

Energy Recovery, Inc.  
Form 10-Q  
November 10, 2014

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended September 30, 2014**

**OR**

**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: 001-34112**

**Energy Recovery, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation)

**01-0616867**

(IRS Employer Identification No.)

**1717 Doolittle Drive, San Leandro, CA**

(Address of Principal Executive Offices)

**94577**

(Zip Code)

**(510) 483-7370**

(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.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

|                         |                                                                         |
|-------------------------|-------------------------------------------------------------------------|
| Large accelerated filer | Accelerated filer                                                       |
| Non-accelerated filer   | (Do not check if a smaller reporting company) Smaller reporting company |

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2).

Yes No

As of November 4, 2014, there were 51,876,515 shares of the registrant's common stock outstanding.

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**ENERGY RECOVERY, INC.**

**QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2014**

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**PART I — FINANCIAL INFORMATION****Item 1. Financial Statements (unaudited)****ENERGY RECOVERY, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except share data and par value)****(unaudited)**

|                                                                                                                                            | <b>September<br/>30,<br/>2014</b> | <b>December<br/>31,<br/>2013</b> |
|--------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------|----------------------------------|
| <b>ASSETS</b>                                                                                                                              |                                   |                                  |
| <b>Current assets:</b>                                                                                                                     |                                   |                                  |
| Cash and cash equivalents                                                                                                                  | \$ 17,423                         | \$ 14,371                        |
| Restricted cash                                                                                                                            | 3,357                             | 4,311                            |
| Short-term investments                                                                                                                     | 13,751                            | 5,856                            |
| Accounts receivable, net of allowance for doubtful accounts of \$259 and \$241 at September 30, 2014 and December 31, 2013, respectively   | 3,997                             | 15,222                           |
| Unbilled receivables                                                                                                                       | 941                               | 5,442                            |
| Inventories                                                                                                                                | 10,227                            | 4,955                            |
| Deferred tax assets, net                                                                                                                   | 698                               | 698                              |
| Prepaid expenses and other current assets                                                                                                  | 2,107                             | 1,018                            |
| <b>Total current assets</b>                                                                                                                | <b>52,501</b>                     | <b>51,873</b>                    |
| Restricted cash, non-current                                                                                                               | 2,084                             | 4,468                            |
| Unbilled receivables, non-current                                                                                                          | —                                 | 1,197                            |
| Long-term investments                                                                                                                      | 1,381                             | 13,694                           |
| Property and equipment, net of accumulated depreciation of \$14,457 and \$12,082 at September 30, 2014 and December 31, 2013, respectively | 13,873                            | 13,903                           |
| Goodwill                                                                                                                                   | 12,790                            | 12,790                           |
| Other intangible assets, net                                                                                                               | 3,362                             | 4,008                            |
| Other assets, non-current                                                                                                                  | 2                                 | 2                                |
| <b>Total assets</b>                                                                                                                        | <b>\$ 85,993</b>                  | <b>\$ 101,935</b>                |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                |                                   |                                  |
| <b>Current liabilities:</b>                                                                                                                |                                   |                                  |
| Accounts payable                                                                                                                           | \$ 1,253                          | \$ 1,209                         |
| Accrued expenses and other current liabilities                                                                                             | 5,357                             | 7,963                            |
| Income taxes payable                                                                                                                       | 15                                | 22                               |

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|                                                                                                                                                                                                                                                             |                  |                   |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|-------------------|
| Accrued warranty reserve                                                                                                                                                                                                                                    | 689              | 709               |
| Deferred revenue                                                                                                                                                                                                                                            | 1,099            | 779               |
| <b>Total current liabilities</b>                                                                                                                                                                                                                            | <b>8,413</b>     | <b>10,682</b>     |
| Deferred tax liabilities, non-current, net                                                                                                                                                                                                                  | 2,300            | 2,131             |
| Deferred revenue, non-current                                                                                                                                                                                                                               | 13               | 130               |
| Other non-current liabilities                                                                                                                                                                                                                               | 898              | 2,077             |
| <b>Total liabilities</b>                                                                                                                                                                                                                                    | <b>11,624</b>    | <b>15,020</b>     |
| Commitments and Contingencies (Note 9)                                                                                                                                                                                                                      |                  |                   |
| <b>Stockholders' equity:</b>                                                                                                                                                                                                                                |                  |                   |
| Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding                                                                                                                                                           | —                | —                 |
| Common stock, \$0.001 par value; 200,000,000 shares authorized; 53,916,801 and 51,766,598 shares issued and outstanding at September 30, 2014, respectively; and 53,136,704 and 51,354,101 shares issued and outstanding at December 31, 2013, respectively | 54               | 53                |
| Additional paid-in capital                                                                                                                                                                                                                                  | 122,738          | 119,932           |
| Accumulated other comprehensive loss                                                                                                                                                                                                                        | (27 )            | (107 )            |
| Treasury stock, at cost, 2,150,203 and 1,782,603 shares repurchased at September 30, 2014 and December 31, 2013, respectively                                                                                                                               | (5,633 )         | (4,000 )          |
| Accumulated deficit                                                                                                                                                                                                                                         | (42,763 )        | (28,963 )         |
| <b>Total stockholders' equity</b>                                                                                                                                                                                                                           | <b>74,369</b>    | <b>86,915</b>     |
| <b>Total liabilities and stockholders' equity</b>                                                                                                                                                                                                           | <b>\$ 85,993</b> | <b>\$ 101,935</b> |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share data)****(unaudited)**

|                                                        | <b>Three Months Ended</b>     |             | <b>Nine Months Ended</b>      |             |
|--------------------------------------------------------|-------------------------------|-------------|-------------------------------|-------------|
|                                                        | <b>September 30,<br/>2014</b> | <b>2013</b> | <b>September 30,<br/>2014</b> | <b>2013</b> |
| Net revenue                                            | \$ 5,342                      | \$ 4,868    | \$ 15,646                     | \$ 19,810   |
| Cost of revenue                                        | 3,007                         | 1,966       | 7,991                         | 8,615       |
| Gross profit                                           | 2,335                         | 2,902       | 7,655                         | 11,195      |
| Operating expenses:                                    |                               |             |                               |             |
| General and administrative                             | 3,078                         | 3,625       | 8,112                         | 11,121      |
| Sales and marketing                                    | 2,351                         | 1,737       | 7,548                         | 5,607       |
| Research and development                               | 2,131                         | 1,027       | 5,089                         | 3,246       |
| Amortization of intangible assets                      | 216                           | 230         | 646                           | 691         |
| Restructuring charges                                  | —                             | 140         | —                             | 184         |
| Total operating expenses                               | 7,776                         | 6,759       | 21,395                        | 20,849      |
| Loss from operations                                   | (5,441 )                      | (3,857 )    | (13,740 )                     | (9,654 )    |
| Other non-operating income, net of expenses            | (2 )                          | 27          | 127                           | 79          |
| Loss before income taxes                               | (5,443 )                      | (3,830 )    | (13,613 )                     | (9,575 )    |
| Provision for income taxes                             | 63                            | 36          | 187                           | 258         |
| Net loss                                               | \$ (5,506 )                   | \$ (3,866 ) | \$ (13,800 )                  | \$ (9,833 ) |
| Basic and diluted net loss per share                   | \$ (0.11 )                    | \$ (0.08 )  | \$ (0.27 )                    | \$ (0.19 )  |
| Shares used in basic and diluted per share calculation | 51,861                        | 51,052      | 51,626                        | 51,020      |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**

(in thousands)

(unaudited)

|                                                | <b>Three Months<br/>Ended</b> |             | <b>Nine Months<br/>Ended</b>  |             |
|------------------------------------------------|-------------------------------|-------------|-------------------------------|-------------|
|                                                | <b>September 30,<br/>2014</b> | <b>2013</b> | <b>September 30,<br/>2014</b> | <b>2013</b> |
| Net loss                                       | \$ (5,506)                    | \$ (3,866)  | \$ (13,800)                   | \$ (9,833)  |
| Other comprehensive income (loss), net of tax: |                               |             |                               |             |
| Foreign currency translation adjustments       | 22                            | (10 )       | 68                            | (8 )        |
| Unrealized (loss) gain on investments          | (6 )                          | 15          | 12                            | (20 )       |
| Other comprehensive income (loss)              | 16                            | 5           | 80                            | (28 )       |
| Comprehensive loss                             | \$ (5,490)                    | \$ (3,861)  | \$ (13,720)                   | \$ (9,861)  |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

|                                                                             | <b>Nine Months<br/>Ended</b>  |                  |
|-----------------------------------------------------------------------------|-------------------------------|------------------|
|                                                                             | <b>September 30,<br/>2014</b> | <b>2013</b>      |
| <b>Cash Flows From Operating Activities</b>                                 |                               |                  |
| <b>Net loss</b>                                                             | <b>\$(13,800)</b>             | <b>\$(9,833)</b> |
| Adjustments to reconcile net loss to net cash used in operating activities: |                               |                  |
| Depreciation and amortization                                               | 3,025                         | 2,801            |
| Loss on disposal of fixed assets                                            | —                             | 19               |
| Non-cash restructuring charges                                              | —                             | 184              |
| Amortization of premiums/discounts on investments                           | 348                           | 279              |
| Share-based compensation                                                    | 1,628                         | 1,717            |
| (Gain) loss on foreign currency transactions                                | (10)                          | (5)              |
| Deferred income taxes                                                       | 169                           | 167              |
| Provision for doubtful accounts                                             | 293                           | 248              |
| Provision for warranty claims                                               | 87                            | 177              |
| Valuation adjustments for excess or obsolete inventory                      | 212                           | 81               |
| Other non-cash adjustments                                                  | (179)                         | (88)             |
| Changes in operating assets and liabilities:                                |                               |                  |
| Accounts receivable                                                         | 10,935                        | 6,869            |
| Unbilled receivables                                                        | 5,698                         | 4,848            |
| Inventories                                                                 | (5,484)                       | (3,906)          |
| Prepaid and other assets                                                    | (1,045)                       | 2,933            |
| Accounts payable                                                            | 64                            | (718)            |
| Accrued expenses and other liabilities                                      | (2,256)                       | (2,635)          |
| Change in fair value of contingent consideration (Note 4 & Note12)          | (1,524)                       | —                |
| Income taxes payable                                                        | (7)                           | (17)             |
| Deferred revenue                                                            | 203                           | (387)            |
| <b>Net cash (used in) provided by operating activities</b>                  | <b>(1,643)</b>                | <b>2,734</b>     |
| <b>Cash Flows From Investing Activities</b>                                 |                               |                  |
| Capital expenditures                                                        | (2,301)                       | (1,077)          |
| Proceeds from sale of assets held for sale                                  | —                             | 1,161            |
| Purchase of marketable securities                                           | (273)                         | (13,104)         |
| Maturities of marketable securities                                         | 4,355                         | 8,000            |
| Release of restricted cash                                                  | 3,338                         | 1,068            |
| <b>Net cash provided by (used in) investing activities</b>                  | <b>5,119</b>                  | <b>(3,952)</b>   |
| <b>Cash Flows From Financing Activities</b>                                 |                               |                  |



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|                                                                         |                 |                 |
|-------------------------------------------------------------------------|-----------------|-----------------|
| Repayment of capital lease obligation                                   | —               | (18 )           |
| Net proceeds from issuance of common stock                              | 1,165           | 425             |
| Repurchase of common stock for treasury                                 | (1,633 )        | —               |
| <b>Net cash (used in) provided by financing activities</b>              | <b>(468 )</b>   | <b>407</b>      |
| <b>Effect of exchange rate differences on cash and cash equivalents</b> | <b>44</b>       | <b>(16 )</b>    |
| <b>Net change in cash and cash equivalents</b>                          | <b>3,052</b>    | <b>(827 )</b>   |
| <b>Cash and cash equivalents, beginning of period</b>                   | <b>14,371</b>   | <b>16,642</b>   |
| <b>Cash and cash equivalents, end of period</b>                         | <b>\$17,423</b> | <b>\$15,815</b> |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

**ENERGY RECOVERY, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**Note 1 — The Company and Summary of Significant Accounting Policies**

*The Company*

Energy Recovery, Inc. (the “Company”, “Energy Recovery”, “we”, “our”, or “us”) designs, develops, manufactures, and sells energy recovery devices that transform untapped energy into reusable energy from industrial fluid flows and pressure cycles. Our products are marketed and sold in fluid flow markets, such as desalination and oil and gas, under the trademarks ERI<sup>®</sup>, PX<sup>®</sup>, Pressure Exchanger<sup>®</sup>, PX Pressure Exchanger<sup>®</sup>, IsoBoost<sup>™</sup>, IsoGen<sup>™</sup>, and IsoPro<sup>™</sup>. Our products are developed and manufactured in the United States of America (“U.S.”) at our headquarters in San Leandro, California. We also have sales offices in Madrid, Spain; Dubai, United Arab Emirates; and Shanghai, Peoples Republic of China.

*Use of Estimates*

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“U.S. GAAP”) requires our management to make judgments, assumptions, and estimates that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Our more significant estimates and judgments that we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill, long-lived assets, and acquired intangible assets; useful lives for depreciation and amortization; valuation adjustments for excess and obsolete inventory; deferred taxes and valuation allowances on deferred tax assets; and evaluation and measurement of contingencies, including contingent consideration. Actual results could differ materially from those estimates.

*Basis of Presentation*

The condensed consolidated financial statements include the accounts of Energy Recovery, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The accompanying condensed consolidated financial statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2013 condensed consolidated balance sheet was derived from audited financial statements, and may not include all disclosures required by U.S. GAAP; however, we believe that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto for the fiscal year ended December 31, 2013 included in our Annual Report on Form 10-K filed with the SEC on March 11, 2014.

In the opinion of management, all adjustments, consisting of only normal recurring adjustments that are necessary to present fairly the financial position, results of operations, and cash flows for the interim periods, have been made. The results of operations for the interim periods are not necessarily indicative of the operating results for the full fiscal year or any future periods.

***Change in Method of Accounting for Inventory Valuation***

Prior to January 1, 2014, inventories were stated at the lower of cost (using the weighted average cost method) or market. Effective January 1, 2014, with the final implementation of our new enterprise resource planning (“ERP”) system, we changed our method of accounting for inventories to the first-in, first-out (“FIFO”) method. We believe that the change is preferable, as the FIFO method better reflects the current value of inventories and provides more accurate matching of manufacturing costs and revenues. Due to the limited capabilities of our former ERP system, we determined that it was impracticable to retrospectively apply the FIFO costing method to prior periods. As such, prior period consolidated financial statements have not been retroactively adjusted. The cumulative effect of this change was not material.

**Recent Accounting Pronouncements**

On May 28, 2014, the Financial Accounting Standards Board issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers*. The amendment requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, which is January 1, 2017 for us. Early application is not permitted. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. We are evaluating the effect that ASU 2014-09 will have on our consolidated financial statements and related disclosures. We have not yet selected a transition method nor have we determined the effect of the standard on our ongoing financial reporting.

**Note 2 — Goodwill and Other Intangible Assets**

Goodwill as of September 30, 2014 and December 31, 2013 of \$12.8 million was the result of our acquisition of Pump Engineering, LLC in December 2009. During the three and nine months ended September 30, 2014, there were no changes in the recognized amount of goodwill.

The components of identifiable other intangible assets, all of which are finite-lived, as of the dates indicated were as follows (in thousands):

|                        | <b>September 30, 2014</b> |                     |                    |                 |
|------------------------|---------------------------|---------------------|--------------------|-----------------|
|                        | <b>Gross</b>              |                     | <b>Accumulated</b> | <b>Net</b>      |
|                        | <b>Carrying</b>           | <b>Accumulated</b>  | <b>Impairment</b>  | <b>Carrying</b> |
|                        | <b>Amount</b>             | <b>Amortization</b> | <b>Losses</b>      | <b>Amount</b>   |
| Developed technology   | \$6,100                   | \$ (2,948 )         | \$ —               | \$ 3,152        |
| Non-compete agreements | 1,310                     | (1,285 )            | —                  | 25              |
| Backlog                | 1,300                     | (1,300 )            | —                  | —               |
| Trademarks             | 1,200                     | (180 )              | (1,020 )           | —               |
| Customer relationships | 990                       | (978 )              | —                  | 12              |
| Patents                | 585                       | (370 )              | (42 )              | 173             |
| Total                  | \$11,485                  | \$ (7,061 )         | \$ (1,062 )        | \$ 3,362        |

**December 31, 2013**

|                        | <b>Gross</b>    |                     | <b>Accumulated</b> | <b>Net</b>      |
|------------------------|-----------------|---------------------|--------------------|-----------------|
|                        | <b>Carrying</b> | <b>Accumulated</b>  | <b>Impairment</b>  | <b>Carrying</b> |
|                        | <b>Amount</b>   | <b>Amortization</b> | <b>Losses</b>      | <b>Amount</b>   |
| Developed technology   | \$6,100         | \$ (2,491 )         | \$ —               | \$ 3,609        |
| Non-compete agreements | 1,310           | (1,169 )            | —                  | 141             |
| Backlog                | 1,300           | (1,300 )            | —                  | —               |
| Trademarks             | 1,200           | (180 )              | (1,020 )           | —               |
| Customer relationships | 990             | (924 )              | —                  | 66              |
| Patents                | 585             | (351 )              | (42 )              | 192             |
| Total                  | \$11,485        | \$ (6,415 )         | \$ (1,062 )        | \$ 4,008        |

Accumulated impairment losses at September 30, 2014 include a \$1.0 million impairment loss from 2012 for trademarks, a \$31,000 loss for patents from 2007, and an \$11,000 loss for patents from 2010.

**Note 3 — Loss per Share**

Basic and diluted net loss per share is based on the weighted average number of common shares outstanding during the period. Potential dilutive securities are excluded from the calculation of loss per share, as their inclusion would be anti-dilutive.

The following table shows the computation of basic and diluted loss per share (in thousands, except per share data):

|                                                              | <b>Three Months<br/>Ended</b> |             | <b>Nine Months<br/>Ended</b>  |             |
|--------------------------------------------------------------|-------------------------------|-------------|-------------------------------|-------------|
|                                                              | <b>September 30,<br/>2014</b> | <b>2013</b> | <b>September 30,<br/>2014</b> | <b>2013</b> |
| Numerator:                                                   |                               |             |                               |             |
| Net loss                                                     | \$(5,506 )                    | \$(3,866 )  | \$(13,800 )                   | \$(9,833 )  |
| Denominator:                                                 |                               |             |                               |             |
| Basic and diluted weighted average common shares outstanding | 51,861                        | 51,052      | 51,626                        | 51,020      |
| Basic and diluted net loss per share                         | \$(0.11 )                     | \$(0.08 )   | \$(0.27 )                     | \$(0.19 )   |

The following potential common shares were not considered in the computation of diluted loss per share because their effect would have been anti-dilutive (in thousands):

|               | <b>Three and<br/>Nine Months<br/>Ended</b> |             |
|---------------|--------------------------------------------|-------------|
|               | <b>September<br/>30,<br/>2014</b>          | <b>2013</b> |
| Stock options | 6,481                                      | 7,303       |
| Warrants      | 200                                        | 900         |

**Note 4 — Other Financial Information**

**Restricted Cash**

We have pledged cash in connection with stand-by letters of credit and credit cards. We have deposited corresponding amounts into money market and non-interest bearing accounts at three financial institutions for these items as follows (in thousands):

|                                                    | <b>September<br/>30,</b> | <b>December<br/>31,</b> |
|----------------------------------------------------|--------------------------|-------------------------|
|                                                    | <b>2014</b>              | <b>2013</b>             |
| Contingent and other consideration for acquisition | \$ —                     | \$ 2,504                |
| Collateral for stand-by letters of credit          | 3,042                    | 1,492                   |
| Collateral for credit cards                        | 315                      | 315                     |
| Current restricted cash                            | \$ 3,357                 | \$ 4,311                |
| <br>                                               |                          |                         |
| Contingent and other consideration for acquisition | \$ —                     | \$ 1,000                |
| Collateral for stand-by letters of credit          | 2,084                    | 3,468                   |
| Non-current restricted cash                        | \$ 2,084                 | \$ 4,468                |
| Total restricted cash                              | \$ 5,441                 | \$ 8,779                |

We acquired Pump Engineering, LLC in December 2009. Under the terms of the purchase agreement, \$3.5 million of consideration was contingent upon achievement of certain performance milestones. These performance milestones were tied to: (i) achieving certain minimum product energy efficiency metrics (\$1.3 million); (ii) meeting certain product delivery time schedules (\$1.2 million); and (iii) meeting certain product warranty metrics (\$1.0 million). During the fourth quarter of 2010, the first two performance milestones were not met. Accordingly, we withheld payment of \$2.5 million under the contractual terms of the purchase agreement.

In August 2011, the former shareholders of Pump Engineering, LLC filed a claim against us seeking damages in the amount of \$2.5 million and their litigation costs. As a result, we restricted cash of \$3.5 million, the entire amount of the original contingent consideration in an escrow account. On August 8, 2014, we entered into a settlement agreement (the "Agreement") in this matter. Under the Agreement, we received \$2.125 million from the established escrow account, and the plaintiffs received \$1.375 million from the said escrow account with neither party admitting to any liability or responsibility. The \$3.5 million of restricted cash related to the amount held in escrow was released.

***Inventories***

Our inventories consisted of the following (in thousands):

|                 | <b>September<br/>30,</b> | <b>December<br/>31,</b> |
|-----------------|--------------------------|-------------------------|
|                 | <b>2014</b>              | <b>2013</b>             |
| Raw materials   | \$ 3,327                 | \$ 2,431                |
| Work in process | 2,365                    | 1,427                   |
| Finished goods  | 4,535                    | 1,097                   |
| Inventories     | \$ 10,227                | \$ 4,955                |

***Prepaid Expenses and Other Current Assets***

Prepaid expenses and other current assets consisted of the following (in thousands):

|                                           | <b>September<br/>30,</b> | <b>December<br/>31,</b> |
|-------------------------------------------|--------------------------|-------------------------|
|                                           | <b>2014</b>              | <b>2013</b>             |
| Interest receivable                       | \$ 107                   | \$ 163                  |
| Supplier advances                         | 743                      | 203                     |
| Other prepaid expenses and current assets | 1,257                    | 652                     |
| Prepaid expenses and other current assets | \$ 2,107                 | \$ 1,018                |

***Accrued Expenses and Other Current Liabilities***

Accrued expenses and other current liabilities consisted of the following (in thousands):

|  | <b>September<br/>30,</b> | <b>December<br/>31,</b> |
|--|--------------------------|-------------------------|
|  | <b>2014</b>              | <b>2013</b>             |



|                                                               |          |          |
|---------------------------------------------------------------|----------|----------|
| Payroll and commissions payable                               | \$ 2,827 | \$ 4,857 |
| Contingent consideration (current portion) and legal expenses | 1,256    | 1,603    |
| Other accrued expenses and current liabilities                | 1,274    | 1,503    |
| Accrued expenses and other current liabilities                | \$ 5,357 | \$ 7,963 |

### *Accumulated Other Comprehensive Loss*

Changes in accumulated other comprehensive loss by component for the nine months ended September 30, 2014 were as follows (in thousands):

|                                | <b>Foreign<br/>Currency<br/>Translation<br/>Adjustments</b> | <b>Unrealized<br/>Gains<br/>(Losses)<br/>on<br/>Investments</b> | <b>Total<br/>Accumulated<br/>Other<br/>Comprehensive<br/>Loss</b> |
|--------------------------------|-------------------------------------------------------------|-----------------------------------------------------------------|-------------------------------------------------------------------|
| Balance, December 31, 2013     | \$ (106 )                                                   | \$ (1 )                                                         | \$ (107 )                                                         |
| Net other comprehensive income | 68                                                          | 12                                                              | 80                                                                |
| Balance, September 30, 2014    | \$ (38 )                                                    | \$ 11                                                           | \$ (27 )                                                          |

There were no reclassifications of amounts out of accumulated other comprehensive loss, as there have been no sales of securities or translation adjustments that impacted other comprehensive income during the quarter. The tax impact of the changes in accumulated other comprehensive loss was not material.

### **Note 5 — Investments**

Our short-term and long-term investments are all classified as available-for-sale. There were no sales of available-for-sale securities during the three and nine months ended September 30, 2014.

Available-for-sale securities as of the dates indicated consisted of the following (in thousands):

|                                        | <b>September 30, 2014</b> |                                                   |                                                    |                       |
|----------------------------------------|---------------------------|---------------------------------------------------|----------------------------------------------------|-----------------------|
|                                        | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Holding<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Holding<br/>Losses</b> | <b>Fair<br/>Value</b> |
| Short-term investments:                |                           |                                                   |                                                    |                       |
| State and local government obligations | \$677                     | \$ —                                              | \$ —                                               | \$677                 |
| Corporate notes and bonds              | 13,059                    | 16                                                | (1 )                                               | 13,074                |
| Total short-term investments           | \$13,736                  | \$ 16                                             | \$ (1 )                                            | \$13,751              |
| Long-term investments:                 |                           |                                                   |                                                    |                       |
| Corporate notes and bonds              | \$1,384                   | \$ 1                                              | \$ (4 )                                            | \$1,381               |
| Total long-term investments            | \$1,384                   | \$ 1                                              | \$ (4 )                                            | \$1,381               |
| Total available-for-sale securities    | \$15,120                  | \$ 17                                             | \$ (5 )                                            | \$15,132              |

|                                        | <b>December 31, 2013</b>  |                                                   |                                                    |                       |
|----------------------------------------|---------------------------|---------------------------------------------------|----------------------------------------------------|-----------------------|
|                                        | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Holding<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Holding<br/>Losses</b> | <b>Fair<br/>Value</b> |
| Short-term investments:                |                           |                                                   |                                                    |                       |
| State and local government obligations | 2,113                     | 3                                                 | —                                                  | 2,116                 |
| Corporate notes and bonds              | 3,739                     | 2                                                 | (1 )                                               | 3,740                 |
| Total short-term investments           | \$5,852                   | \$ 5                                              | \$ (1 )                                            | \$5,856               |
| Long-term investments:                 |                           |                                                   |                                                    |                       |
| State and local government obligations | 227                       | 1                                                 | —                                                  | 228                   |
| Corporate notes and bonds              | 13,472                    | 11                                                | (17 )                                              | 13,466                |
| Total long-term investments            | \$13,699                  | \$ 12                                             | \$ (17 )                                           | \$13,694              |
| Total available-for-sale securities    | \$19,551                  | \$ 17                                             | \$ (18 )                                           | \$19,550              |

Gross unrealized losses and fair values of our investments in an unrealized loss position as of the dates indicated, aggregated by investment category and length of time that the security has been in a continuous loss position, were as follows (in thousands):

|  | <b>September 30, 2014</b>      |                                 |              |
|--|--------------------------------|---------------------------------|--------------|
|  | <b>Less than 12<br/>months</b> | <b>12 months or<br/>greater</b> | <b>Total</b> |

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|                           | <b>Gross</b>      |                          | <b>Gross</b>      |                          | <b>Gross</b>      |                          |
|---------------------------|-------------------|--------------------------|-------------------|--------------------------|-------------------|--------------------------|
|                           | <b>Fair Value</b> | <b>Unrealized Losses</b> | <b>Fair Value</b> | <b>Unrealized Losses</b> | <b>Fair Value</b> | <b>Unrealized Losses</b> |
| Corporate notes and bonds | \$3,129           | \$ (5 )                  | \$ —              | \$ —                     | \$3,129           | \$ (5 )                  |
| Total                     | \$3,129           | \$ (5 )                  | \$ —              | \$ —                     | \$3,129           | \$ (5 )                  |

**December 31, 2013**

|                           | <b>Less than 12 months</b> |                          | <b>12 months or greater</b> |                          | <b>Total</b>            |                          |
|---------------------------|----------------------------|--------------------------|-----------------------------|--------------------------|-------------------------|--------------------------|
|                           | <b>Gross Fair Value</b>    | <b>Unrealized Losses</b> | <b>Gross Fair Value</b>     | <b>Unrealized Losses</b> | <b>Gross Fair Value</b> | <b>Unrealized Losses</b> |
| Corporate notes and bonds | \$4,919                    | \$ (17 )                 | \$524                       | \$ (1 )                  | \$5,443                 | \$ (18 )                 |
| Total                     | \$4,919                    | \$ (17 )                 | \$524                       | \$ (1 )                  | \$5,443                 | \$ (18 )                 |

Expected maturities can differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties. The amortized cost and fair value of available-for-sale securities that had stated maturities as of September 30, 2014 are shown below by contractual maturity (in thousands):

|                                        | <b>September 30, 2014</b> |                   |
|----------------------------------------|---------------------------|-------------------|
|                                        | <b>Amortized Cost</b>     | <b>Fair Value</b> |
| Due in one year or less                | \$—                       | \$—               |
| Due after one year through three years | 15,120                    | 15,132            |
| Total available-for-sale securities    | \$15,120                  | \$15,132          |

**Note 6 — Lines of Credit***Lines of Credit*

In June 2012, we entered into a loan agreement (the “2012 Agreement”) with a financial institution. The 2012 Agreement provides for a total available credit line of \$16.0 million. Under the 2012 Agreement, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total stand-by letters of credit issued under the 2012 Agreement may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. At no time may the aggregate of the revolving loans and stand-by letters of credit exceed the total available credit line of \$16.0 million. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate plus 0% or a Eurodollar loan that bears interest equal to the adjusted LIBOR plus 1.25%. Stand-by letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a facility fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line. The 2012 Agreement also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. The 2012 Agreement matures in June 2015 and is collateralized by substantially all of our assets. As of September 30, 2014 and December 31, 2013, there were no advances drawn under the 2012 Agreement. Stand-by letters of credit collateralized under the 2012 Agreement totaled \$2.7 million and \$1.3 million as of September 30, 2014 and December 31, 2013, respectively. Total cash restricted related to these stand-by letters of credit totaled \$2.7 million and \$1.3 million as of September 30, 2014 and December 31, 2013, respectively.

We are subject to certain financial and administrative covenants under the 2012 Agreement. As of September 30, 2014, we were in compliance with these covenants.

In 2009, we entered into a loan and security agreement (the “2009 Agreement”) with another financial institution. The 2009 Agreement, as amended, provided a total available credit line of \$16.0 million. Under the 2009 Agreement, we were allowed to draw advances of up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for stand-by letters of credit, provided that the aggregate of the outstanding advances and collateral did not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incurred interest based on a prime rate index or LIBOR plus 1.375%. The 2009 Agreement, as amended, also required us to maintain cash collateral balances equal to at least 101% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit and 100% of the amount of all outstanding advances. The 2009 Agreement expired at the end of May 2012, at which time we became required to maintain a cash collateral balance equal to at least 105% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit. There were no advances drawn under the 2009 Agreement’s credit line at the time it expired. Remaining stand-by letters of credit issued under the 2009 Agreement totaled \$2.3 million and \$3.6 million as of September 30, 2014 and December 31, 2013, respectively. Total cash restricted related to these stand-by letters of credit totaled \$2.4 million and \$3.7 million as of September 30, 2014 and December 31, 2013, respectively.

**Note 7 — Equity**

***Stock Repurchase Program***

In February 2014, our Board of Directors authorized a stock repurchase program under which up to three million shares, not to exceed \$6.0 million in aggregate cost, of our outstanding common stock could be repurchased through December 31, 2014 at the discretion of management. We account for treasury stock using the cost method. Cost includes fees charged in connection with acquiring the treasury stock. During the three months ended September 30, 2014, 252,300 shares at an aggregate cost of \$1.0 million were repurchased under this authorization. During the nine months ended September 30, 2014, 367,600 shares at an aggregate cost of \$1.6 million were repurchased under this authorization.

In October 2014, an additional 329,253 shares at an aggregate cost of \$1.2 million were repurchased under this authorization.

***Share-Based Compensation Expense***

For the three and nine months ended September 30, 2014 and 2013, we recognized share-based compensation expense related to employees and consultants as follows (in thousands):

|                                        | <b>Three<br/>Months<br/>Ended</b> |             | <b>Nine Months<br/>Ended</b> |             |
|----------------------------------------|-----------------------------------|-------------|------------------------------|-------------|
|                                        | <b>September<br/>30,</b>          |             | <b>September 30,</b>         |             |
|                                        | <b>2014</b>                       | <b>2013</b> | <b>2014</b>                  | <b>2013</b> |
| Cost of revenue                        | \$27                              | \$18        | \$75                         | \$57        |
| General and administrative             | 222                               | 339         | 916                          | 1,153       |
| Sales and marketing                    | 80                                | 123         | 388                          | 358         |
| Research and development               | 84                                | 50          | 249                          | 149         |
| Total share-based compensation expense | \$413                             | \$530       | \$1,628                      | \$1,717     |

As of September 30, 2014, total unrecognized compensation cost related to non-vested share-based awards, net of estimated forfeitures, was \$3.9 million, which is expected to be recognized as expense over a weighted average period of approximately 2.98 years.

In March 2014, we granted 957,000 stock options to certain officers and other employees. The options vest over a four-year period, have an exercise price of \$6.00 per share, and expire 10 years from the grant date.

Also, in March 2014, we granted 10,000 stock options to an employee. The options vest over a four-year period, have an exercise price of \$5.32 per share, and expire 10 years from the grant date.

In April 2014, we granted 440,000 stock options to our President and Chief Executive Officer in lieu of his participation in the 2014 cash incentive plan. The options vest over a four-year period, have an exercise price of \$4.96 per share, and expire 10 years from the grant date.

In June 2014, we granted 50,000 stock options to a certain employee as part of the offer letter of employment. The options vest over a four-year period, have an exercise price of \$5.91 per share, and expire 10 years from the grant date.

In July 2014, we granted 100,000 stock options to our new Chief Financial Officer as part of his promotion. The options vest over a four-year period, have an exercise price of \$4.91 per share, and expire 10 years from the grant date.

On October 1, 2014, we granted 100,000 and 180,000 stock options to our new Chief Financial Officer as the second part of his promotion and to certain other employees, respectively. The options vest over a four-year period, have an exercise price of \$3.31 per share, and expire 10 years from the grant date.

On October 15, 2014, we granted 75,000 stock options to our new Chief Sales Officer as part of his offer letter of employment. The options vest over a four-year period, have an exercise price of \$3.80 per share, and expire 10 years from the grant date.

### ***Warrants***

On July 29, 2014, warrants to purchase 400,000 shares of common stock were exercised for 311,111 shares in lieu of cash proceeds. The remaining 88,889 warrants were cancelled and considered payment for the exercise.

### **Note 8 — Income Taxes**

The effective tax rate for the nine months ended September 30, 2014 and 2013 was (1.4%) and (2.7%), respectively. As of December 31, 2013, a valuation allowance of approximately \$13.4 million was established to reduce our deferred income tax assets to the amount expected to be realized. As such, no tax benefit related to our pre-tax loss was recognized for the three or nine months ended September 30, 2014, as there was no change in our assessment of the amount of deferred income tax assets expected to be realized.

**Note 9 — Commitments and Contingencies*****Operating Lease Obligations***

We lease facilities under fixed non-cancellable operating leases that expire on various dates through November 2019. Future minimum lease payments consist of the following (in thousands):

|                                     | <b>September<br/>30,</b> |
|-------------------------------------|--------------------------|
|                                     | <b>2014</b>              |
| 2014 (remaining three months)       | \$ 456                   |
| 2015                                | 1,543                    |
| 2016                                | 1,575                    |
| 2017                                | 1,567                    |
| 2018                                | 1,591                    |
| Thereafter                          | 1,398                    |
| Total future minimum lease payments | \$ 8,130                 |

***Product Warranty***

The following table summarizes the activity related to the product warranty liability during the three and nine months ended September 30, 2014 and 2013 (in thousands):

|                                           | <b>Three<br/>Months<br/>Ended</b> |             | <b>Nine Months<br/>Ended</b> |             |
|-------------------------------------------|-----------------------------------|-------------|------------------------------|-------------|
|                                           | <b>September<br/>30,</b>          |             | <b>September 30,</b>         |             |
|                                           | <b>2014</b>                       | <b>2013</b> | <b>2014</b>                  | <b>2013</b> |
| Balance, beginning of period              | \$705                             | \$1,027     | \$709                        | \$1,172     |
| Warranty costs charged to cost of revenue | 34                                | 39          | 87                           | 177         |
| Change in estimate                        | —                                 | —           | —                            | (132 )      |
| Utilization of warranty                   | (50 )                             | (30 )       | (107 )                       | (181 )      |
| Balance, end of period                    | \$689                             | \$1,036     | \$689                        | \$1,036     |



Based on management's analysis of warranty liability experience, a change in estimate of our warranty reserve of \$132,000 was recorded in 2013.

### ***Purchase Obligations***

We enter into purchase order arrangements with our vendors. As of September 30, 2014, there were open purchase orders for which we had not yet received the related goods or services. These arrangements are subject to change based on our sales demand forecasts, and we have the right to cancel the arrangements prior to the date of delivery. As of September 30, 2014, we had approximately \$1.8 million of cancellable open purchase order arrangements related primarily to materials and parts.

### ***Guarantees***

We enter into indemnification provisions under our agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, we generally indemnify and hold harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of our activities, generally limited to personal injury and property damage caused by our employees at a customer's desalination plant in proportion to the employee's percentage of fault for the accident. Damages incurred for these indemnifications would be covered by our general liability insurance to the extent provided by the policy limitations. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, we had no liabilities recorded for these agreements as of September 30, 2014 and December 31, 2013.

In certain cases, we issue warranty and product performance guarantees to our customers for amounts ranging from 10% to 30% of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication, and operating performance. These guarantees, generally in the form of stand-by letters of credit or bank guarantees secured by stand-by letters of credit, typically remain in place for periods ranging up to 24 months and in some cases up to 59 months, and relate to the underlying product warranty period. The stand-by letters of credit are collateralized by restricted cash and our credit facility. Of the \$5.0 million in outstanding stand-by letters of credit at September 30, 2014, \$2.3 million was issued under the 2009 Agreement and \$2.7 million was issued under the 2012 Agreement. The stand-by letters of credit outstanding at September 30, 2014 were collateralized by restricted cash of \$5.1 million.

### ***Litigation***

Note 9 – Commitments and Contingencies, under the caption “Litigation” of our Annual Report on Form 10-K filed with the SEC on March 11, 2014, provides information on certain litigation in which we are involved. Unfavorable rulings, judgments, or settlement terms regarding these litigation matters could have a material adverse impact on our business, financial condition, results of operations, and cash flows. Although none of the litigation matters can be quantified with absolute certainty, we have established accruals covering exposure and relating to contingencies to the extent that they are reasonably estimable and probable based on available facts.

See Note 4 – “Equity – Restricted Cash,” for a discussion of our August 2014 settlement of the litigation concerning the Pump Engineering, LLC acquisition.

On September 10, 2014, the Company terminated the employment of Mr. Borja Sanchez-Blanco, Senior Vice President of Sales, for cause on the basis of breach of duty of trust and conduct leading to conflicts of interest. On October 3, 2014, Mr. Blanco filed a complaint with the labor commissioner in Madrid, Spain against the Company and its subsidiary Energy Recovery Iberia SL. Mr. Blanco alleges among other things, that he was terminated without cause. The complaint alleges wages due (salary and bonus) of approximately €567,000 and alleged stock option gains of €630,000, as a result of the alleged termination without cause. At this time, no reserve has been accrued as we have determined that an award to Mr. Blanco is not probable.

### **Note 10 — Business Segment and Geographic Information**

We manufacture and sell high-efficiency energy recovery devices and pumps as well as related services under one reportable segment. Our chief operating decision-maker is the chief executive officer (“CEO”). The CEO reviews financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance. Accordingly, we have concluded that we have one reportable segment.

The following geographic information includes net revenue attributable to our domestic and international customers based on the customers’ requested delivery locations, except for certain cases in which the customer directed us to deliver our products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use, rather than the delivery location, is reflected in the table below (in thousands, except percentages):

|                       | <b>Three Months Ended</b> |                           | <b>Nine Months Ended</b>  |                           |
|-----------------------|---------------------------|---------------------------|---------------------------|---------------------------|
|                       | <b>September 30, 2014</b> | <b>September 30, 2013</b> | <b>September 30, 2014</b> | <b>September 30, 2013</b> |
| Domestic revenue      | \$249                     | \$778                     | \$833                     | \$2,541                   |
| International revenue | 5,093                     | 4,090                     | 14,813                    | 17,269                    |
| Total revenue         | \$5,342                   | \$4,868                   | \$15,646                  | \$19,810                  |

## Revenue by country:

|               |     |   |     |   |     |   |     |   |
|---------------|-----|---|-----|---|-----|---|-----|---|
| Egypt         | 13  | % | 2   | % | 9   | % | 4   | % |
| United States | 5   |   | 16  |   | 5   |   | 13  |   |
| Singapore     | 4   |   | 11  |   | 2   |   | 4   |   |
| China         | 3   |   | 17  |   | 6   |   | 9   |   |
| Turkey        | 3   |   | 13  |   | 2   |   | 3   |   |
| India         | 2   |   | 2   |   | 4   |   | 11  |   |
| South Korea   | *   |   | 16  |   | *   |   | 5   |   |
| Others **     | 70  |   | 23  |   | 72  |   | 51  |   |
| Total         | 100 | % | 100 | % | 100 | % | 100 | % |

\* Less than 1%.

\*\* Includes remaining countries not separately disclosed. No country in this line item accounted for more than 10% of our net revenue during the periods presented.

All of our long-lived assets were located in the United States at September 30, 2014 and December 31, 2013.

**Note 11 — Concentrations**

Customers accounting for 10% or more of our accounts receivable and unbilled receivables were as follows:

|            | <b>September<br/>30,</b> | <b>December<br/>31,</b> |   |
|------------|--------------------------|-------------------------|---|
|            | <b>2014</b>              | <b>2013</b>             |   |
| Customer A | *                        | 19                      | % |
| Customer B | *                        | 16                      | % |
| Customer C | *                        | 17                      | % |
| Customer D | *                        | 14                      | % |

\* Less than 10%.

Revenue from customers representing 10% or more of net revenue varies from period to period. For the periods indicated, customers representing 10% or more of net revenue were:

|            | <b>Three<br/>Months<br/>Ended</b> | <b>September<br/>30,</b> | <b>September<br/>30,</b> |             |
|------------|-----------------------------------|--------------------------|--------------------------|-------------|
|            | <b>2014</b>                       | <b>2013</b>              | <b>2014</b>              | <b>2013</b> |
| Customer E | *                                 | 17 %                     | *                        | *           |
| Customer F | *                                 | 16 %                     | *                        | *           |
| Customer G | *                                 | 10 %                     | *                        | *           |

\* Less than 10%.

**Note 12 — Fair Value Measurements**

The authoritative guidance for measuring fair value provides a hierarchy that prioritizes the inputs to valuation techniques used in measuring fair value as follows:

Level 1 — Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 — Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable; and

Level 3 — Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions that market participants would use in pricing.

The carrying values of cash and cash equivalents, restricted cash, accounts receivable, unbilled receivables, accounts payable, and other accrued expenses approximate fair value due to the short-term maturity of those instruments. For our investments in available-for-sale securities, if quoted prices in active markets for identical investments are not available to determine fair value (Level 1), then we use quoted prices for similar assets or inputs other than quoted prices that are observable either directly or indirectly (Level 2). The investments included in Level 2 consist primarily of certificates of deposits; commercial paper; and municipal, corporate, and agency obligations.

The carrying amount of the contingent consideration arising from our acquisition of Pump Engineering, LLC was measured at fair value on a recurring basis using unobservable inputs in which little or no market activity existed (Level 3). The estimated fair value of the contingent consideration was determined based entirely on management's assessment of the weighted probability of payment under various scenarios. See Note 4 – "Equity – Restricted Cash," for a discussion of our August 2014 settlement of the litigation concerning this contingent consideration.

The fair value of financial assets and liabilities measured on a recurring basis for the indicated periods was as follows (in thousands):

|                                          | <b>September<br/>30,<br/>2014</b> | <b>Level<br/>1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level<br/>3<br/>Inputs</b> |
|------------------------------------------|-----------------------------------|-------------------------------|---------------------------|-------------------------------|
| Assets:                                  |                                   |                               |                           |                               |
| Short-term available-for-sale securities | \$ 13,751                         | \$ —                          | \$ 13,751                 | \$ —                          |
| Long-term available-for-sale securities  | 1,381                             | —                             | 1,381                     | —                             |
| Total assets                             | \$ 15,132                         | \$ —                          | \$ 15,132                 | \$ —                          |
| Liabilities:                             |                                   |                               |                           |                               |
| Contingent consideration*                | \$ —                              | \$ —                          | \$ —                      | \$ —                          |
| Total liabilities                        | \$ —                              | \$ —                          | \$ —                      | \$ —                          |



|                                          | <b>December<br/>31,<br/>2013</b> | <b>Level<br/>1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level<br/>3<br/>Inputs</b> |
|------------------------------------------|----------------------------------|-------------------------------|---------------------------|-------------------------------|
| <b>Assets:</b>                           |                                  |                               |                           |                               |
| Short-term available-for-sale securities | \$ 5,856                         | \$ —                          | \$5,856                   | \$—                           |
| Long-term available-for-sale securities  | 13,694                           | —                             | 13,694                    | —                             |
| Total assets                             | \$ 19,550                        | \$ —                          | \$19,550                  | \$—                           |
| <b>Liabilities:</b>                      |                                  |                               |                           |                               |
| Contingent consideration*                | \$ 1,524                         | \$ —                          | \$—                       | \$1,524                       |
| Total liabilities                        | \$ 1,524                         | \$ —                          | \$—                       | \$1,524                       |

\* Included in Accrued Expenses and Other Current Liabilities and Other Non-Current Liabilities.

The reconciliation of the beginning and ending balances for assets and liabilities measured on a recurring basis using significant unobservable inputs (Level 3) for the period ended September 30, 2014 was as follows (in thousands):

|                             | <b>Contingent<br/>Consideration</b> |
|-----------------------------|-------------------------------------|
| Balance, December 31, 2013  | \$ 1,524                            |
| Net gain on settlement      | (149 )                              |
| Settlement payment          | (1,375 )                            |
| Balance, September 30, 2014 | \$ —                                |

### Note 13 — Subsequent Events

See Note 7 – “Equity”, for discussion of options granted and shares repurchased in October 2014.

See Note 9 – “Commitments and Contingencies – Litigation”, for discussion of Litigation arising in October 2014.

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

*The discussion in this item and in other items of this Form 10-Q contains forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions, or strategies regarding the future.*

*Forward-looking statements that represent our current expectations about future events are based on assumptions and involve risks and uncertainties. If the risks or uncertainties occur or the assumptions prove incorrect, then our results may differ materially from those set forth or implied by the forward-looking statements. Our forward-looking statements are not guarantees of future performance or events.*

*Words such as "expects," "anticipates," "believes," "estimates," variations of such words, and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Forward-looking statements in this report include, without limitation, statements about the following:*

*our belief that the levels of gross profit margin are sustainable to the extent that volume is healthy, our product mix favors PX devices, and we continue to realize cost savings through production efficiencies and enhanced yields;*

*our expectation that our expenses for research and development and sales and marketing will continue to increase as a result of the diversification into markets outside of desalination;*

*our expectation that sales outside of the United States will remain a significant portion of our net revenue;*

*our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated liquidity needs for the foreseeable future, with the exception of a decision to enter into an acquisition and/or fund investments in newly developed technology arising from rapid market adoption that could require us to seek additional equity or debt financing; and*

*our expectation that, as we expand our international sales, a portion of our revenue could continue to be denominated in foreign currencies.*



*You should not place undue reliance on these forward-looking statements, which reflect management's opinions only as of the date of the filing of this Quarterly Report on Form 10-Q. All forward-looking statements included in this document are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected in the forward-looking statements, as disclosed from time to time in our reports on Forms 10-K, 10-Q, and 8-K as well as in our Annual Reports to Stockholders and, if necessary, updated in "Part II, Item 1A: Risk Factors." We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements.*

## Overview

We are in the business of designing, developing, and manufacturing energy recovery devices to transform untapped energy into reusable energy from industrial fluid flows and pressure cycles. Our company was founded in 1992, and we introduced the initial version of our Pressure Exchanger<sup>®</sup> energy recovery device in early 1997. In December 2009, we acquired Pump Engineering, LLC, which manufactured centrifugal energy recovery devices known as turbochargers and high-pressure pumps.

Our energy recovery devices are primarily used in seawater reverse osmosis desalination. Since 2011, we have invested significant research and development costs to expand into other pressurized fluid flow industries such as oil and gas.

Our revenue is principally derived from the sale of our energy recovery devices. We also derive revenue from the sale of our high-pressure and circulation pumps which we manufacture and sell in connection with our energy recovery devices for use in desalination plants. Additionally, we receive revenue from the sale of spare parts and services, including start-up and commissioning services that we provide to our customers. The three and nine months ended September 30, 2014 also includes revenue from shipments of energy recovery devices for oil & gas customers pertaining to an operating lease with a customer in Saudi Arabia.

A significant portion of our net revenue typically has been generated from sales to a limited number of large engineering, procurement, and construction (“EPC”) firms that are involved with the design and construction of large desalination plants. Sales to these firms often involve a long sales cycle that can range from 6 to 16 months, and in some cases, up to 24 months. A single large desalination project can generate an order for numerous energy recovery devices and generally represents a significant revenue opportunity. We also sell our devices to many small- to medium-sized original equipment manufacturers (“OEMs”) which commission smaller desalination plants, order fewer energy recovery devices per plant, and have shorter sales cycles.

In the oil and gas market, we are generating lease revenue from the deployment of an IsoGen<sup>™</sup> system in Saudi Arabia. Additionally, there are a number of pilot projects to which we have deployed some of our oil and gas devices that have not, as of yet, generated revenue.

We often experience substantial fluctuations in net revenue from quarter to quarter and from year to year due to the fact that a single order for our energy recovery devices by a large EPC firm for a particular plant may represent significant revenue. In addition, historically our EPC customers tend to order a significant amount of equipment for delivery in the fourth quarter, and as a consequence, a significant portion of our annual sales typically occurs during that quarter. During the fourth quarter of 2013, five large mega-project (“MPD”) shipments contributed to a significant

increase in net revenue, making it the strongest revenue quarter in the Company's history. Normal seasonality trends generally show our lowest revenue in the first quarter of the year, with the first quarter of 2014 having followed that trend. Net revenue in the second and third quarter of 2014, which historically have included one or more MPD shipments, was adversely impacted by the timing of MPD shipments, and as such, did not include any MPD shipments.

A limited number of our customers account for a substantial portion of our net revenue and accounts receivable. Revenue from customers representing 10% or more of net revenue varies from period to period. For the three and nine months ended September 30, 2014, no customer accounted for more than 10% of our net revenue. For the three months ended September 30, 2013, three customers accounted for 17%, 16%, and 10%, respectively of our net revenue. No other customer accounted for more than 10% of our net revenue during this period. For the nine months ended September 30, 2013, no customer accounted for more than 10% of our net revenue.

During the three and nine months ended September 30, 2014 and 2013, the majority of our net revenue was attributable to sales outside of the United States. We expect sales outside of the United States to remain a significant portion of our net revenue for the next few years.

Our condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the condensed consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent that there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill, long-lived assets, and acquired intangible assets; useful lives for depreciation and amortization; valuation adjustments for excess and obsolete inventory; deferred taxes and valuation allowances on deferred tax assets; and evaluation and measurement of contingencies, including contingent consideration.

*Three Months Ended September 30, 2014 Compared to the Three Months Ended September 30, 2013***Results of Operations**

The following table sets forth certain data from our operating results as a percentage of net revenue for the periods indicated (in thousands, except percentages):

|                                           | <b>Three Months Ended September 30,</b> |        |             |       |                   |        | <b>Change</b>     |  |
|-------------------------------------------|-----------------------------------------|--------|-------------|-------|-------------------|--------|-------------------|--|
|                                           | <b>2014</b>                             |        | <b>2013</b> |       | <b>Increase /</b> |        | <b>(Decrease)</b> |  |
| <b>Results of Operations:*</b>            |                                         |        |             |       |                   |        |                   |  |
| Net revenue                               | \$5,342                                 | 100 %  | \$4,868     | 100 % | \$474             | 10 %   |                   |  |
| Cost of revenue                           | 3,007                                   | 56 %   | 1,966       | 40 %  | 1,041             | 53 %   |                   |  |
| Gross profit                              | 2,335                                   | 44 %   | 2,902       | 60 %  | (567 )            | (20% ) |                   |  |
| Operating expenses:                       |                                         |        |             |       |                   |        |                   |  |
| General and administrative                | 3,078                                   | 58 %   | 3,625       | 74 %  | (547 )            | (15% ) |                   |  |
| Sales and marketing                       | 2,351                                   | 44 %   | 1,737       | 36 %  | 614               | 35 %   |                   |  |
| Research and development                  | 2,131                                   | 40 %   | 1,027       | 21 %  | 1,104             | 107 %  |                   |  |
| Amortization of intangible assets         | 216                                     | 4 %    | 230         | 5 %   | (14 )             | (6% )  |                   |  |
| Restructuring charges                     | —                                       | —      | 140         | 3 %   | (140 )            | (100%) |                   |  |
| Total operating expenses                  | 7,776                                   | 146 %  | 6,759       | 139 % | 1,017             | 15 %   |                   |  |
| Loss from operations                      | (5,441)                                 | (102%) | (3,857)     | (79%) | (1,584)           | (41% ) |                   |  |
| Other non-operating income (expense), net | (2 )                                    | 0 %    | 27          | 1 %   | (29 )             | (107%) |                   |  |
| Loss before income taxes                  | (5,443)                                 | (102%) | (3,830)     | (79%) | (1,613)           | (42% ) |                   |  |
| Provision for income taxes                | 63                                      | 1 %    | 36          | 1 %   | 27                | 75 %   |                   |  |
| Net loss                                  | \$(5,506)                               | (103%) | \$(3,866)   | (79%) | \$(1,640)         | (42% ) |                   |  |

\* Percentages may not add up to 100% due to rounding

**Net Revenue**

Our net revenue increased by \$474,000, or 10%, to \$5.3 million for the three months ended September 30, 2014 from \$4.9 million for the three months ended September 30, 2013. The increase was primarily due to higher OEM shipments of \$186,000, higher aftermarket shipments of \$95,000, and revenue attributable to an oil & gas operating lease of \$193,000. There were no MPD shipments in the third quarter of 2014 nor the third quarter of 2013.

Although we operate under one segment, we categorize revenue based on the type of energy recovery device and its related products and services. The following table reflects revenue by product category and as a percentage of total net revenue (in thousands, except percentages):

|                                                         | <b>Three Months Ended<br/>September 30,</b> |       |             |       |
|---------------------------------------------------------|---------------------------------------------|-------|-------------|-------|
|                                                         | <b>2014</b>                                 |       | <b>2013</b> |       |
| PX devices and related products and services            | \$2,351                                     | 44 %  | \$3,554     | 73 %  |
| Turbochargers, pumps, and related products and services | 2,798                                       | 52 %  | 1,314       | 27 %  |
| Oil and gas product operating lease                     | 193                                         | 4 %   | —           | —     |
| Net revenue                                             | \$5,342                                     | 100 % | \$4,868     | 100 % |

During the three months ended September 30, 2014 and 2013, a significant portion of our net revenue was attributable to sales outside of the United States. Revenue attributable to domestic and international sales as a percentage of net revenue was as follows:

|                       | <b>Three<br/>Months<br/>Ended</b> |             |
|-----------------------|-----------------------------------|-------------|
|                       | <b>September<br/>30,</b>          |             |
|                       | <b>2014</b>                       | <b>2013</b> |
| Domestic revenue      | 5 %                               | 16 %        |
| International revenue | 95 %                              | 84 %        |
| Net revenue           | 100 %                             | 100 %       |

### ***Gross Profit***

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. For the three months ended September 30, 2014, gross profit as a percentage of net revenue was 44%. For the three months ended September 30, 2013, gross profit as a percentage of net revenue was 60%.

The decrease in gross profit as a percentage of net revenue for the three months ended September 30, 2014 as compared to the same period of last year was primarily due to a large shift in product mix toward turbochargers and pumps and to lower production volume.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, and the volume of production in our manufacturing plant that determines our operating leverage. Accordingly, we are not able to predict our future levels of gross profit margin with certainty. We do believe, however, that the levels of gross profit margin are sustainable to the extent that volume is healthy, our product mix favors PX devices, and we continue to realize cost savings through production efficiencies and enhanced yields.

Manufacturing average headcount decreased to 37 in the third quarter of 2014 from 44 in the third quarter of 2013.

Share-based compensation expense included in cost of revenue was \$27,000 and \$18,000 for the three months ended September 30, 2014 and 2013, respectively.

### ***General and Administrative Expense***

General and administrative expense decreased by \$547,000, or 15%, to \$3.1 million for the three months ended September 30, 2014 from \$3.6 million for the three months ended September 30, 2013. As a percentage of net revenue, general and administrative expense decreased to 58% for the three months ended September 30, 2014 from 74% for the three months ended September 30, 2013 primarily due to higher net revenue offset by lower general and administrative expenses in the current period.

General and administrative average headcount remained constant at 28 for the third quarter of 2014 and the third quarter of 2013.

Of the \$547,000 decrease in general and administrative expense for the three months ended September 30, 2014 compared to the same quarter of 2013, \$442,000 related to compensation and employee-related benefits, \$36,000 related to occupancy costs, \$29,000 related to bad debt expense, \$22,000 related to other general administrative expenses, and \$18,000 related to professional fees and other service. Decreases in compensation, employee-related benefits and occupancy costs are primarily associated with the redeployment of personnel to oil & gas development.

Share-based compensation expense included in general and administrative expense was \$222,000 and \$339,000 for the three months ended September 30, 2014 and 2013, respectively.

### *Sales and Marketing Expense*

Sales and marketing expense increased by \$614,000, or 35%, to \$2.4 million for the three months ended September 30, 2014 from \$1.7 million for the three months ended September 30, 2013. As a percentage of net revenue, sales and marketing expense increased to 44% for the three months ended September 30, 2014 from 36% for the three months ended September 30, 2013 primarily due to higher sales and marketing expense in the current period.

Sales and marketing average headcount increased to 35 in the third quarter of 2014 from 27 in the third quarter of 2013.

Of the \$614,000 increase in sales and marketing expense for the three months ended September 30, 2014 compared to the same quarter of 2013, \$269,000 related to compensation and employee-related benefits partially associated with the increase in headcount, \$212,000 related to professional and other services, and \$115,000 related to marketing costs associated with trade show participation, all to further accelerate growth in new markets such as oil & gas. Additionally, there was an increase of \$52,000 related to occupancy costs also associated with the increase in headcount. The increases were offset by decreases of \$34,000 related to commissions on sales.

Share-based compensation expense included in sales and marketing expense was \$80,000 and \$123,000 for the three months ended September 30, 2014 and 2013, respectively.

As we continue to pursue new addressable markets such as oil & gas outside of seawater desalination, we anticipate that our sales and marketing expenses will increase in the future.





***Research and Development Expense***

Research and development expense increased by \$1.1 million, or 107%, to \$2.1 million for the three months ended September 30, 2014 from \$1.0 million for the three months ended September 30, 2013. As a percentage of net revenue, research and development expense increased to 40% for the three months ended September 30, 2014 from 21% for the three months ended September 30, 2013 primarily due to higher research and development expense in the current period.

Average headcount in our research and development department increased to 21 in the third quarter of 2014 from 16 in the third quarter of 2013.

Of the \$1.1 million increase in research and development expense for the three months ended September 30, 2014 compared to the same quarter of 2013, \$658,000 related to costs associated with the Company's investment in product development for markets outside of seawater desalination such as oil & gas, \$424,000 related to compensation, employee-related benefits, and occupancy cost, and \$21,000 related to outside consulting and professional fees.

Share-based compensation expense included in research and development expense was \$84,000 and \$50,000 for the three months ended September 30, 2014 and 2013, respectively.

As we continue to advance our existing technologies and develop new energy recovery and efficiency-enhancing solutions for markets outside of seawater desalination such as oil & gas, we anticipate that our research and development expenses will increase in the future.

***Amortization of Intangible Assets***

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. Amortization expense decreased by \$14,000 in the third quarter of 2014 compared to the third quarter of 2013 due to a change in the amortization amount for customer relationships, which applies a variable amortization schedule (in this case, sum-of-the-years-digit).

***Restructuring Charges***

In 2011, we initiated a restructuring plan to consolidate our North American operations and transfer our Michigan-based operations to our manufacturing center and headquarters in San Leandro, California. In connection with this restructuring plan, we classified the land and building located in Michigan as assets held for sale at December 31, 2011. The land and building were sold in September 2013. Net proceeds from the sale totaled \$1.2 million, resulting in a loss on the sale for these assets of \$140,000 recorded in restructuring changes during the three months ended September 30, 2013.

***Non-Operating Income (Expense), Net***

Non-operating income (expense), net, decreased by \$29,000 to expense of \$2,000 in the three months ended September 30, 2014 from income of \$27,000 in the three months ended September 30, 2013. The decrease was primarily due to \$21,000 of higher net foreign currency losses in the third quarter of 2014 compared to the third quarter of 2013 offset by \$8,000 of higher interest income during the same period.

***Income Taxes***

The income tax provision was \$63,000 in the three months ended September 30, 2014 compared to \$36,000 in the three months ended September 30, 2013. The tax provision for the three months ended September 30, 2014 primarily related to the deferred tax effects associated with the amortization of goodwill and state and other taxes. The tax expense for the three months ended September 30, 2013 primarily related to a federal tax to actual provision adjustment, the deferred tax effects associated with the amortization of goodwill, and state and other taxes.

*Nine Months Ended September 30, 2014 Compared to Nine Months Ended September 30, 2013***Results of Operations**

The following table sets forth certain data from our operating results as a percentage of net revenue for the periods indicated (in thousands, except percentages):

|                                           | <b>Nine Months Ended September 30,</b> |       |             |       |                   |        | <b>Change</b>     |  |
|-------------------------------------------|----------------------------------------|-------|-------------|-------|-------------------|--------|-------------------|--|
|                                           | <b>2014</b>                            |       | <b>2013</b> |       | <b>Increase /</b> |        | <b>(Decrease)</b> |  |
| <b>Results of Operations:*</b>            |                                        |       |             |       |                   |        |                   |  |
| Net revenue                               | \$15,646                               | 100 % | \$19,810    | 100 % | \$(4,164)         | (21% ) |                   |  |
| Cost of revenue                           | 7,991                                  | 51 %  | 8,615       | 43 %  | (624 )            | (7% )  |                   |  |
| Gross profit                              | 7,655                                  | 49 %  | 11,195      | 57 %  | (3,540)           | (32% ) |                   |  |
| Operating expenses:                       |                                        |       |             |       |                   |        |                   |  |
| General and administrative                | 8,112                                  | 52 %  | 11,121      | 56 %  | (3,009)           | (27% ) |                   |  |
| Sales and marketing                       | 7,548                                  | 48 %  | 5,607       | 28 %  | 1,941             | 35 %   |                   |  |
| Research and development                  | 5,089                                  | 33 %  | 3,246       | 16 %  | 1,843             | 57 %   |                   |  |
| Amortization of intangible assets         | 646                                    | 4 %   | 691         | 3 %   | (45 )             | (7% )  |                   |  |
| Restructuring charges                     | —                                      | —     | 184         | 1 %   | (184 )            | (100%) |                   |  |
| Total operating expenses                  | 21,395                                 | 137 % | 20,849      | 105 % | 546               | 3 %    |                   |  |
| Loss from operations                      | (13,740)                               | (88%) | (9,654 )    | (49%) | (4,086)           | (42% ) |                   |  |
| Other non-operating income (expense), net | 127                                    | 1 %   | 79          | 0 %   | 48                | 61 %   |                   |  |
| Loss before income taxes                  | (13,613)                               | (87%) | (9,575 )    | (48%) | (4,038)           | (42% ) |                   |  |
| Provision for income taxes                | 187                                    | 1 %   | 258         | 1 %   | (71 )             | (28% ) |                   |  |
| Net loss                                  | \$(13,800)                             | (88%) | \$(9,833 )  | (50%) | \$(3,967)         | (40% ) |                   |  |

\* Percentages may not add up to 100% due to rounding

**Net Revenue**

Our net revenue decreased by \$4.2 million, or 21%, to \$15.6 million for the nine months ended September 30, 2014 from \$19.8 million for the nine months ended September 30, 2013. The decrease was primarily due to lower MPD shipments of \$1.5 million, as the first nine months of 2014 did not include any MPD shipments, and lower OEM shipments of \$4.4 million. The decreases in MPD and OEM shipments were offset by higher aftermarket shipments of

\$1.2 million and revenue attributable to an oil & gas operating lease of \$0.5 million.

Although we operate under one segment, we categorize revenue based on the type of energy recovery device and its related products and services. The following table reflects revenue by product category and as a percentage of total net revenue (in thousands, except percentages):

|                                                         | <b>Nine Months Ended</b> |      |             |      |
|---------------------------------------------------------|--------------------------|------|-------------|------|
|                                                         | <b>September 30,</b>     |      |             |      |
|                                                         | <b>2014</b>              |      | <b>2013</b> |      |
| PX devices and related products and services            | \$8,790                  | 57 % | \$14,253    | 72 % |
| Turbochargers, pumps, and related products and services | 6,321                    | 40 % | 5,557       | 28 % |
| Oil and gas product operating lease                     | 535                      | 3 %  | —           | —    |
| Net revenue                                             | \$15,646                 | 100% | \$19,810    | 100% |

During the nine months ended September 30, 2014 and 2013, a significant portion of our net revenue was attributable to sales outside of the United States. Revenue attributable to domestic and international sales as a percentage of net revenue was as follows:

|                       | <b>Nine</b>      |             |
|-----------------------|------------------|-------------|
|                       | <b>Months</b>    |             |
|                       | <b>ended</b>     |             |
|                       | <b>September</b> |             |
|                       | <b>30,</b>       |             |
|                       | <b>2014</b>      | <b>2013</b> |
| Domestic revenue      | 16 %             | 13 %        |
| International revenue | 84 %             | 87 %        |
| Net revenue           | 100%             | 100 %       |

### ***Gross Profit***

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. For the nine months ended September 30, 2014, gross profit as a percentage of net revenue was 49%. For the nine months ended September 30, 2013, gross profit as a percentage of net revenue was 57%.

The decrease in gross profit as a percentage of net revenue for the nine months ended September 30, 2014 as compared to the same period of last year was primarily due to a large shift in product mix toward turbochargers and pumps and to lower production volume.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, and the volume of production in our manufacturing plant that determines our operating leverage. Accordingly, we are not able to predict our future levels of gross profit margin with certainty. We do believe, however, that the levels of gross profit margin are sustainable to the extent that volume is healthy, our product mix favors PX devices, and we continue to realize cost savings through production efficiencies and enhanced yields.

Manufacturing average headcount decreased to 41 for the first nine months of 2014 from 44 for the first nine months of 2013.

Share-based compensation expense included in cost of revenue was \$75,000 and \$57,000 for the nine months ended September 30, 2014 and 2013, respectively.

### ***General and Administrative Expense***

General and administrative expense decreased by \$3.0 million, or 27%, to \$8.1 million for the nine months ended September 30, 2014 from \$11.1 million for the nine months ended September 30, 2013. As a percentage of net revenue, general and administrative expense decreased to 52% for the nine months ended September 30, 2014 from 56% for the nine months ended September 30, 2013 primarily due to lower general and administrative expense and

lower net revenue in the current period.

General and administrative average headcount decreased to 27 for the first nine months of 2014 from 28 for the first nine months of 2013.

Of the \$3.0 million decrease in general and administrative expense for the nine months ended September 30, 2014 compared to the same period of 2013, \$1.4 million primarily related to compensation and employee-related benefits associated with the redeployment of personnel to oil & gas development and other headcount reductions, \$850,000 related to the reversal of VAT expensed in 2011 and prior for which we subsequently sought recovery and a conclusion was reached by the Spanish authorities during the first quarter of 2014, \$553,000 related to professional fees and other services, primarily related to legal and IT expenses, and \$193,000 related to bad debt expense, occupancy costs, and other administrative costs.

Share-based compensation expense included in general and administrative expense was \$916,000 and \$1.2 million for the nine months ended September 30, 2014 and 2013, respectively.

### *Sales and Marketing Expense*

Sales and marketing expense increased by \$1.9 million, or 35%, to \$7.5 million for the nine months ended September 30, 2014 from \$5.6 million for the nine months ended September 30, 2013. As a percentage of net revenue, sales and marketing expense increased to 48% for the nine months ended September 30, 2014 from 28% for the nine months ended September 30, 2013 primarily due to higher sales and marketing expense and lower net revenue in the current period.

Sales and marketing average headcount increased to 32 for the first nine months of 2014 from 26 in the first nine months of 2013.

Of the \$1.9 million increase in sales and marketing expense for the nine months ended September 30, 2014 compared to the same quarter of 2013, \$1.6 million related to compensation and employee-related benefits associated with the increase in headcount and \$404,000 related to marketing costs associated with trade show participation to further accelerate growth in new markets such as oil & gas. Additionally there was an increase of \$74,000 related to occupancy costs also associated with the increase in headcount. The increases were offset by decreases of \$151,000 related to commissions to sales representatives and other sales and marketing expenses.

Share-based compensation expense included in sales and marketing expense was \$388,000 and \$358,000 for the nine months ended September 30, 2014 and 2013, respectively.

As we continue to pursue new addressable markets such as oil & gas outside of seawater desalination, we anticipate that our sales and marketing expenses will increase in the future.

### ***Research and Development Expense***

Research and development expense increased by \$1.8 million, or 57%, to \$5.1 million for the nine months ended September 30, 2014 from \$3.2 million for the nine months ended September 30, 2013. As a percentage of net revenue, research and development expense increased to 33% for the nine months ended September 30, 2014 from 16% for the nine months ended September 30, 2013 primarily due to higher research and development expense and lower net revenue in the current period.

Research and development average headcount increased to 18 for the first nine months of 2014 compared to 17 in the first nine months of 2013.

Of the \$1.8 million increase in research and development expense for the nine months ended September 30, 2014 compared to the same quarter of 2013, \$1.2 million related to costs associated with the Company's investment in product development for markets outside of seawater desalination such as oil & gas, \$367,000 related to compensation and employee related benefits, \$259,000 related to outside consulting and professional fees, and \$59,000 related to occupancy cost.

Share-based compensation expense included in research and development expense was \$249,000 and \$149,000 for the nine months ended September 30, 2014 and 2013, respectively.

As we continue to advance our existing technologies and develop new energy recovery and efficiency-enhancing solutions for markets outside of seawater desalination such as oil & gas, we anticipate that our research and development expenses will increase in the future.

### ***Amortization of Intangible Assets***

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. Amortization expense decreased by \$45,000, or 7% to \$646,000 in the first nine months of 2014 from \$691,000 for the first nine months of 2013 due to a change in the amortization amount for customer relationships, which applies a variable amortization schedule (in this case, sum-of-the-years-digit).



***Restructuring Charges***

In 2011, we initiated a restructuring plan to consolidate our North American operations and transfer our Michigan-based operations to our manufacturing center and headquarters in San Leandro, California. In connection with this restructuring plan, we classified the land and building located in Michigan as assets held for sale at December 31, 2011. The land and building were sold in September 2013. Net proceeds from the sale totaled \$1.2 million, resulting in a loss on the sale for these assets of \$140,000 recorded in restructuring changes during the nine months ended September 30, 2013. Additional restructuring charges during 2013 included an impairment loss on assets held for sale of \$44,000.

***Non-Operating Income (Expense), Net***

Non-operating income (expense), net, increased by \$48,000 to income of \$127,000 in the nine months ended September 30, 2014 from income of \$79,000 in the nine months ended September 30, 2013. The increase was primarily due to \$120,000 of higher interest income in the first nine months of 2014, primarily related to our VAT tax refund, compared to the first nine months of 2013 offset by a difference of \$72,000 of higher net foreign currency losses during the same period.

***Income Taxes***

The income tax provision was \$187,000 in the nine months ended September 30, 2014 compared to \$258,000 in the nine months ended September 30, 2013. The tax provision for the nine months ended September 30, 2014 primarily relates to the deferred tax effects associated with the amortization of goodwill and state and other taxes. The tax expense for the nine months ended September 30, 2013 primarily related to a federal tax to actual provision adjustment, the deferred tax effects associated with the amortization of goodwill, and state and other taxes.

## Liquidity and Capital Resources

### *Overview*

Our primary source of cash historically has been customer payments for our products and services and proceeds from the issuance of common stock. From January 1, 2005 through September 30, 2014, we issued common stock for aggregate net proceeds of \$85.6 million, excluding common stock issued in exchange for promissory notes. The proceeds from the sales of common stock have been used to fund our operations and capital expenditures.

As of September 30, 2014, our principal sources of liquidity consisted of unrestricted cash and cash equivalents of \$17.4 million that are invested primarily in money market funds; short-term and long-term investments of \$15.1 million that are primarily invested in marketable debt securities; and accounts receivable of \$4.0 million. We invest cash not needed for current operations predominantly in high-quality, investment-grade, and marketable debt instruments with the intent to make such funds available for operating purposes as needed.

We currently have unbilled receivables pertaining to customer contractual holdback provisions, whereby we will invoice the final installment due under a sales contract 16 to 35 months after the product was shipped to the customer and revenue has been recognized. The customer holdbacks represent amounts intended to provide a form of security to the customer; accordingly, these receivables have not been discounted to present value as they provide security to only one party in the agreement. At September 30, 2014 we had \$0.9 million of short- and long-term unbilled receivables.

In 2009, we entered into a loan and security agreement (the “2009 Agreement”) with a financial institution. The 2009 Agreement, as amended, provided a total available credit line of \$16.0 million. Under the 2009 Agreement, we were allowed to draw advances of up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for stand-by letters of credit, provided that the aggregate of the outstanding advances and collateral did not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incurred interest based on a prime rate index or on LIBOR plus 1.375%. The amended 2009 Agreement also required us to maintain a cash collateral balance equal to at least 101% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit and 100% of the amount of all outstanding advances.

During the periods presented, we provided certain customers with stand-by letters of credit to secure our obligations for the delivery and performance of products in accordance with sales arrangements. Some of these stand-by letters of credit were issued under our 2009 Agreement. The stand-by letters of credit generally terminate within 12 to 48 months from issuance. As of September 30, 2014, the amounts outstanding on stand-by letters of credit collateralized under our 2009 Agreement totaled approximately \$2.3 million, and restricted cash related to the stand-by letters of credit issued under the 2009 Agreement was approximately \$2.4 million. All of this \$2.4 million of restricted cash was

classified as current. The 2009 Agreement expired at the end of May 2012, at which time we became required to maintain a cash collateral balance equal to at least 105% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit. There were no advances drawn on the line of credit under the 2009 Agreement at the time of its expiration. The restricted cash related to the outstanding stand-by letters of credit under the 2009 Agreement is expected to be released at various dates through 2015.

In June 2012, we entered into a loan agreement (the "2012 Agreement") with another financial institution. The 2012 Agreement provides for a total available credit line of \$16.0 million. Under the 2012 Agreement, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total stand-by letters of credit issued under the 2012 Agreement may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. At no time may the aggregate of the revolving loans and stand-by letters of credit exceed the total available credit line of \$16.0 million. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate plus 0% or a Eurodollar loan that bears interest equal to the adjusted LIBOR plus 1.25%. Stand-by letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line.

We are subject to certain financial and administrative covenants under the 2012 Agreement. As of September 30, 2014, we were in compliance with these covenants.

The 2012 Agreement requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. The 2012 Agreement matures on June 5, 2015 and is collateralized by substantially all of our assets. As of September 30, 2014 there were no advances drawn under the 2012 Agreement's line of credit. The amounts outstanding on stand-by letters of credit collateralized under the 2012 Agreement totaled approximately \$2.7 million, and restricted cash related to the stand-by letters of credit issued under the 2012 Agreement was approximately \$2.7 million as of September 30, 2014. Of this \$2.7 million of restricted cash, \$0.6 million was classified as current and \$2.1 million was classified as non-current.

In 2012, our company credit card vendor required us to restrict cash for outstanding credit card balances. Accordingly, we have restricted \$315,000 of cash for credit card balances at September 30, 2014, all of which was classified as current.

### ***Cash Flows from Operating Activities***

Net cash (used in) provided by operating activities were \$(1.6) million and \$2.7 million for the nine months ended September 30, 2014 and 2013, respectively. For the nine months ended September 30, 2014, a net loss of \$(13.8) million was adjusted to \$(8.2) million by non-cash items totaling \$5.6 million. For the nine months ended September 30, 2013, the net loss of \$(9.8) million was adjusted to \$(4.3) million by non-cash items totaling \$5.5 million. Non-cash adjustments during the nine months ended September 30, 2014, primarily include depreciation and amortization of \$3.0 million, share-based compensation of \$1.6 million, amortization of premiums/discounts on investments of \$0.3 million, and provisions for doubtful accounts of \$0.3 million.

The net cash impact from changes in assets and liabilities was approximately \$6.6 million and \$7.0 for the nine months ended September 30, 2014 and 2013, respectively. Net changes in assets and liabilities during the nine months ended September 30, 2014 are primarily attributable to a decrease of \$16.6 million in accounts receivable and unbilled receivables as a result of the timing of invoices and collections for large projects that were shipped in the fourth quarter of 2013. This change was offset by an increase in inventory of \$5.5 million as a result of inventory buildup for future shipments, a decrease in accrued expenses and other liabilities of \$2.3 million as a result of a VAT settlement in Spain and the timing of payments to employees, vendors, and other third parties, a decrease in the fair value of our contingent consideration of \$1.5 million due to the settlement of the litigation related to it, and an increase of \$1.0 million in prepaid expenses.

### ***Cash Flows from Investing Activities***

Cash flows provided by (used in) investing activities primarily relate to maturities of investments in marketable securities and the release of restricted cash offset by capital expenditures to support our growth and additional investments in marketable securities.

Net cash provided by (used in) investing activities was \$5.1 million and \$(4.0) million for the nine months ended September 30, 2014 and 2013, respectively. Cash flows provided by investing activities for the nine months ended September 30, 2014 was primarily due to the maturity of marketable securities of \$4.4 million and the release of \$3.3 million of restricted cash mostly due to the settlement of a litigation case. These sources of cash provided by investing activities were offset by \$2.3 million of additions to property and equipment and the purchase of \$.3 million of marketable securities.

### ***Cash Flows from Financing Activities***

Net cash (used in) provided by financing activities was (\$468,000) and \$407,000 for the nine months ended September 30, 2014 and 2013, respectively. Net cash used in financing activities for the nine months ended September 30, 2014 was the result of \$1.6 million used to repurchase the Company common stock for treasury offset by \$1.2 million received for the issuance of common stock due to option and warrant exercises

### ***Liquidity and Capital Resource Requirements***

We believe that our existing cash balances and cash generated from operations will be sufficient to meet our anticipated capital requirements for at least the next twelve months. However, we may need to raise additional capital or incur additional indebtedness to continue to fund our operations or to support acquisitions in the future. Our future capital requirements will depend on many factors, including our rate of revenue growth, if any, the expansion of our sales and marketing and research and development activities, the amount and timing of cash used for stock repurchases, the timing and extent of our expansion into new geographic territories, the timing of new product introductions, and the continuing market acceptance of our products. We may enter into potential material investments in, or acquisitions of, complementary businesses, services, or technologies in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

### **Contractual Obligations**

We lease facilities under fixed non-cancellable operating leases that expire on various dates through 2019. The total of the future minimum lease payments under these leases as of September 30, 2014 was \$8.1 million. For additional information, see Note 9 — “Commitments and Contingencies” to the unaudited condensed consolidated financial statements.

In the course of our normal operations, we also enter into purchase commitments with our suppliers for various raw materials and components parts. The purchase commitments covered by these arrangements are subject to change based on sales forecasts for future deliveries. As of September 30, 2014, we had approximately \$1.8 million of cancellable open purchase order arrangements related primarily to materials and parts.

We have agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of September 30, 2014, we believe that our exposure related to these guarantees and indemnities was not material.

### **Off-Balance Sheet Arrangements**

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships such as entities often referred to as structured finance or special purpose entities that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

### **Recent Accounting Pronouncements**

See Note 1 — “The Company and Summary of Significant Accounting Policies” to the condensed consolidated financial statements regarding the impact of certain recent accounting pronouncements on our condensed consolidated financial statements.

### **Item 3. Quantitative and Qualitative Disclosure About Market Risk**

The information in this section should be read in connection with the information on financial market risk related to changes in currency exchange rates and interest rates in Part II, Item 7A, “Quantitative and Qualitative Disclosure About Market Risk,” in our Annual Report on Form 10-K for the year ended December 31, 2013.

#### ***Foreign Currency Risk***

The majority of our revenue contracts have been denominated in United States Dollars. In some circumstances, we have priced certain international sales in Euros.

As we expand our international sales, we expect that a portion of our net revenue could continue to be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in exchange rates. Our international sales and marketing operations incur expenses that are denominated in foreign currencies. These expenses could be materially affected by currency fluctuations. Our exposures are to fluctuations in exchange rates for the United States Dollar versus the Euro, United Arab Emirates Dirham, and Chinese Yuan. Changes in currency exchange rates could adversely affect our consolidated operating results or financial position. Additionally, our international sales and marketing operations maintain cash balances denominated in foreign currencies. To decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we have not maintained excess cash balances in foreign currencies. We have not hedged our exposure to changes in foreign currency exchange rates because expenses and cash balances in foreign currencies have been insignificant to date and exchange rate fluctuations have had little impact on our operating results and cash flows.

### ***Interest Rate Risk***

We have an investment portfolio of fixed income marketable debt securities, including amounts classified as cash equivalents, short-term investments, and long-term investments. At September 30, 2014, our short- and long-term investments totaled \$15.1 million. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. We invest primarily in high-quality, short-term and long-term debt instruments of the U.S. government and its agencies as well as high-quality corporate issuers. These investments are subject to interest rate fluctuations and will decrease in market value if interest rates increase. To minimize the exposure due to adverse shifts in interest rates, we maintain investments with an average maturity of less than eighteen months. A hypothetical 1% increase in interest rates would have resulted in an approximately \$99,000 decrease in the fair value of our fixed-income debt securities as of September 30, 2014.

### ***Concentration of Credit Rate Risk***

Our investments in marketable debt securities are subject to potential loss of value due to counterparty credit risk. To minimize this risk, we invest pursuant to a Board-approved investment policy. The policy mandates high-credit-rating requirements and restricts our exposure to any single corporate issuer or sector by imposing concentration limits.

#### **Item 4. Controls and Procedures.**

(a) *Evaluation of disclosure controls and procedures.* Under the supervision and with the participation of our management, including the President and Chief Executive Officer and the Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 as of the end of the period covered by this report.

Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that these disclosure controls and procedures are effective.

(b) *Changes in internal controls.* There were no changes in our internal control over financial reporting during the quarter ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II — OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

Note 9 – “Commitments and Contingencies”, under the caption “Litigation” of our Annual Report on Form 10-K filed with the SEC on March 11, 2014, provides information on certain litigation in which we are involved.

For an update on the litigation matters previously disclosed in our Form 10-K, see Note 9 – “Commitments and Contingencies”, under the caption “Litigation” of this quarterly report on Form 10-Q.

#### **Item 1A. Risk Factors**



There has been no material changes in our risk factors from those disclosed in Part I, Item 1A, in our Annual Report on Form 10-K filed on March 11, 2014.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds***Purchases of Equity Securities by the Issuer and Affiliated Purchasers*

The following table summarizes the stock repurchase activity during the three months ended September 30, 2014:

| <b>Period</b> |              |                       | <b>Total<br/>Number of<br/>Shares<br/>Purchased</b> | <b>Average<br/>Price Paid<br/>per Share</b> | <b>Total<br/>Number of<br/>Shares<br/>Purchased<br/>as Part of<br/>Publicly<br/>Announced<br/>Program</b> | <b>Maximum<br/>Number of<br/>Shares<br/>That May Yet<br/>be<br/>Purchased<br/>Under<br/>the Program</b> |
|---------------|--------------|-----------------------|-----------------------------------------------------|---------------------------------------------|-----------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------|
| July 1        | —            | July 31, 2014         | —                                                   | —                                           | —                                                                                                         | —                                                                                                       |
| August 1      | —            | August 31,<br>2014    | 45,500                                              | \$ 3.9631                                   | 45,500                                                                                                    | <b>2,839,200</b>                                                                                        |
| September 1   | —            | September 31,<br>2014 | 206,800                                             | \$ 3.9635                                   | 206,800                                                                                                   | <b>2,632,400</b>                                                                                        |
|               | <b>Total</b> |                       | <b>252,300</b>                                      | <b>\$ 3.9634</b>                            | <b>252,300</b>                                                                                            | <b>2,632,400</b>                                                                                        |

In February 2014, our Board of Directors authorized a stock repurchase program under which up to three million shares, not to exceed \$6.0 million in aggregate cost, of our outstanding common stock could be repurchased through December 31, 2014 at the discretion of management.

**Item 6. Exhibits**

| <b><u>Exhibit<br/>No.</u></b> | <b><u>Description</u></b>       |
|-------------------------------|---------------------------------|
| 10.1                          | Radakovich Settlement Agreement |

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- 10.2 Offer Letter of Employment to Mr. David Barnes, Chief Sales Officer dated September 22, 2014
- 31.1 Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002
- 31.2 Certification of Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002
- 32.1 Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

**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.

Registrant: Energy Recovery, Inc.

By: /s/ THOMAS S. ROONEY, JR.      President and Chief Executive Officer      November 10, 2014  
    **Thomas S. Rooney, Jr.**                      (Principal Executive Officer)

/s/ JOEL GAY                                      Chief Financial Officer                      November 10, 2014  
**Joel Gay**                                          (Principal Financial Officer)

**Exhibit List**

| <b><u>Exhibit No.</u></b> | <b><u>Description</u></b>                                                                                                                                                      |
|---------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1                      | Radakovich Settlement Agreement                                                                                                                                                |
| 10.2                      | Offer Letter of Employment to Mr. David Barnes, Chief Sales Officer dated September 22, 2014                                                                                   |
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| 101.INS                   | XBRL Instance Document                                                                                                                                                         |
| 101.SCH                   | XBRL Taxonomy Extension Schema Document                                                                                                                                        |
| 101.CAL                   | XBRL Taxonomy Extension Calculation Linkbase Document                                                                                                                          |
| 101.DEF                   | XBRL Taxonomy Extension Definition Linkbase Document                                                                                                                           |
| 101.LAB                   | XBRL Taxonomy Extension Label Linkbase Document                                                                                                                                |
| 101.PRE                   | XBRL Taxonomy Extension Presentation Linkbase Document                                                                                                                         |