Energy Recovery, Inc.
Form 10-Q
November 03, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2017
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________ to __________

Commission File Number: 001-34112
Energy Recovery, Inc.
(Exact name of registrant as specified in its charter)

Delaware	01-0616867
(State or other jurisdiction of incorporation)	(IRS Employer Identification No.)
1717 Doolittle Drive, San Leandro, CA	94577
(Address of Principal Executive Offices)	(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 x 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 x No

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

Large accelerated filer	o		Accelerated filer	x
Non-accelerated filer	o	(Do not check if a smaller reporting company)	Smaller reporting company	o
Emerging growth company	o			

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of October 31, 2017, there were 53,595,035 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.
QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2017
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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)

	September 30, 2017	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$ 19,245	$ 61,364
Restricted cash	2,908	2,297
Short-term investments	72,241	39,073
Accounts receivable, net of allowance for doubtful accounts of $96 and $130 at September 30, 2017 and December 31, 2016, respectively	11,929	11,759
Unbilled receivables, current	573	190
Cost and estimated earnings in excess of billings	4,453	1,825
Inventories	6,283	4,550
Prepaid expenses and other current assets	1,663	1,311
Total current assets	119,295	122,369
Restricted cash, non-current	182	2,087
Deferred tax assets, non-current	1,711	1,270
Property and equipment, net of accumulated depreciation of $23,352 and $21,385 at September 30, 2017 and December 31, 2016, respectively	13,632	8,643
Goodwill	12,790	12,790
Other intangible assets, net	1,427	1,900
Other assets, non-current	2	4
Total assets	$ 149,039	$ 149,063
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,336	$ 1,505
Accrued expenses and other current liabilities	7,657	9,019
Income taxes payable	142	16
Accrued warranty reserve	314	406
Deferred revenue	6,230	6,201
Current portion of long-term debt	11	11
Total current liabilities	17,690	17,158
Long-term debt, net of current portion	19	27
Deferred tax liabilities, non-current	2,428	2,233
Deferred revenue, non-current	60,223	63,958
Other non-current liabilities	411	554
Total liabilities	80,771	83,930
Commitments and Contingencies (Note 9)		
Stockholders' equity:		
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; 57,855,263 shares issued and 53,592,430 shares outstanding at September 30, 2017, and 56,884,207 shares issued and 53,162,551, shares outstanding at December 31, 2016	58	57

Additional paid-in capital	146,320		139,676	
Accumulated other comprehensive loss	(77	)	(118	)
Treasury stock, at cost, 4,262,833 repurchased at September 30, 2017 and 3,721,656 repurchased at December 31, 2016	(20,486	)	(16,210	)
Accumulated deficit	(57,547	)	(58,272	)
Total stockholders' equity	68,268		65,133	
Total liabilities and stockholders' equity	$ 149,039		$ 149,063	

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Product revenue	$13,834	$11,024	$37,017	$33,048
Product cost of revenue	4,254	3,968	12,394	11,878
Product gross profit	9,580	7,056	24,623	21,170
License and development revenue	1,250	1,250	3,750	3,750
Operating expenses:				
General and administrative	4,034	3,971	12,369	12,847
Sales and marketing	2,061	2,512	6,688	6,517
Research and development	3,038	2,319	8,624	7,406
Amortization of intangible assets	157	158	473	473
Total operating expenses	9,290	8,960	28,154	27,243
Income (loss) from operations	1,540	(654)	219	(2,323)
Other (expense) income:				
Interest expense	(1)	(1)	(2)	(2)
Other non-operating income	233	79	462	137
Income (loss) before income taxes	1,772	(576)	679	(2,188)
Provision for (benefit from) income taxes	66	3	(46)	(99)
Net income (loss)	$1,706	$(579)	$725	$(2,089)
Basic net income (loss) per share	$0.03	$(0.01)	$0.01	$(0.04)
Diluted net income (loss) per share	$0.03	$(0.01)	$0.01	$(0.04)
Shares used in basic per share calculation	53,580	52,106	53,717	52,227
Shares used in diluted per share calculation	55,140	52,106	55,571	52,227

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net income (loss)	$1,706	$(579)	$725	$(2,089)
Other comprehensive income (loss), net of tax				
Foreign currency translation adjustments	13	5	48	(1)
Unrealized (loss) income on investments	(3)	5	(7)	(26)
Other comprehensive income (loss)	10	10	41	(27)
Comprehensive income (loss)	$1,716	$(569)	$766	$(2,116)

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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

	Nine Months Ended September 30,	
	2017	2016
Cash Flows From Operating Activities		
Net income (loss)	$725	$(2,089)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Share-based compensation	3,136	2,640
Depreciation and amortization	2,704	2,771
Amortization of premiums on investments	379	94
Provision for warranty claims	145	134
Unrealized loss on foreign currency transactions	69	65
Provision for doubtful accounts	16	68
Change in fair value of put options	—	33
Other non-cash adjustments	(145)	(120)
Valuation adjustments for excess or obsolete inventory	(230)	(175)
Reversal of accruals related to expired warranties	(237)	(201)
Deferred income taxes	(244)	(270)
Changes in operating assets and liabilities:		
Accounts payable	1,831	(69)
Income taxes payable	126	135
Deferred revenue, product	81	557
Accounts receivable	(186)	3,330
Prepaid and other assets	(350)	(598)
Unbilled receivables	(383)	971
Inventories	(1,503)	839
Accrued expenses and other liabilities	(1,728)	(1,598)
Cost and estimated earnings in excess of billings	(2,628)	(440)
Deferred revenue, license and development	(3,750)	(3,750)
Net cash (used in) provided by operating activities	(2,172)	2,327
Cash Flows From Investing Activities		
Maturities of marketable securities	30,977	1,000
Restricted cash	1,294	(15)
Capital expenditures	(6,843)	(900)
Purchases of marketable securities	(64,530)	(15,912)
Net cash used in investing activities	(39,102)	(15,827)
Cash Flows From Financing Activities		
Net proceeds from issuance of common stock	3,722	3,708
Repayment of long-term debt	(8)	(7)
Tax payment for employee shares withheld	(228)	—
Repurchase of common stock	(4,276)	(9,375)
Net cash used in financing activities	(790)	(5,674)
Effect of exchange rate differences on cash and cash equivalents	(55)	(66)
Net change in cash and cash equivalents	(42,119)	(19,240)
Cash and cash equivalents, beginning of period	61,364	99,931

Cash and cash equivalents, end of period	$19,245	$80,691

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,” “our,” “us,” and “we”) is an energy solutions provider to industria fluid flow markets worldwide. Our core competencies are fluid dynamics and advanced material science. Our products make industrial processes more operationally and capital expenditure efficient. Our solutions convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. Our solutions are marketed and sold in fluid flow markets, such as water, oil & gas, and chemical processing, under the trademarks ERI®, PX®, Pressure Exchanger®, PX Pressure Exchanger®, VorTeq™, MTeq™, IsoBoost®, IsoGen®, AT™, and AquaBold™. We own, manufacture, and/or develop our solutions, in whole or in part, in the United States of America, (“U.S.”) and the Republic of Ireland.
Use of Estimates
The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”) requires our management to make judgments, assumptions, and estimates that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. The accounting policies that reflect our more significant estimates and judgments and that we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition; capitalization of research and development assets; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill 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. Those estimates could change, and as a result, 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 GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2016 condensed consolidated balance sheet was derived from audited financial statements, and may not include all disclosures required by GAAP; however, we believe that the disclosures are adequate to make the information presented not misleading. The September 30, 2017 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, 2016 included in our Annual Report on Form 10-K filed with the SEC on March 10, 2017.
In the opinion of management, all adjustments, consisting of 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.
Recent Accounting Pronouncements
Recently issued accounting pronouncement not yet adopted
In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The update 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 and will replace most existing revenue recognition guidance in GAAP when it becomes effective. The update also requires more detailed disclosures to enable readers of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. ASU 2014-09 was originally effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. On July

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9, 2015, the FASB voted to approve a one-year deferral of the effective date of ASU 2014-09. Additionally, the FASB decided to permit early adoption, but not before the original effective date (that is, annual periods beginning after December 15, 2016). ASU 2014-09 permits the use of either the full retrospective or cumulative effect transition (modified retrospective) method.

In March and April 2016, the FASB issued ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) and ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606) Identifying Performance Obligations and Licensing, respectively. The amendments in these updates are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations and to clarify two aspects of Topic 606: identifying performance obligations and the licensing implementation guidance, while retaining the related principles for those areas. The effective date and transition requirements for both ASU 2016-08 and ASU 2016-10 are the same as those for ASU 2014-09 as deferred.

To assess the impact of and to implement Topic 606, the Company formed a project team, which has operated since 2014, to evaluate internal processes. We plan to adopt Topic 606 as of January 1, 2018 using the full retrospective transition method. We continue to evaluate the effect that ASU 2014-09 will have on our financial statements and related disclosures. For revenue streams related to water desalination products, we do not expect the impact to be material based on our analysis performed to date; however, we are continuing to assess. For transactions accounted for under the percentage-of-completion method, we are still assessing whether these contracts may be accounted for over time under the new revenue standard. For license and development revenue, there may be a material difference in the timing of revenue recognition under the new standard, with the most likely impact being an overall acceleration of the recognition of deferred revenue, since under existing guidance revenue is recognized on a straight-line basis over the fifteen-year term of the license. At this time, we are still performing our analysis and we will continue to assess the impact on our revenue streams in 2017.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 modifies certain aspects of the recognition, measurement, presentation, and disclosure of financial instruments. For public entities, ASU 2016-01 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, and early adoption is permitted. We do not expect the adoption of this standard to have a material impact on our financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). ASU 2016-02 impacts any entity that enters into a lease with some specified scope exceptions. The guidance updates and supersedes Topic 840, Leases. For public entities, ASU 2016-02 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. We continue to determine the impact of this guidance on our financial statements; as a lessee, we expect a material impact on the balance sheet to reflect the impact of operating leases and no material impact on the income statement. We plan to early adopt this standard on January 1, 2018.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 impacts all entities that are required to present a statement of cash flows under Topic 230. The amendment provides guidance on eight specific cash flow issues. For public entities, ASU 2016-15 is effective for fiscal periods beginning after December 15, 2017 and interim periods within those years. Early adoption is permitted and should be applied using a retrospective transition method to each period presented. We plan to adopt this standard on January 1, 2018. We do not expect the adoption of this standard to have a material impact on our financial statements.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory. ASU 2016-16 requires recognition of the current and deferred income tax effects of an intra-entity asset transfer, other than inventory, when the transfer occurs, as opposed to current GAAP, which requires companies to defer the income tax effects of intra-entity asset transfers until the asset has been sold to an outside party. The income tax effects of intra-entity inventory transfers will continue to be deferred until the inventory is sold. ASU 2016-16 is effective on January 1, 2018, with early adoption permitted. The update is required to be adopted on a modified retrospective basis with the cumulative-effect adjustment recorded to retained earnings as of the beginning

of the period of adoption. We plan to adopt this standard on January 1, 2018. We do not expect the adoption of this standard to have a material impact on our financial statements.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash. ASU 2016-18 is intended to reduce diversity in practice in the classification and presentation of changes in restricted cash on the Consolidated Statement of Cash Flows. ASU 2016-18 requires that the Consolidated Statement of Cash Flows explain the change in total cash and equivalents and amounts generally described as restricted cash or restricted cash equivalents when reconciling the beginning-of-period and end-of-period total amounts. The standard also requires reconciliation between the total cash and equivalents and restricted cash presented on the Consolidated Statement of Cash Flows and the cash and cash

equivalents balance presented on the Consolidated Balance Sheet. ASU 2016-18 is effective retrospectively on January 1, 2018, with early adoption permitted. We plan to adopt this standard on January 1, 2018. We do not expect the adoption of this standard to have a material impact on our financial position or results of operations.
In January 2017, the FASB issued ASU No. 2017-04, Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. ASU 2017-04 eliminates Step 2 of the goodwill impairment quantitative test and allows for the determination of impairment by comparing the fair value of the reporting unit with its carrying amount. The amendments in this updates should be applied on a prospective basis. For public entities which are SEC filers, this amendment is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for testing dates after January 1, 2017. We expect to adopt this standard January 1, 2020 and do not expect the adoption of this standard to have a material impact on our financial statements.
In May 2017, the FASB issued ASU No. 2017-09, Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting. ASU 2017-09 provides guidance about which changes to the terms or conditions of a share-base payment award require an entity to apply modification accounting under Topic 718. ASU 2017-09 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. We plan to adopt this standard on January 1, 2018. We do not expect the adoption of this standard to have a material impact on our financial position or results of operations.
Recently adopted accounting pronouncement
In March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. ASU 2016-09 requires excess tax benefits and tax deficiencies (the difference between the deduction for tax purposes and the compensation cost recognized for financial reporting purposes) be recognized as income tax expense or benefit in the income statement. Previously, these amounts were recognized directly to shareholder’s equity. The excess tax benefit from share-based compensation, previously classified as a financing activity, will be classified as an operating activity. Additionally, cash paid when directly withholding shares on an employee’s behalf for tax withholding purposes, is classified as a financing activity. For public entities, ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. We adopted this guidance effective January 1, 2017. The adoption resulted in an increase to the net operating loss carryforward deferred tax asset and a corresponding increase in valuation allowance of $6.9 million attributable to excess tax benefits not previously recognized as they did not reduce income taxes payable. We elected to continue to estimate forfeitures as part of the recognition of cost associated with equity awards. We applied prospectively all excess tax benefits and tax deficiencies resulting from settlement of awards after the date of adoption. No adjustments were recorded for any windfall benefits previously recorded in additional paid-in capital. We withheld shares valued at $0.2 million for tax withholding purposes for the nine months ended September 30, 2017 and reflected this in the cash flow statement as a financing activity.

Note 2 - Goodwill and Other Intangible Assets
Goodwill was $12.8 million as of September 30, 2017 and December 31, 2016, which was the result of our acquisition of Pump Engineering, LLC in December 2009. In July 2015 with the adoption of a new organizational and reporting structure based on our operating segments, Water and Oil & Gas, we changed the measurement date of our annual goodwill impairment test from December to July. As a result, we completed the required annual testing of goodwill for impairment for all reporting units as of July 1, 2017 and determined that goodwill was not impaired.
During the three and nine months ended September 30, 2017, there were no changes in the recognized amount of goodwill, and there has been no impairment of goodwill to date.

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

	September 30, 2017			
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount
Developed technology	$6,100	$ (4,778)	$ —	$ 1,322
Non-compete agreements	1,310	(1,310)	—	—
Backlog	1,300	(1,300)	—	—
Trademarks	1,200	(180)	(1,020)	—
Customer relationships	990	(990)	—	—
Patents	585	(438)	(42)	105
Total	$11,485	$ (8,996)	$ (1,062)	$ 1,427

	December 31, 2016			
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount
Developed technology	$6,100	$ (4,321)	$ —	$ 1,779
Non-compete agreements	1,310	(1,310)	—	—
Backlog	1,300	(1,300)	—	—
Trademarks	1,200	(180)	(1,020)	—
Customer relationships	990	(990)	—	—
Patents	585	(422)	(42)	121
Total	$11,485	$ (8,523)	$ (1,062)	$ 1,900

Accumulated impairment losses at September 30, 2017 and December 31, 2016 include impairment charges for trademarks in 2012 and impairment charges for patents in 2007 and 2010.

Note 3 - Income (loss) per Share

Basic and diluted net income (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 income (loss) per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Numerator:				
Net income (loss)	$1,706	$(579)	$725	$(2,089)
Denominator:				
Basic weighted average common shares outstanding	53,580	52,106	53,717	52,227
Weighted average effect of dilutive stock awards	1,560	—	1,854	—
Diluted weighted average common shares outstanding	55,140	52,106	55,571	52,227
Basic net income (loss) per share	$0.03	$(0.01)	$0.01	$(0.04)
Diluted net income (loss) per share	$0.03	$(0.01)	$0.01	$(0.04)

The following potential common shares were excluded from the computation of diluted income (loss) per share because their effect would have been anti-dilutive (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Stock options	3,858	6,938	3,565	6,938
Restricted stock units	286	214	285	214

Note 4 - Other Financial Information

Restricted Cash

We have pledged cash in connection with certain stand-by letters of credit and company credit cards. We have deposited corresponding amounts into accounts at several financial institutions for these items as follows (in thousands):

	September 30, 2017	December 31, 2016
Collateral for stand-by letters of credit	$ 2,908	$ 2,297
Current restricted cash	$ 2,908	$ 2,297
Collateral for credit cards	$ 85	$ —
Collateral for stand-by letters of credit	97	2,087
Non-current restricted cash	$ 182	$ 2,087
Total restricted cash	$ 3,090	$ 4,384

Inventories

Our inventories are stated at the lower of cost (using the first-in, first-out method) or market and consisted of the following (in thousands):

	September 30, 2017	December 31, 2016
Raw materials	$ 2,034	$ 1,783
Work in process	1,483	1,146
Finished goods	2,766	1,621
Inventories, net	$ 6,283	$ 4,550

Prepaid and Other Current Assets

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

	September 30, 2017	December 31, 2016
Supplier advances	$ 188	$ 73
Interest receivable	388	272
Other prepaid expenses and current assets	1,087	966
Total prepaid expenses and other current assets	$ 1,663	$ 1,311

Accrued Expenses and Other Current Liabilities

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

	September 30, 2017	December 31, 2016
Unbilled project costs	1,556	1,069
Other accrued expenses and current liabilities	2,035	2,253
Payroll and commissions payable	4,066	5,697
Total accrued expenses and other current liabilities	$ 7,657	$ 9,019

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss for the nine months ended September 30, 2017, were as follows (in thousands):

	Foreign Currency Translation Adjustments Net of Tax Benefit	Unrealized Losses on Investments	Total Accumulated Other Comprehensive Loss
Balance, December 31, 2016	$ (90)	$ (28)	$ (118)
Net other comprehensive income (loss)	48	(7)	41
Balance, September 30, 2017	$ (42)	$ (35)	$ (77)

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 loss during the quarter. The tax impact of the changes in accumulated other comprehensive loss was not material.

Note 5 - Investments

Our short-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, 2017.

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

	September 30, 2017			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Corporate notes and bonds	$72,276	$ 59	$ (94)	$72,241
Total short-term investments	$72,276	$ 59	$ (94)	$72,241

	December 31, 2016			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Corporate notes and bonds	$39,100	$ 6	$ (33)	$39,073
Total short-term investments	$39,100	$ 6	$ (33)	$39,073

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):

	September 30, 2017					
	Less than 12 months		12 months or greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate notes and bonds	$57,393	$ (94)	$ —	$ —	$57,393	$ (94)
Total	$57,393	$ (94)	$ —	$ —	$57,393	$ (94)

	December 31, 2016					
	Less than 12 months		12 months or greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate notes and bonds	$29,667	$ (33)	$ —	$ —	$29,667	$ (33)
Total	$29,667	$ (33)	$ —	$ —	$29,667	$ (33)

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, 2017 are shown below by contractual maturity (in thousands):

	September 30, 2017	
	Amortized Cost	Fair Value
Due in one year or less	$72,276	$72,241
Total	$72,276	$72,241

Note 6 - Long-Term Debt and Line of Credit

Debt

In March 2015, we entered into a loan agreement with a financial institution for a $55,000 fixed-rate installment loan carrying an annual interest rate of 6.35%. The loan is payable in equal monthly installments and matures on April 2, 2020. The note is secured by the asset purchased.

Long-term debt consisted of the following (in thousands):

	September 30, 2017	December 31, 2016
Loan payable	$ 30	$ 38
Less: current portion	(11)	(11)
Total long-term debt	$ 19	$ 27

Future minimum principal payments due under long-term debt arrangements consist of the following (in thousands):

	September 30, 2017
2017 (remaining three months)	$ 3
2018	11
2019	12
2020	4
Total debt	$ 30

Line of Credit

In June 2012, we entered into a loan agreement with a financial institution (“Financial Institution 1”). The loan agreement was amended in June 2015, (as amended, the “Loan Agreement”). The Loan Agreement provided for a total available credit line of $16.0 million. Under the Loan Agreement, we were allowed to draw advances not to exceed the lesser of the $16 million credit line or the credit line minus all outstanding revolving loans. Revolving loans could be in the form of a base rate loan that bore interest equal to the prime rate or a Eurodollar loan that bore interest equal to the adjusted LIBOR rate plus 1.25%. Stand-by letters of credit were subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility was subject to a facility fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line. The Loan Agreement also required 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. This Loan Agreement was terminated on January 24, 2017. With the termination of the Loan Agreement, the cash collateral requirement was increased to 105% on all stand-by letters of credit and all corporate credit cards outstanding at termination. At December 31, 2016, there were no advances drawn under the Loan Agreement.

Stand-by letters of credit collateralized by restricted cash at Financial Institution 1 totaled $1.9 million and $3.1 million as of September 30, 2017 and December 31, 2016, respectively. Restricted cash related to stand-by letters of credit at Financial Institution 1 totaled $2.0 million and $3.1 million as of September 30, 2017 and December 31, 2016, respectively.

On January 27, 2017, we entered into a loan and pledge agreement (the “Loan and Pledge Agreement”) with another financial institution (“Financial Institution 2”). The Loan and Pledge Agreement provides for a committed revolving credit line of $16.0 million and an uncommitted revolving credit line of $4.0 million. Under the Loan and Pledge Agreement we are allowed to borrow and request letters of credit against the eligible assets held from time to time in the pledged account maintained with the financial institution. Stand-by letters of credit are secured by pledged U.S. investments and there is no cash collateral balance required. Stand-by letters of credit are subject to fees, in an amount equal to 0.7% per annum of the face amount of the letter of credit, that are payable quarterly and are non-refundable. Revolving loans incur interest per annum at a base rate equal to the LIBOR rate plus 1.5%. Any default bears the aforementioned interest rate plus an additional 2%. The unused portion of the credit line is subject to a fee equal to the product of 0.2% per annum multiplied by the difference, if positive, between $16.0 million and the average daily balance of all advances under the committed facility plus aggregate average daily undrawn amounts of all letters of credit issued under the committed facility during the immediately preceding month or portion thereof. The Loan and Pledge Agreement was amended on March 17, 2017 to increase the amount of allowable stand-by letters of credit held with other financial institutions from $4.1 million to $5.1 million.

At September 30, 2017 and December 31, 2016, we had stand-by letters of credit at Financial Institution 2 totaling $5.5 million and $0.3 million, respectively. Restricted cash related to stand-by letters of credit at Financial Institution 2 totaled $0 and $0.3 million at September 30, 2017 and December 31, 2016, respectively.

At September 30, 2017 and December 31, 2016, we also had stand-by letters of credit collateralized by restricted cash at another financial institution (“Financial Institution 3”) totaling $1.0 million and $1.0 million, respectively. Restricted cash related to stand-by letters of credit at Financial Institution 3 totaled $1.0 million and $1.0 million as of September 30, 2017 and December 31, 2016, respectively.

At September 30, 2017 and December 31, 2016, total stand-by letters of credit at all financing institutions totaled $8.4 million and $4.4 million, respectively. Restricted cash related to all stand-by letters of credit at September 30, 2017 and December 31, 2016 totaled $3.0 million and $4.4 million, respectively.

Note 7 - Equity

Stock Repurchase Program

In March 2017, our Board of Directors authorized a stock repurchase program under which the Company, at the discretion of management, could repurchase up to $15.0 million in aggregate cost of our outstanding common stock through September 30, 2017. This authorization has expired. As of September 30, 2017, 541,177 shares, at an aggregate cost of $4.3 million had been repurchased under the authorization. We account for stock repurchases using the cost method. Cost includes fees charged in connection with acquiring the outstanding common stock.

In January 2016, our Board of Directors authorized a stock repurchase program under which the Company, at the discretion of management, could repurchase up to $6.0 million in aggregate cost of our outstanding common stock through June 30, 2016 (the “January Authorization”). In May 2016, our Board of Directors rescinded the January Authorization and authorized a new stock repurchase program under which the Company, at the discretion of management, could repurchase up to $10.0 million in aggregate cost of our outstanding common stock through October 31, 2016 (the “May Authorization”). At December 31, 2016, 673,700 shares, at an aggregate cost of $4.1 million, had been repurchased under the January Authorization and 568,500 shares, at an aggregate cost of $5.3 million, had been repurchased under the May Authorization. The May Authorization expired in October 2016.

Share-Based Compensation Expense

For the three and nine months ended September 30, 2017 and 2016, we recognized share-based compensation expense related to employees as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Cost of revenue	$41	$16	$117	$78
General and administrative	580	378	1,698	1,635
Sales and marketing	191	218	628	502
Research and development	204	163	693	425
Total share-based compensation expense	$1,016	$775	$3,136	$2,640

Stock Option Plan

In June 2016, our stockholders approved the 2016 Incentive Plan (the "Plan"), that permits the grant of stock options, stock appreciation rights ("SARs"), restricted stock ("RS" or "RSA"), restricted stock units ("RSUs"), performance units, performance shares, and other stock-based awards to employees, officers, directors, and consultants. Prior to the approval of the Plan, we maintained the Amended and Restated 2008 Equity Incentive Plan (the "Prior Plan"). Stock-based awards granted under the Plan and the Prior Plan, generally vest over four years and expire no more than ten years after the date of grant. Subject to adjustments, as provided in the Plan, the number of shares of common stock initially authorized for issuance under the Plan was 4,441,083 (which consist of 3,830,000 new shares plus 611,083 shares that were authorized and unissued under the Prior Plan) plus up to 7,635,410 shares that were set aside for awards granted under the Prior Plan that were subsequently forfeited. The Plan supersedes all previously issued stock incentive plans (including the Prior Plan) and is currently the only available plan from which equity awards may be granted.

Stock Option Activity

The following table summarizes the stock option activity under the Plan and includes options granted under all previous plans.

	Options Outstanding			
	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life(in Years)	Aggregate Intrinsic Value (2)
Balance, December 31, 2016	5,882,861	$ 4.81	6.3	$32,683,000
Granted	673,062	$ 9.57	—	—
Exercised	(920,662)	$ 4.04	—	—
Forfeited	(217,617)	$ 6.47	—	—
Balance, September 30, 2017	5,417,644	$ 5.46	6.6	$15,100,000
Vested and exercisable as of September 30, 2017	3,570,351	$ 4.75	5.7	$11,672,000
Vested and exercisable as of September 30, 2017 and expected to vest thereafter (1)	5,121,800	$ 5.34	6.5	$14,686,000

(1) Options that are expected to vest are net of estimated future option forfeitures in accordance with the provisions of ASC 718. "Compensation – Stock Compensation."

(2) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair value of our common stock as of September 30, 2017 and December 31, 2016 of $7.90 and $10.35 per

share, respectively.

As of September 30, 2017, total unrecognized compensation cost related to non-vested option awards, net of estimated forfeitures, was $5.5 million, which is expected to be recognized as expense over a weighted average period of approximately 2.5 years.

Restricted Stock Unit Activity

The following table summarizes the restricted stock unit activity under the Plan and includes restricted stock units granted under all previous plans.

	Units	Weighted Average Grant-Date Fair Value Per Unit
Unvested at December 31, 2016	213,514	$ 8.65
Awarded	161,415	$ 10.15
Vested	(78,095)	$ 8.65
Forfeited	(10,681)	$ 8.52
Unvested at September 30, 2017	286,153	$ 9.50

As of September 30, 2017, total unrecognized compensation cost related to non-vested restricted stock units, net of estimated forfeitures, was $1.9 million, which is expected to be recognized as expense over a weighted average period of approximately 3.0 years.

Note 8 - Income Taxes

The effective tax rate for the nine months ended September 30, 2017 and 2016 was (6.57)% and 4.5%, respectively. As of December 31, 2016, a valuation allowance of approximately $21.1 million reduced our deferred income tax assets to the amount expected to be realized. The tax benefit recognized for the nine months ended September 30, 2017, was primarily related to losses in our Ireland subsidiary.

Note 9 - Commitments and Contingencies

Operating Lease Obligations

We lease facilities under fixed non-cancellable operating leases that expire on various dates through July 2021. Future minimum lease payments consist of the following (in thousands):

	September 30, 2017
2017 (remaining three months)	$ 432
2018	1,668
2019	1,461
2020	59
2021	34
Total future minimum lease payments	$ 3,654

Product Warranty

The following table summarizes the activity related to the product warranty liability during the three and nine months ended September 30, 2017 and 2016 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Balance, beginning of period	$374	$411	$406	$461
Warranty costs charged to cost of revenue	54	38	145	134
Release of accrual for expired warranties	(114)	(55)	(237)	(201)
Balance, end of period	$314	$394	$314	$394

Purchase Obligations

We enter into purchase order arrangements with our vendors. As of September 30, 2017, 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, 2017, we had approximately $3.1 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 have no liabilities recorded for these agreements as of September 30, 2017 and December 31, 2016.

In certain cases, we issue warranty and product performance guarantees to our customers for amounts generally equal to 10% or less of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication, and operating performance. These guarantees are generally stand-by letters of credit that typically remain in place for periods ranging up to twenty-four (24) months, and in some cases up to forty-seven (47) months. All stand-by letters of credit at September 30, 2017 and December 31, 2016, totaled $8.4 million and $4.4 million, respectively.

Litigation

The Company is named in and subject to various proceedings and claims in connection with our business. We are contesting the allegations in these claims, and we believe that there are meritorious defenses in each of these matters. The outcome of matters we have been and currently are involved in cannot be determined at this time, and the results cannot be predicted with certainty. There can be no assurance that these matters will not have a material adverse effect on our results of operations in any future period and a significant judgment could have a material adverse impact on our financial condition, results of operations and cash flows. We may in the future become involved in additional litigation in the ordinary course of our business, including litigation that could be material to our business. Based on currently available information and review with outside counsel, management does not believe that the currently known actions or threats against the Company will result in any material adverse effect on our financial condition, results of operations, or cash flows.

On September 10, 2014, the Company terminated the employment of its Senior Vice President, Sales, Borja Blanco, on the basis of breach of duty of trust and conduct leading to conflict of interest. On October 24, 2014, Mr. Blanco filed a labor claim against ERI Iberia in Madrid, Spain, challenging the fairness of his dismissal and seeking

compensation (“Case 1”). A hearing was held on November 13, 2015, after which the labor court ruled that it did not have jurisdiction over the matter. Mr. Blanco has appealed and the Company has filed statements of counter appeal. Based on currently available information and review with outside counsel, the Company has determined that an award to Mr. Blanco is not probable. While a loss may be reasonably possible, an estimate of loss, if any, cannot reasonably be determined at this time.

On November 24, 2014, Mr. Blanco filed a second action based on breach of contract theories in the same court as Case 1, but the cases are separate. In Case 2, Mr. Blanco seeks payment of an unpaid bonus, stock options, and non-compete compensation. The court ruled that this case is stayed until a final ruling is issued in Case 1. Based on currently available information and review with outside counsel, the Company has determined that an award to Mr. Blanco is not probable. While a loss may be reasonably possible, an estimate of loss, if any, cannot reasonably be determined at this time.

On February 18 and July 27, 2016, two derivative action complaints were filed in connection with the Company's previously reported stockholder class action lawsuit in the Superior Court for the State of California, County of Alameda where the Company was named as a nominal defendant under the captions, Goldberg v. Rooney, et al., HG 16804359, and Gerald McManiman v. Gay, et al., RG 16824960. The complaints have been consolidated under the caption, In Re Energy Recovery, Inc. Derivative Litigation, HG16804359. The consolidated complaint alleges breach of fiduciary duty, waste of corporate assets, and unjust enrichment causes of action against the individually named defendants. Based on currently available information and review with outside counsel, the Company is not able to estimate a potential loss, if any, due to the early stage of the matter.

The previously reported consolidated stockholder class action lawsuit - In Re Energy Recovery Inc. Securities Litigation, Case No.3:15cv-00265 EMC - was dismissed with prejudice by the United States District Court of the Northern District of California on August 28, 2017.

Note 10 - Business Segment and Geographic Information

We are an energy solutions provider to industrial fluid flow markets worldwide. We manufacture and sell high-efficiency energy recovery devices and pumps as well as related products and services. Our chief operating decision-maker (“CODM”) is the chief executive officer (“CEO”).

Our reportable operating segments consist of the Water Segment and the Oil & Gas Segment. These segments are based on the industries in which the products are sold, the type of energy recovery device sold, and the related products and services. The Water Segment consists of revenue associated with products sold for use in reverse osmosis water desalination, as well as the related identifiable expenses. The Oil & Gas Segment consists of product revenue associated with products sold for use in gas processing, chemical processing, and hydraulic fracturing and license and development revenue associated with hydraulic fracturing, as well as related identifiable expenses.

Operating income for each segment excludes other income and expenses and certain expenses managed outside the operating segment. Costs excluded from operating income include various corporate expenses such as income taxes and other separately managed general and administrative expenses not related to the identified segments. Assets and liabilities are reviewed at the consolidated level by the CODM and are not accounted for by segment. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating income (loss).

The following summarizes financial information by segment for the periods presented (in thousands):

	Three Months Ended September 30, 2017			Three Months Ended September 30, 2016		
	Water	Oil &Gas	Total	Water	Oil &Gas	Total
Product revenue	$13,227	$607	$13,834	$10,568	$456	$11,024
Product cost of revenue	3,818	436	4,254	3,647	321	3,968
Product gross profit	9,409	171	9,580	6,921	135	7,056
License and development revenue	—	1,250	1,250	—	1,250	1,250
Operating expenses:						
General and administrative	334	361	695	346	278	624
Sales and marketing	1,296	431	1,727	1,434	750	2,184
Research and development	316	2,669	2,985	262	2,023	2,285
Amortization of intangibles	157	—	157	158	—	158
Total operating expenses	2,103	3,461	5,564	2,200	3,051	5,251
Operating income (loss)	$7,306	$(2,040)	5,266	$4,721	$(1,666)	3,055
Less:						
Corporate operating expenses			3,726			3,709
Consolidated operating income (loss)			1,540			(654)
Non-operating income			232			78
Income (loss) before income taxes			$1,772			$(576)

	Nine Months Ended September 30, 2017			Nine Months Ended September 30, 2016		
	Water	Oil &Gas	Total	Water	Oil &Gas	Total
Product revenue	$33,707	$3,310	$37,017	$32,592	$456	$33,048
Product cost of revenue	10,003	2,391	12,394	11,557	321	11,878
Product gross profit	23,704	919	24,623	21,035	135	21,170
License and development revenue	—	3,750	3,750	—	3,750	3,750
Operating expenses:						
General and administrative	965	1,085	2,050	828	650	1,478
Sales and marketing	4,039	1,635	5,674	3,663	2,133	5,796
Research and development	810	7,734	8,544	954	6,394	7,348
Amortization of intangibles	473	—	473	473	—	473
Total operating expenses	6,287	10,454	16,741	5,918	9,177	15,095
Operating income (loss)	$17,417	$(5,785)	11,632	$15,117	$(5,292)	9,825
Less:						
Corporate operating expenses			11,413			12,148
Consolidated operating income (loss)			219			(2,323)