFERRED INCOME TAXES		365		520
GOODWILL				22,196
DEFINITE-LIVED INTANGIBLE ASSETS, net		7,089		11,435
OTHER ASSETS		369		963
Total assets	$	62,004	$	87,788
LIABILITIES AND STOCKHOLDERS' EQUITY				
CURRENT LIABILITIES:				
Line of credit	$	5,770	$	8,534
Current portion of long-term debt		2,853		2,829
Current portion of capital lease obligations		372		329
Accounts payable		8,597		9,127
Accrued liabilities		3,327		6,728
Unearned revenue		403		431
Total current liabilities		21,322		27,978
LONG-TERM LIABILITIES:				
Long-term debt, less current portion		17,365		16,464
Capital lease obligations, less current portion		250		172
Liability related to contingent consideration		5,470		5,357
Total long-term liabilities		23,085		21,993
STOCKHOLDERS' EQUITY:				
Common stock, 12,861 and 13,050 issued, respectively		129		131
Additional paid-in capital		24,013		32,754
Retained earnings		14,272		13,784
Treasury stock, at cost, 1,473 and 700 shares, respectively		(20,739)		(8,914)
Accumulated other comprehensive income (loss)		(78)		62
Total stockholders' equity		17,597		37,817
Total liabilities and stockholders' equity	$	62,004	$	87,788

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Quarter Ended	
	March 30, 2002	March 29, 2003
NET SALES	$ 41,581	$ 46,662
COST OF GOODS SOLD	28,894	30,560
Gross profit	12,687	16,102
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES:		
Advertising expense	2,719	3,794
Legal and professional fees	1,260	1,621
Research and development expenses		1,803
Other selling, general and administrative expenses	5,391	8,649
Total selling, general and administrative expenses	9,370	15,867
INCOME FROM OPERATIONS	3,317	235
OTHER EXPENSE, net	(130)	(500)
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES	3,187	(265)
PROVISION FOR INCOME TAXES	(1,247)	(223)
NET INCOME (LOSS)	$ 1,940	$ (488)
PER SHARE INFORMATION:		
Basic net income (loss) per common share	$ 0.17	$ (0.04)
Diluted net income (loss) per common share	$ 0.17	$ (0.04)

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Quarter Ended	
	March 30, 2002	March 29, 2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 1,940	$ (488)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	422	1,407
Amortization of debt issuance costs and discounts		40
Unrealized foreign currency exchange loss		137

	Quarter Ended	
Loss on sale of property and equipment		6
Deferred income taxes	(89)	(172)
Changes in operating assets and liabilities, net of effects of acquisition:		
Inventories	(1,826)	5,605
Other current assets	(264)	(760)
Accounts receivable		(88)
Accounts payable	711	(3,038)
Accrued liabilities	(526)	2,884
Income taxes payable / prepaid income taxes	1,236	395
Unearned revenue	9	28
Net cash provided by operating activities	1,613	5,956
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(481)	(732)
Proceeds from sale of property and equipment	10	33
Purchase of intangible assets	(12)	(23)
Cash paid for acquisition		(6,904)
Deposits and other	(15)	(379)
Net cash used in investing activities	(498)	(8,005)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Common stock repurchases	(2,213)	
Proceeds from exercise of common stock options	34	439
Net borrowings on line of credit	1,102	2,765
Principal payments on capital lease obligations		(109)
Principal payments on long-term debt		(745)
Net cash (used in) provided by financing activities	(1,077)	2,350
EFFECT OF FOREIGN EXCHANGE RATES ON CASH	1	(6)
NET INCREASE IN CASH	39	295
CASH AT BEGINNING OF PERIOD	36	259
CASH AT END OF PERIOD	$ 75	$ 554
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for interest	$ 113	$ 208
Cash paid for income taxes	100	

SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:

During the first quarter of 2003, the Company purchased certain assets and assumed certain liabilities of Lens Express and Lens 1st. The purchase consideration included cash of $6,904, common stock with a fair value of $19,859 and assumed operating liabilities of $4,099 (see Note 6).

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC. AND SUBSIDIARIES
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 of America 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 on Form 10-K for the year ended December 28, 2002.

The results of operations for the 2003 interim period are not necessarily indicative results that may be expected for the full fiscal 2003 year.

NOTE 2. INVENTORIES

Inventories are recorded at the lower of cost (using the first-in, first-out method) or market. Inventories as of December 28, 2002 and March 29, 2003 consisted of the following (in thousands):

	December 28, 2002	March 29, 2003
Purchased contact lenses	$ 36,571	$ 33,690
Manufactured inventories:		
Raw materials	109	90
Work in process	210	359
Finished goods contact lenses	895	756
Total	$ 37,785	$ 34,895

NOTE 3. NET INCOME (LOSS) PER COMMON SHARE

Basic net income (loss) per common share ("Basic EPS") excludes dilution and is computed by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) 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 (loss) per common share. For the quarter ended March 30, 2002, options to purchase 459,157 shares of common stock 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. For the quarter ended March 29, 2003, options to purchase 1,207,482 shares were not included in the computation of Diluted EPS because their effect would be anti-dilutive, thereby decreasing the loss per common share. For the quarter ended March 29, 2003, Basic and Diluted EPS do not include the impact of 700,000 shares of restricted stock held in escrow since the necessary conditions for the release of those shares have not been satisfied (see Note 6).

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 30, 2002	Quarter Ended March 29, 2003

	Net Income	Shares	Per-Share Amount	Loss Net	Shares	Per-Share Amount
Basic EPS	$ 1,940	11,521	$ 0.17	$ (488)	11,985	$ (0.04)
Effect of stock options		101				
Diluted EPS	$ 1,940	11,622	$ 0.17	$ (488)	11,985	$ (0.04)

NOTE 4. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) for the quarters ended March 30, 2002 and March 29, 2003 consists of the following components (in thousands):

	Quarter Ended	
	March 30, 2002	March 29, 2003
Net income (loss)	$ 1,940	$ (488)
Foreign currency translation gain		140
Comprehensive income (loss)	$ 1,940	$ (348)

The foreign currency translation gain results primarily from changes in exchange rates relative to the U.S. dollar from the translation of the Company's Singapore subsidiary financial statements.

NOTE 5. STOCK-BASED COMPENSATION

The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations and uses the intrinsic method of accounting for its stock option grants to employees and directors. Accordingly, no compensation expense has been recognized for these stock option grants. Under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," compensation cost is recognized for the fair market value of each option as estimated on the date of grant using the Black-Scholes option-pricing model.

SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure," amends SFAS No. 123, to provide alternative methods of transition for a voluntary change to the fair market value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require new prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has elected to adopt the "disclosure only" provisions of SFAS No. 148.

If compensation expense for all stock options had been determined consistent with SFAS No. 123, the Company's net income (loss) and basic and diluted net income (loss) per common share would have been as follows (in thousands, except per share amounts):

	Quarter Ended	
	March 30, 2002	March 29, 2003
Net income (loss):		
As reported	$ 1,940	$ (488)
Fair-value based compensation, net of tax	(197)	(278)

	Quarter Ended	
Pro forma	$ 1,743	$ (766)
Basic net income (loss) per common share:		
As reported	$ 0.17	$ (0.04)
Pro forma	$ 0.15	$ (0.06)
Diluted net income (loss) per common share:		
As reported	$ 0.17	$ (0.04)
Pro forma	$ 0.15	$ (0.06)

The weighted average per share fair value of options granted during the quarters ended March 30, 2002 and March 29, 2003 was $7.47 and $11.98, respectively. The fair value of each option grant has been estimated on the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Quarter Ended	
	March 30, 2002	March 29, 2003
Risk-free interest rate	4.0%	2.9%
Expected dividend yield	0.0%	0.0%
Volatility	75%	78%
Expected life	5 years	5 years

NOTE 6. RECENT ACQUISITIONS

IGEL (ClearLab)

On July 24, 2002, the Company completed the acquisition of certain net assets and the majority of the business operations of IGEL, a developer and contract manufacturer of contact lenses based in Singapore. The acquisition was effected through a wholly owned subsidiary of the Company, IGEL Acquisition Co. Pte Ltd (subsequently renamed ClearLab Pte Ltd), and included the purchase of assets of Igel C.M. Laboratory Pte Ltd and International Vision Laboratories Pte Ltd, both subsidiaries of Igel Visioncare Pte Ltd, as well as certain other assets from Sinduchajana Sulistyo and Stephen D. Newman. The assets acquired included principally the long-term leasehold interests in the land and building where the manufacturing facility is located, as well as equipment, inventories, and certain intellectual property rights, including patents key to the operation of the acquired business. ClearLab is in the process of designing and developing a new brand of contact lens that will provide the Company increased control of production and inventory and the flexibility to make a variety of offers to its customers to enhance its capability to provide high quality, cost-effective products. The Company accounted for this transaction under the purchase method in accordance with SFAS No. 141. The

results of operations of ClearLab are included in the consolidated results of the Company from the date of the acquisition.

The consideration paid by the Company consisted of approximately $6.6 million in cash (which includes $1.2 million in transaction costs), $8.9 million in assumed building and business loans to be paid over the next 7 years, $0.7 million in assumed capital lease obligations, a non-interest bearing note payable of $2.1 million to be paid over the next 5 years, 700,000 shares of restricted common stock of the Company, and 270,000 common stock options of the Company in three tranches of 90,000 each with exercise prices of $15, $25 and $35 per share, respectively. The 700,000 shares of restricted common stock are held in escrow, subject to a performance guarantee, and vest over a two-year schedule with no shares released from escrow for a minimum of one year. The Company obtained a $10 million, five-year term loan from a U.S. bank to provide partial financing for this asset purchase. The parent company also executed guarantees for the building and business loans assumed in the transaction.

Lens Express and Lens 1st

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

The consideration paid by the Company consisted of approximately $6.9 million in cash (including $0.4 million in transaction costs), 900,000 shares of restricted common stock of the Company with a fair value of $19.9 million and the assumption of approximately $4.1 million of the aforementioned liabilities. The 900,000 shares of restricted common stock are subject to a lock-up period of 12 months after the acquisition date of January 30, 2003, established under the terms of a lock-up agreement. In connection with the acquisition, the Company entered into a registration rights agreement pursuant to which the Company granted the Seller certain piggyback registration rights with respect to the 900,000 shares of restricted common stock. The following sets forth the consideration paid by the Company (in thousands, except per share amounts):

Cash	$	6,500
Restricted shares (900 shares at $22.07 per share)		19,859
Acquisition expenses		404
Accounts payable		3,575
Accrued expenses		524
Total purchase consideration	$	30,862

For purposes of computing the purchase price, the value of the restricted common stock was determined by taking the average closing price of the Company's common stock as quoted on NASDAQ for the two days before, the day of and the two days following the announcement of the

signing of a letter of intent to acquire Lens Express and Lens 1st. This average price was then reduced by a 15 percent discount due to the restriction provisions associated with the common shares issued.

The following table sets forth the allocation of the purchase price to the tangible and intangible assets acquired (in thousands):

Accounts receivable	$	178
Inventories		2,740
Other assets		76
Property and equipment		572
Customer list		5,100
Goodwill		22,196
Total	$	30,862

The unaudited pro forma information below sets forth summary results of operations as if the acquisitions of ClearLab and Lens Express and Lens 1st had taken place at the beginning of 2002, after giving effect to certain adjustments, including amortization of intangibles, depreciation, interest expense and other adjustments directly attributable to the transaction. The following pro forma information has been prepared for comparative purposes only and does not purport to be indicative of what would have occurred had the acquisitions occurred at the beginning of fiscal 2002 or of results which may occur in the future (in thousands, except per share amounts):

	Quarter Ended	
	March 30, 2002	March 29, 2003

	Quarter Ended	
Net sales	$ 54,314	$ 50,072
Net loss	(321)	(374)
Net loss per common share:		
Basic	$ (0.03)	$ (0.03)
Diluted	$ (0.03)	$ (0.03)

NOTE 7. COMMON STOCK TRANSACTIONS

During the quarter ended March 29, 2003, employees exercised stock options to purchase 62,048 shares of common stock for a total of approximately $439,000. The Company recorded an increase in additional paid-in capital of approximately $270,000 for the income tax benefit related to these stock option exercises.

During the quarter ended March 29, 2003, the Company granted nonqualified stock options to purchase 112,953 shares of common stock to employees and directors of the Company. The exercise prices of the options range from $18.30 to $27.50 per share, which were not less than the quoted fair market values at the grant date. The options vest equally over a four-year period and expire in five to seven years.

The Company's Board of Directors has authorized the repurchase of up to 3,000,000 shares of the Company's common stock. A purchase of the full 3,000,000 shares would equal approximately 23 percent of the total shares issued as of March 29, 2003. 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. From inception of its authorized repurchase

programs through March 29, 2003, the Company had repurchased 1,706,500 shares for a total cost of approximately $22.1 million.

During the quarter ended March 29, 2003, the Company issued 900,000 shares of restricted common stock as a portion of the consideration for the acquisition of Lens Express and Lens 1st (see Note 6). Of the 900,000 shares, 772,655 were issued from treasury stock. The 900,000 shares of restricted common stock are subject to a lock-up period of 12 months after the acquisition date of January 30, 2003. In connection with the acquisition, the Company entered into a registration rights agreement pursuant to which the Company granted the Seller certain piggyback registration rights with respect to the 900,000 shares of restricted common stock.

NOTE 8. DEBT OBLIGATIONS

Effective July 22, 2002, the Company entered into a new loan agreement, providing for both a $10 million term loan and a revolving credit facility for borrowings up to $20 million. The amounts outstanding on both the term loan and the revolving credit facility are limited to a percentage of eligible inventory. As of the effective date, the percentage was 75% and is reduced by 1.25% each calendar quarter beginning September 30, 2002 until the percentage is 50%. The percentage as of March 29, 2003 was 72.50%. The outstanding borrowings are secured by substantially all of the Company's U.S. assets including a portion of the Company's common stock ownership in ClearLab. The agreement contains various financial covenants including a capital expenditure limit, a minimum working capital requirement, a leverage ratio and a minimum net income requirement. Also, if the Company were unable to cure a default on its Singapore debt within 30 days of occurrence, the Company would be in default on this debt. As of December 28, 2002, the Company was not in compliance with the minimum net income covenant or the leverage ratio covenant. However, the Company obtained waivers through April 30, 2004. These waivers also established certain new financial covenants. The Company was in compliance with these modified covenants and all other applicable covenants as of March 29, 2003.

Outstanding borrowings on the revolving credit facility bear interest at a floating rate equal to the lender's prime interest rate plus 0.25 percent (4.50 percent at March 29, 3003) or 2.75 percent above the lender's LIBOR for the applicable period. As of March 29, 2003, the interest rate on the outstanding borrowings was based on the lender's prime interest rate plus 0.25 percent. Interest is payable monthly. The credit facility also includes an unused credit fee equal to one-eighth of one percent, payable quarterly. As of March 29, 2003, the remaining availability on the credit facility was $6.9 million. The credit facility was scheduled to expire on April 30, 2003, however, the Company obtained an extension of the maturity date to July 30, 2003. The Company is in the process of renewing the credit facility. The Company expects that the credit facility will be renewed prior to the expiration of the extension; however, there can be no assurance that the facility will be renewed with similar terms.

As of March 29, 2003, the U.S. bank term loan interest rate was fixed at the 180-day LIBOR rate plus 3% (4.34% at March 29, 2003) until April 3, 2003 at which time the rate was fixed at 4.29% through June 3, 2003.

The Company's Singapore bank term loan contains various financial covenants including minimums on net worth and shareholders' funds. As of December 28, 2002, the Company was not in compliance with the net worth and shareholders' funds covenants. However, the Company obtained waivers through April 30, 2004.

Cross default clauses exist such that if the Company were in default on its U.S. debt, the Company would also be in default on its Singapore debt. If the Company were in default on its Singapore bank term loan, the Company would also be in default on its note payable to the parent of IGEL.

NOTE 9. 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. The Company filed an answer to the amended complaint and, at the request of the Court, filed a motion for summary judgment. In November 2000, the Court issued an order denying the summary judgment motion, finding that there were factual issues regarding whether the KBEO can meet the requirements necessary to obtain injunctive relief, and whether the Kansas law violates the Commerce Clause of the United States Constitution. On June 18, 2002, the court granted a summary judgment motion in favor of the KBEO. However, the court made no findings of any violations of Kansas law. Further, the court based its decision on a Kansas optometry law that has been repealed and amended by the Kansas legislature. To preserve the issues for appeal, the Company filed a motion to alter or amend judgment, asking the court to reverse its decision, and to enter summary judgment in favor of defendant, or to dismiss the KBEO's lawsuit as moot based on the new law. The court denied the motion on September 12, 2002, finding that no new evidence had been presented to persuade the court to change its prior ruling. The court made no new findings of fact and did not change its conclusions of law. On October 11, 2002, the Company filed its Notice of Appeal, and its Docketing Statement was filed on October 30, 2002. On February 7, 2003 the Company filed its opening appellate brief. KBEO has requested, and the appellate court has granted, two requests for additional time to file its response brief. KBEO's response is now due on May 11, 2003 and the Company's reply will be due on June 11, 2003. After the briefs have all been submitted, the court will either issue its ruling or schedule an oral argument.

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

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

NOTE 10. RECENTLY ISSUED ACCOUNTING STANDARDS

In July 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." Under SFAS No. 146, a company will record a liability for a cost associated with an exit or disposal activity when that liability is incurred and can be measured at fair value. A liability is incurred when an event obligates a company to transfer or use assets (i.e., when an event leaves the company little or no discretion to avoid transferring or using the assets in the future). Under previous accounting rules, if a company's management approved an exit plan, the company generally could record the costs of that plan as a liability on the approval

date, even if the company did not incur the costs until a later date. Under SFAS No. 146, some of those costs might qualify for immediate recognition, others might be spread over one or more quarters, and still others might not be recorded until incurred in a much later period. SFAS No. 146 became effective for periods after December 31, 2002 prospectively. The Company adopted this statement during the first quarter of

2003. There was no impact on the financial statements of the Company.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure an amendment to FASB Statement No. 123, Accounting for Stock-Based Compensation." SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock- based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. The Company has elected to continue using the intrinsic method of accounting for employee stock-based compensation and has adopted the interim disclosure provisions.

In November 2002, the FASB issued Interpretation No. 45 ("FIN No. 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," which expands previously issued accounting guidance and disclosure requirements for certain guarantees. FIN No. 45 requires recognition of an initial liability for the fair value of an obligation assumed by issuing a guarantee. Guarantees are required to be disclosed in the notes to the financial statements for periods ending after December 15, 2002. For certain guarantees issued after December 31, 2002, the fair value of the obligation must be reported on the balance sheet. The adoption of this interpretation had no impact on the financial statements of the Company.

In January 2003, the FASB issued Interpretation No. 46 ("FIN No. 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51," which addresses the consolidation by business enterprises of variable interest entities as defined therein and applies immediately to variable interests in variable interest entities created or obtained after January 31, 2003. The adoption of this interpretation had no impact on the Company's financial statements.

NOTE 11. COMMITMENTS AND CONTINGENCIES

Letter of Intent. On March 13, 2003, the Company signed a letter of intent with a developer and manufacturer of contact lenses, and certain of its shareholders. The Company agreed to pay the developer and manufacturer of contact lenses a non-refundable sum equal to $1.5 million to be used by the entity for research and development activities relating to contact lenses. Of the total, $700,000 was paid on March 14, 2003 and the remaining $800,000 is due three months after the execution date of the letter of intent. Due to the fact that the Company is contractually committed to these payments and the contact lens developer has no substantive operations, the entire amount of these payments has been expensed as research and development. In the event that the contact lens technologies are successfully commercialized, the Company will have the right to acquire contact lens products based on the developed technologies on terms no less favorable than those granted or available to any other customer, licensee or other third party. In addition, the Company was granted a six-month option to either: (1) acquire all of the shares of common stock of the entity; or, (2) acquire from the entity a worldwide license to manufacture, market, sell or otherwise use or exploit specific technology developed by the entity. As consideration for this option, the Company paid $100,000 to the entity on March 14, 2003, which was also expensed as research and development. In the event that the Company does not exercise the option to purchase the shares of the entity, the Company agreed to pay the entity an additional $800,000 at the end of the option period. The Company has also agreed to reimburse the entity and its shareholders in an amount not to exceed $161,000 for any legal and financial expenses

reasonably incurred by the entity in connection with the transactions contemplated by the letter of intent.

In connection with the agreement, and the transactions discussed above, the Company expensed a total of approximately $1.8 million during the first quarter of fiscal 2003 (inclusive of the $161,000 in costs) related to these research and development initiatives. The Company funded these payments from its revolving credit facility.

Advertising Commitments

As of March 29, 2003, the Company had entered into certain noncancelable commitments with various advertising companies that will require the Company to pay approximately $6.0 million for advertising during the remainder of 2003.

NOTE 12. SEGMENT INFORMATION

As a result of the acquisition of IGEL (ClearLab) in the third quarter of fiscal 2002, the Company has two operating segments. These operating segments represent components of the Company for which separate financial information is available and evaluated regularly by management in determining resource allocation and performance assessment. The Company's U.S. segment includes the operations of 1-800 CONTACTS and the operations from the Lens Express and Lens 1st acquisitions. The Company's Singapore segment includes the operations of ClearLab, a developer and contract manufacturer of contact lenses. Operating segment information for the first quarter ended March 29, 2003 is as follows (in thousands):

<

		FHR 3170 EC 5.00% maturity date 6/15/32
		** 1,097,073
		GMACC 2004-C3 A3 4.207% maturity date 12/10/41
		** 1,455,960
		GSK 4.85% maturity date 5/15/13
		** 1,520,964
		GCCFC 2004-GG1 A3 4.344% maturity date 6/10/36
		** 303,256
		Hewlett-Pack Co. 4.5% maturity date 3/01/13
		** 1,461,909
		MER 4.75% maturity date 11/20/09
		** 1,485,744
		MET 4.25% maturity date 7/30/09
		** 986,305
		MG Fund 3.9% maturity date 6/15/09
		** 992,273
		MSC 2004-IQ8 A2 3.960% maturity date 6/15/40
		** 200,813
		Oracle Corp. 4.95% maturity date 4/15/13
		** 1,517,363
U.S.	**Singapore**	TIAAGL 144A 5.125% maturity date 10/10/12
		** 1,456,949

THE PINNACLE WEST CAPITAL CORPORATION SAVINGS PLAN
FORM 5500, SCHEDULE H: PART IV, LINE 4i
SCHEDULE OF ASSETS (HELD AT END OF YEAR)
DECEMBER 31, 2008

Identity of Issuer, Borrower, Lessor or Similar Party	Description	Cost	Current Value
WBCMT 2006-C29 A2 5.275% maturity date 11/15/48		**	1,207,761
AIG Financial Products Wrap maturity date 1/16/24, yield 5.156%		**	226,615
BACM 2005-1 A3 4.877% maturity date 11/10/42		**	1,651,918
BACM 2005-2 AAB 4.742% maturity date 7/10/43		**	1,150,113
BAC 7.40% maturity date 1/15/11		**	2,119,618
CWL 2005-10 AF3 4.638% maturity date 9/25/35		**	1,152,037
CCCIT 2004-A8 4.90% maturity date 12/12/16		**	1,249,688
FGG11751 5.00% maturity date 8/01/20		**	915,177
FGG12976 5.50% maturity date 3/01/21		**	1,488,258
FGG11810 5.50% maturity date 12/1/20		**	878,959
FHLB 3.625% maturity date 10/18/13		**	1,574,934
FN255891 5.00% maturity date 10/1/20		**	708,339
FNR 2003-75 NB 3.25% maturity date 8/25/18		**	582,286
FNR 2003-109 CX 4.00% maturity date 7/25/16		**	841,478
FHR 2808 YA 4.50% maturity date 2/15/17		**	905,860
FHR 3178 A 6.00% maturity date 12/15/28		**	1,424,769
FHR 3262 ME 5.50% maturity date 1/15/27		**	893,819
FNMA 961978 4.50% maturity date 3/01/23		**	1,420,602
HSBC 5.25% maturity date 1/14/11		**	1,493,647
RFMS2 2006-HI2 A3 5.790% maturity date 2/25/36		**	403,726
HON 4.25% maturity date 03/01/13		**	1,493,295
JNJ 5.15% maturity date 8/15/12		**	1,609,009
LLY 5.20% maturity date 3/15/17		**	2,029,474
UBS A.G. Wrap maturity date 11/15/19, yield 4.18%			71,186
CD 2007-CD4 A3 5.293% maturity date 12/11/49		**	1,241,025
CAT 4.35% maturity date 3/04/09		**	1,500,270
FGG11678 4.50% maturity date 4/01/20		**	600,644
FN254437 FNMA 7-yr 5.00% maturity date 8/01/09		**	199,556
FN677680 4.50% maturity date 2/01/18		**	306,803
FHR 2611 KC 3.50% maturity date 1/15/17		**	521,202
FNR 2005-121 AJ 4.50% maturity date 7/25/32		**	1,425,520
FHR 3048 QA 5.00% maturity date 3/15/24		**	1,401,664
FNCI 4.50% Pool 683124 maturity date 2/01/18		**	765,550
FN695871 4.50% maturity date 4/01/18		**	431,045
FORDO 2007-B A4A 5.240% maturity date 7/15/12		**	406,328
MSC 2006-IQ11 A2 5.693% maturity date 10/15/42		**	1,693,063
MSDWC 2002-TOP7 A1 5.380% maturity date 1/15/39		**	185,919
PERF 2005-1 A4 4.370% maturity date 6/25/14		**	1,473,046
RFMS2 2004-HS1 AI4 3.770% maturity date 1/25/22		**	1,006,938
WBCMT 2005-C17 A2 4.782% maturity date 3/15/42		**	1,221,100
WBCMT 2004-C10 A2 3.857%maturity date 2/15/41		**	1,226,676

WFC 4.20% maturity date 1/15/10	**	602,304
WFC 5.25% maturity date 10/23/12	**	911,205

THE PINNACLE WEST CAPITAL CORPORATION SAVINGS PLAN
FORM 5500, SCHEDULE H: PART IV, LINE 4i
SCHEDULE OF ASSETS (HELD AT END OF YEAR)
DECEMBER 31, 2008

Identity of Issuer, Borrower, Lessor or Similar Party	Description	Cost	Current Value
Monumental Life Insurance Co. Wrap maturity date 1/15/20, Yield 4.937%			186,235
CWL 2005-12 1A4 5.323% maturity date 6/25/34		**	1,257,547
CARAT 2008-1 A4 4.460% maturity date 7/15/14		**	1,095,469
CHAIT 2005-A7 A7 4.550% maturity date 3/15/13		**	951,563
CHAIT 2007-A17 A 5.120% maturity date 10/15/14		**	914,375
C 5.125% maturity date 2/14/11		**	1,966,541
CRMSI 2006-1 A3 5.706% maturity date 7/25/36		**	1,228,359
C 2.875% FDIC maturity date 12/09/11		**	2,067,838
COP 5.50% maturity date 4/15/13		**	1,021,397
Dupont EI Nemour 5% maturity date 7/15/13		**	748,210
FGG18056 5.00% maturity date 6/01/20		**	612,338
FGB11935 4.50% maturity date 1/01/19		**	1,029,069
FNR 2003-67 GN 3.50% maturity date 1/25/25		**	247,066
FHR 2664 GA 4.50% maturity date 1/15/18		**	756,426
FHR 3095 GB 5.00% maturity date 4/15/24		**	718,952
FNMA 3.625% maturity date 2/12/13		**	2,115,601
GSMS 2006-GG6 A2 5.506% maturity date 4/10/38		**	1,729,150
JPM 5.375% maturity date 1/15/14		**	2,013,026
JPMCC 2001-CIB3 A2 6.044% maturity date 11/15/35		**	671,747
JPMC 2003-ML1A A2 4.767% maturity date 3/12/39		**	1,487,787
LBUBS 2004-C6 A3 4.547% maturity date 8/15/29		**	910,186
MLCFC 2006-1 A2 5.439% maturity date 2/12/39		**	1,027,786
MSC 2003-IQ5 A3 4.710% maturity date 4/15/38		**	411,503
RAMP 2004-RS6 AI4 5.457% maturity date 5/25/32		**	485,222
RASC 2004-KS2 AI6 4.30% maturity date 3/25/34		**	685,641
WBCMT 2006-C25 A2 5.684% maturity date 5/15/43		**	1,315,501
WOART 2008-A A4A 4.740% maturity date 10/15/13		**	979,125
JP Morgan Bank Wrap maturity date 2/16/21, yield 4.897%		**	162,898
SO 4.70% maturity date 12/1/10		**	1,522,423
AXP 4.875% maturity date 7/15/13		**	1,895,332
FGG11678 4.50% maturity date 4/01/20		**	900,966
FGG13156 5.00% maturity date 5/01/23		**	1,447,227
FGG11850 5.50% maturity date 7/01/20		**	580,895
FHR 2378 A 5.00% maturity date 5/15/15		**	25,482
FNMA Pool #254458 5% 8-1-1 5.00% maturity date 8/01/17		**	669,482
FNR 2003-125 AM 4.00% maturity date 2/25/17		**	399,171
FNR 2003-109 CJ 4.00% maturity date 7/25/16		**	281,118
FHR 2685 DQ 4.50% maturity date 11/15/22		**	1,027,262
FHR 2685 MX 4.00% maturity date 7/15/16		**	1,091,876
FHR 2713 G 4.00% maturity date 8/15/16		**	753,232
FHR 2901 CA 4.50% maturity date 11/15/19		**	859,691

FHR 3002 YD 4.50% maturity date 7/15/25	**	1,052,002
FHR 3152 LA 6.00% maturity date 11/15/25	**	1,366,078
FNR 2007-27 MQ 5.50% maturity date 4/25/27	**	1,719,425
FHR 3347 PB 5.00% maturity date 11/15/30	**	1,551,820
FNMA 3.875% maturity date 7/12/13	**	1,601,259
FN695896 4.50% maturity date 5/01/18	**	443,128
FN 889255 5.00% maturity date 3/01/23	**	1,368,971
GNR 2002-15 PG 5.50% maturity date 11/20/31	**	56,529
JPM 2.125% FDIC GTD TLGP maturity date 6/22/12	**	1,206,129
MI 5.35% maturity date 4/01/11	**	1,576,094

THE PINNACLE WEST CAPITAL CORPORATION SAVINGS PLAN
FORM 5500, SCHEDULE H: PART IV, LINE 4i
SCHEDULE OF ASSETS (HELD AT END OF YEAR)
DECEMBER 31, 2008

Identity of Issuer, Borrower, Lessor or Similar Party	Description	Cost	Current Value
MET 5.75% 144A 5.75% maturity date 7/25/11		**	965,595
MS 2.0% FDIC GTD TLGP maturity date 9/22/11		**	955,729
MSC 2004-HQ3 A2 4.050% maturity date 1/13/41		**	1,097,427
RAMP 2003-RS7 AI4 5.090% maturity date 2/25/31		**	211,363
RAMP 2004-RS10 AI4 4.570% maturity date 11/25/32		**	531,813
USAOT 2008-1 A4 4.500% maturity date 10/15/13		**	1,211,719
WOART 2008-B A4 5.580% maturity date 4/15/14		**	918,638
Rabobank Nederland N.V. Wrap maturity date 1/25/23, yield 4.695%		**	116,315
BK 4.95% MTN maturity date 11/1/12		**	1,532,435
BSCMS 2001-TOP4 A1 5.060% maturity date 11/15/16		**	219,974
BSCMS 2006-TOP24 A2 5.478% maturity date 10/12/41		**	1,224,091
FGB13150 4.00% maturity date 3/01/19		**	1,032,847
FN254486 5.00% maturity date 9/01/17		**	415,311
FNR 2003-14 AN 3.50% maturity date 3/25/33		**	498,687
FNR 2003-57 NB 3.00% maturity date 6/25/18		**	479,872
FNR 2005-85 AJ 4.50% maturity date 2/25/24		**	1,223,360
FHR 2950 AB 4.50% maturity date 2/15/24		**	621,839
FNR 2007-43 MA 5.50% maturity date 5/25/27		**	1,689,117
FN768658 4.50% maturity date 2/01/19		**	498,019
FN 900999 5.50% maturity date 9/01/21		**	1,137,638
FN 933488 5.0% maturity date 3/01/23		**	1,445,003
GE 4.875% maturity date 3/04/15		**	1,456,835
LBUBS 2005-C5 A-2 4.885% maturity date 9/15/30		**	870,000
LBUBS 2002-C7 A-3 4.659% maturity date 12/15/26		**	1,400,615
LBUBS 2003-C5 A3 4.254% maturity date 7/15/27		**	1,352,390
MBNAP 2005-2 A4 - 144A 4.470% maturity date 6/15/13		**	947,500
MSDWC 2003-TOP9 A1 3.980% maturity date 11/13/36		**	505,738
T 2.375% maturity date 8/31/10		**	1,030,566
T 3.125% maturity date 8/31/13		**	1,617,773
WB 5.35% maturity date 3/15/11		**	2,002,929
NATIXIS Wraps maturity date 4/15/25, yield 5.144%		**	69,213
BSCMS 2004-T14 A2 4.170% maturity date 1/12/41		**	564,402
BSCMS 2002-TOP6 A1 5.920% maturity date 10/15/36		**	793,409
CWL 2004-7 AF4 4.774% maturity date 8/25/32		**	431,642
CWL 2005-7 AF4 4.867%maturity date 6/25/35		**	764,688
CFAB 2004-2 1A4 5.323% maturity date 5/25/31		**	1,234,394
CHAIT 2008-A4 4.650% maturity date 3/15/15		**	1,329,609
FGE91523 4.50% maturity date 9/01/17		**	1,015,090
FGG12809 5.50% maturity date 9/01/22		**	1,173,277
FGG12996 5.00% maturity date 2/01/23		**	1,326,205

FNR 2003-112 AB 4.00% maturity date 6/25/16	**	517,422
FHR 2770 QA 4.00% maturity date 7/15/18	**	1,098,068
FHR 2849 AL 5.00% maturity date 5/15/18	**	633,693
FHR 3211 MH 5.00% maturity date 9/15/26	**	1,607,810
FN920197 5.50% maturity date 12/01/21	**	2,218,139
GMACC 2003-C3 A3 4.646% maturity date 4/10/40	**	908,553
IBM 5.05% maturity date 10/22/12	**	1,017,385

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THE PINNACLE WEST CAPITAL CORPORATION SAVINGS PLAN
FORM 5500, SCHEDULE H: PART IV, LINE 4i
SCHEDULE OF ASSETS (HELD AT END OF YEAR)
DECEMBER 31, 2008

Identity of Issuer, Borrower, Lessor or Similar Party	Description	Cost	Current Value
JPMCC 2005-CB11 A4 5.335% maturity date 8/12/37		**	461,053
RAMP 2004-RS8 5.060% AI4 maturity date 6/25/32		**	682,210
USB 5.3% maturity date 4/28/09		**	1,512,156
Total synthetic investment contracts			173,912,925
Guaranteed Investment Contracts	Fixed Income Fund		
New York Life Insurance Company maturity date 3/31/09, yield 3.46%		**	2,956,132
New York Life Insurance Company maturity date 10/31/13 yield 3.99%		**	8,482,706
Total guaranteed investment contracts			11,438,838
Other Investments			
*Pinnacle West Common Stock	Pinnacle West Stock Fund	**	97,995,919
****Participant Loans	Participant Loans	**	21,726,370
Self-Directed Brokerage Account	Self-Directed Brokerage Account	**	9,415,300
Total other investments			129,137,589
Total Assets Held for Investment Purposes			$ 682,978,386

* Related Party.

** Cost information not provided as investments are participant-directed.

*** Short-Term Investments represent $18,368,463 from the Fixed Income Fund and $1,788,827 from the Pinnacle West Stock Fund.

**** Interest rates for outstanding loans as of December 31, 2008 ranged from 5.0% to 10.5% with maturity dates ranging from 2009 to 2023.

Exhibits Filed

Exhibit No.	Description
23.1	Consent of Independent Registered Public Accounting Firm

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SIGNATURES

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

THE PINNACLE WEST CAPITAL
CORPORATION SAVINGS PLAN

Date: June 24, 2009

By: /s/ Lori Sundberg
Lori Sundberg
Chairman of the Administrative Committee
and Vice President, Human Resources
Arizona Public Service Company

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EXHIBIT INDEX

Exhibit No.	Description
23.1	Consent of Independent Registered Public Accounting Firm

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