Energy Recovery, Inc.
Form 10-Q
August 02, 2018

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 June 30, 2018
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 or Organization)	(I.R.S. 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 o

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 o

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	Smaller reporting company o	Emerging growth company o
		(Do not check if a smaller reporting company)		

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. o

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 July 31, 2018, there were 53,579,862 shares of the registrant's common stock outstanding.

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PART I — FINANCIAL INFORMATION

Item 1 — Financial Statements (unaudited)

ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2018	December 31, 2017
	(In thousands, except share data and par value)	
ASSETS		
Current assets:		
Cash and cash equivalents	$16,378	$ 27,780
Restricted cash	808	2,664
Short-term investments	72,207	70,020
Accounts receivable, net of allowance for doubtful accounts of $420 and $103 at June 30, 2018 and December 31, 2017, respectively	11,304	12,465
Contract assets	5,984	6,278
Inventories	6,375	5,514
Income Tax Receivable	145	—
Prepaid expenses and other current assets	1,720	1,342
Total current assets	114,921	126,063
Restricted cash, non-current	86	182
Contract assets, non-current	108	—
Deferred tax assets, non-current	19,444	7,933
Property and equipment, net	12,988	13,393
Operating lease, right of use asset	12,669	2,843
Goodwill	12,790	12,790
Other intangible assets, net	954	1,269
Other assets, non-current	285	12
Total assets	$174,245	$ 164,485
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,932	$ 4,091
Accrued expenses and other current liabilities	5,157	7,948
Lease liabilities	336	1,603
Income taxes payable	—	432
Accrued warranty reserve	389	366
Contract liabilities	17,651	15,909
Current portion of long-term debt	12	11
Total current liabilities	25,477	30,360
Long-term debt, less current portion	10	16
Lease liabilities, non-current	13,033	1,698
Contract liabilities, non-current	33,124	40,517
Other non-current liabilities	240	—
Total liabilities	71,884	72,591
Stockholders' equity:		
Preferred stock, $0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding at June 30, 2018 and December 31, 2017	—	—

Common stock, $0.001 par value; 200,000,000 shares authorized; 58,950,907 shares issued and 53,494,972 shares outstanding at June 30, 2018 and 58,168,433 shares issued and 53,905,600 shares outstanding at December 31, 2017	59	58
Additional paid-in capital	154,524	149,006
Accumulated comprehensive loss	(194)	(125)
Treasury stock, at cost, 5,455,935 shares repurchased at June 30, 2018 and 4,262,833 shares repurchased at December 31, 2017	(30,486)	(20,486)
Accumulated deficit	(21,542)	(36,559)
Total stockholders' equity	102,361	91,894
Total liabilities and stockholders' equity	$174,245	$ 164,485

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In thousands, except per share data)			
Product revenue	$17,406	$10,864	$28,464	$23,109
Product cost of revenue	5,976	3,572	9,290	8,184
Product gross profit	11,430	7,292	19,174	14,925
License and development revenue	3,358	3,050	6,107	5,298
Operating expenses:				
General and administrative	4,927	3,927	10,764	8,335
Sales and marketing	1,858	2,174	3,770	4,627
Research and development	3,605	3,077	7,522	5,586
Amortization of intangible assets	158	158	316	316
Total operating expenses	10,548	9,336	22,372	18,864
Income from operations	4,240	1,006	2,909	1,359
Other income (expense):				
Interest income	373	198	674	369
Interest expense	(1)	—	(1)	(1)
Other non-operating (expense) income, net	9	(87)	(44)	(140)
Total other income, net	381	111	629	228
Income before income taxes	4,621	1,117	3,538	1,587
(Benefit from) provision for income taxes	(11,122)	188	(11,479)	236
Net income	$15,743	$929	$15,017	$1,351
Income per share:				
Basic	$0.29	$0.02	$0.28	$0.03
Diluted	$0.28	$0.02	$0.27	$0.02
Number of shares used in per share calculations:				
Basic	53,747	53,748	53,747	53,786
Diluted	55,406	55,565	55,437	55,804

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In thousands)			
Net income	$15,743	$929	$15,017	$1,351
Other comprehensive (loss) income, net of tax:				
Foreign currency translation adjustments	(33)	25	(12)	35
Unrealized (loss) income on investments	7	(5)	(57)	(4)
Other comprehensive (loss) income, net of tax	(26)	20	(69)	31
Comprehensive income	$15,717	$949	$14,948	$1,382

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2018	2017
	(In thousands)	
Cash Flows From Operating Activities:		
Net income	$15,017	$1,351
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Stock-based compensation	3,184	2,120
Depreciation and amortization	2,040	1,820
Amortization of premiums on investments	267	230
Provision for warranty claims	135	91
Reversal of accruals related to expired warranties	(84)	(123)
Unrealized (gain) loss on foreign currency translation	(51)	16
Provision for doubtful accounts	328	10
Adjustments for excess or obsolete inventory	17	(119)
Deferred income taxes	(11,512)	(233)
Loss on disposal of fixed assets	22	—
Other non-cash adjustments	2	(93)
Changes in operating assets and liabilities:		
Accounts receivable	833	(536)
Contract assets	186	(2,223)
Inventories	(907)	(1,657)
Prepaid and other assets	(10,477)	(522)
Accounts payable	(1,976)	1,324
Accrued expenses and other liabilities	7,532	(3,099)
Income taxes	(577)	412
Contract liabilities	(5,649)	(4,753)
Net cash used in operating activities	(1,670)	(5,984)
Cash Flows From Investing Activities:		
Maturities of marketable securities	40,638	12,505
Purchases of marketable securities	(43,117)	(31,146)
Capital expenditures	(1,536)	(3,777)
Net cash used in investing activities	(4,015)	(22,418)
Cash Flows From Financing Activities:		
Net proceeds from issuance of common stock	2,390	3,682
Tax payment for employee shares withheld	(76)	(195)
Repayment of long-term debt	(5)	(5)
Repurchase of common stock	(10,000)	(4,276)
Net cash used in financing activities	(7,691)	(794)
Effect of exchange rate differences on cash and cash equivalents	22	(15)
Net change in cash, cash equivalents and restricted cash	(13,354)	(29,211)
Cash, cash equivalents and restricted cash, beginning of year	30,626	65,748
Cash, cash equivalents and restricted cash, end of period	$17,272	$36,537

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Description of Business and Significant Accounting Policies

Energy Recovery, Inc. and its wholly-owned subsidiaries (the “Company,” “Energy Recovery,” “our,” “us,” or “we”) is an energy solutions provider to industrial fluid flow markets worldwide. The Company’s core competencies are fluid dynamics and advanced material science. The Company’s products make industrial processes more operationally and capital expenditure efficient. The Company’s solutions convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. The Company’s 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™. The Company owns, manufactures, and/or develops its solutions, in whole or in part, in the United States of America (“U.S.”) and the Republic of Ireland (“Ireland”).

Basis of Presentation

The Company’s 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 in consolidation.

The accompanying Condensed Consolidated Financial Statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in the financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. The December 31, 2017 Condensed Consolidated Balance Sheet was derived from audited financial statements, and may not include all disclosures required by GAAP; however, the Company believes that the disclosures are adequate to make the information presented not misleading. The June 30, 2018 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, 2017 included in the Company’s Annual Report on Form 10-K filed with the SEC on March 8, 2018.

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.

Use of Estimates

The preparation of the Condensed Consolidated Financial Statements in conformity with GAAP requires the Company’s management to make judgments, assumptions, and estimates that affect the amounts reported in the Condensed Consolidated Financial Statements and accompanying Notes to Condensed Consolidated Financial Statements. The accounting policies that reflect the Company’s more significant estimates and judgments and that the Company believes are the most critical to aid in fully understanding and evaluating the Company’s reported financial results are revenue recognition; capitalization of research and development assets; allowance for doubtful accounts; valuation of right of use asset; and lease liability; 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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Recent Accounting Pronouncements

Recently Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09 (“ASU 2014-09”), Revenue from Contracts with Customers (Topic 606), referred to as Accounting Standards Codification (“ASC”) 606 (“ASC 606”) or “New Revenue Standard.” ASC 606 supersedes the revenue recognition requirements of ASC 605, Revenue Recognition, and requires entities to recognize revenue when control of promised goods or services is transferred to customers at an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods and services.

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. ASC 606 permits the use of either the full retrospective or cumulative effect transition (modified retrospective) method upon adoption.

In March and April 2016, the FASB issued ASU No. 2016-08 (“ASU 2016-08”), Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) and ASU No. 2016-10 (“ASU 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 ASC 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 referred.

The Company adopted “ASU 2014-09”, “ASU 2016-08” and “ASU 2016-10” (the combination is also known as “ASC 606” o “New Revenue Standard”) as of January 1, 2018 using the full retrospective transition method. To assess the impact of and to implement ASC 606, the Company formed a project team, which has operated since 2014, to evaluate internal processes. The Company has implemented changes to its current policies and practices, and internal controls over financial reporting to address the requirements of the standard.

Water Segment Revenue. Performance obligations identified under ASC 606, are consistent with deliverables identified under ASC 605. Revenue recognition for performance obligations accounted for under ASC 606 is consistent with ASC 605 given the transfer of control of the promised goods or services follows the same pattern. Adoption of ASC 606 did not have a material impact on the timing of revenue and expense recognition.

Oil & Gas Segment - Cost-to-Total Cost (“CTC”) Revenue. Performance obligations identified under ASC 606, are consistent with deliverables identified under ASC 605. Revenue recognition for performance obligations accounted for under ASC 606 is consistent with ASC 605 given the transfer of control of the promised goods or services follows the same pattern. Adoption of ASC 606 did not have a material impact on the timing of revenue and expense recognition.

Oil & Gas Segment - License and Development Revenue. License and development revenue associated with the up-front non-refundable $75.0 million exclusivity payment received in connection with the VorTeq license agreement (the “VorTeq License Agreement”) that the Company entered into with Schlumberger Technology Corporation (the “VorTeq Licensee”) under ASC 605 was recognized on a straight-line basis over the fifteen-year term of the license, while the two subsequent milestone payments of $25.0 million each that could be earned under the VorTeq License

Agreement were to be recognized in full when achieved under milestone accounting.

License and development revenue under ASC 606, which includes both the upfront non-refundable $75.0 million exclusivity payment and the two milestone payments of $25.0 million each, when determined probable, is comprised of:

- revenue recognition over time based on an input measure of progress based on a cost driver, which management has determined is the best estimate of the progress made on the project during the period from inception until full commercialization, for the amount allocated to the exclusive Missile (as defined in Note 14, “VorTeq Partnership and License Agreement”) license and research and development services, and

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

- revenue recognition related to stand-ready, when and if available, upgrades subsequent to full commercialization, recognized over time ratably over the period, which matches the transfer of benefit to the customer on a daily basis, commencing after full commercial launch until the expiration of the contract.

The changes in license and development revenue due to the adoption of ASC 606 are as follows.

	Years Ended December 31,		
	2017	2016	2015
	(In thousands)		
License and development revenue, as previously reported	$5,000	$5,000	$1,042
Change in revenue due to adoption the New Revenue Standard	6,106	3,069	290
License and development revenue, as adjusted	$11,106	$8,069	$1,332

The changes in the contract liability balance related to license and development revenue due to the adoption of ASC 606 are as follows.

	December 31, 2017	December 31, 2016
	(In thousands)	
License and development contract liability, as previously reported	$63,958	$ 68,958
Change in contract liability due to adoption the New Revenue Standard	9,465	3,359
License and development contract liability, as adjusted	$54,493	$ 65,599

For license and development revenue, performance obligations identified under ASC 606 differs somewhat from contingent and non-contingent deliverables identified under ASC 605 due to transfer of control considerations.

Under ASC 606, the Company concluded that the Missile license represents functional intellectual property and that the license is not distinct from the research and development services to be provided prior to product commercialization. The transaction price allocated to this combined performance obligation of a continually evolving license will be recognized over the estimated period required to result in full commercial launch using an input measure of progress of the cost of salaries and wages and travel expenses related to the project prior to full commercial launch.

The milestone method of accounting has been eliminated under ASC 606. Instead of recognizing the full amount of each milestone payment as revenue in the period in which it is achieved, the Company will revise its estimate of the transaction price to include development milestone payments only when they become probable of achievement and revenue will be recognized consistent with the input measure of progress.

The Company has concluded that its obligation to provide when and if available updates to its technology in the period subsequent to full commercial launch represents a performance obligation. The transaction price allocated to this stand-ready performance obligation will be recognized ratably over the period commencing after full commercial launch until the expiration of the contract.

See Note 14, “VorTeq Partnership and License Agreement” for additional discussion on the VorTeq License Agreement, and Note 3, “Revenues,” for further discussion of revenue recognition.

In February 2016, the FASB issued ASU No. 2016-02 ("ASU 2016-02"), Leases (Topic 842), also referred to as "ASC 842" or "New Lease Standard," which supersedes ASC 840, Leases (Topic 840), and provides principles for the recognition, measurement, presentation and disclosure of leases for both lessees and lessors. The FASB has continued to clarify this guidance through the issuance of additional ASUs. The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification determines whether lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease, respectively. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than twelve months regardless of classification. Leases with a term of twelve months or less will be accounted for similar to existing guidance for operating leases.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The Company early adopted ASU 2016-02 on January 1, 2018 concurrent with the Company's adoption of the New Revenue Standard and elected the available practical expedients. The adoption of ASU 2016-02 had no impact on the Company's Condensed Consolidated Statements of Operations. The most significant impact was the recognition of right of use assets and liabilities for operating leases. Adoption of the standard required the Company to restate certain previously reported results, including the recognition of additional operating lease right of use assets and liabilities.

In November 2016, the FASB issued ASU 2016-18 ("ASU 2016-18"), Statement of Cash Flows (Topic 230): Restricted Cash, also referred to as "New Cash Flow Presentation Standard." 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. The Company adopted ASU 2016-18 on January 1, 2018. The Company recast its Condensed Consolidated Statements of Cash Flows for the prior period presented based on the restricted cash balance on the balance sheet date and has provided a reconciliation of cash, cash equivalents and restricted cash in Note 5, "Other Financial Information."

In January 2016, the FASB issued ASU No. 2016-01 ("ASU 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. The Company adopted ASU 2016-01 on January 1, 2018. The adoption ASU 2016-01 did not have a material impact on the Company's financial position or results of operations.

In August 2016, the FASB issued ASU No. 2016-15 ("ASU 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 ASC 230, Statement of Cash Flows. 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. Adoption should be applied using a retrospective transition method to each period presented. The Company adopted ASU 2016-15 on January 1, 2018. The adoption of ASU 2016-15 did not have a material impact on the Company's financial position or results of operations.

In October 2016, the FASB issued ASU 2016-16 ("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 legacy 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. The Company adopted ASU 2016-16 on January 1, 2018. The adoption of ASU 2016-16 did not have a material impact on the Company's financial position or results of operations.

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 ASC 718, Compensation – Stock Compensation. ASU 2017-09 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The Company adopted ASU 2017-09 on January 1, 2018. The adoption of ASU 2017-09 did not have an impact on the Company’s financial position or results of operations.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Impact of Recently Adopted Accounting Pronouncements

The following table illustrates changes in the Condensed Consolidated Balance Sheets as previously reported prior to, and as adjusted subsequent to, the adoption of the New Revenue Standard and New Lease Standard at January 1, 2018.

	December 31, 2017			
	As Previously Reported	Adoption of New Revenue Standard	Adoption of New Lease Standard	As Adjusted
	(In thousands)			
Assets				
Current assets:				
Contract assets	$6,411	$ (133)	$ —	$ 6,278
Total current assets	126,196	(133)	—	126,063
Non-current assets				
Deferred tax assets, non-current	7,902	31	—	7,933
Operating lease, right of use asset	—	—	2,843	2,843
Total assets	161,744	(102)	2,843	164,485
Liabilities and Stockholders' Equity				
Current liabilities:				
Accrued expenses and other current liabilities	8,517	(469)	(100)	7,948
Lease liabilities	—	—	1,603	1,603
Contract liabilities	6,416	9,493	—	15,909
Total current liabilities	19,833	9,024	1,503	30,360
Non-current liabilities				
Lease liabilities, non-current	—	—	1,698	1,698
Contract liabilities, non-current	59,006	(18,489)	—	40,517
Other non-current liabilities	358	—	(358)	—
Total liabilities	79,213	(9,465)	2,843	72,591
Stockholders' equity:				
Accumulated deficit	(45,922)	9,363	—	(36,559)
Total stockholders' equity	82,531	9,363	—	91,894
Total liabilities and stockholders' equity	161,744	(102)	2,843	164,485

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table illustrates changes in the Condensed Consolidated Statement of Operations as previously reported prior to, and as adjusted subsequent to, the adoption of the New Revenue Standard effective January 1, 2018.

	Three Months Ended June 30, 2017			Six Months Ended June 30, 2017		
	As Previously Reported	Adoption of New Revenue Standard	As Adjusted	As Previously Reported	Adoption of New Revenue Standard	As Adjusted
	(In thousands, except for per share data)					
Product revenue	$10,922	$(58)	$10,864	$23,183	$(74)	$23,109
Product cost of revenue	3,530	42	3,572	8,140	44	8,184
Product gross profit	$7,392	$(100)	$7,292	$15,043	$(118)	$14,925
License and development revenue	$1,250	$1,800	$3,050	$2,500	$2,798	$5,298
Income (loss) from operations	(694)	1,700	1,006	(1,321)	2,680	1,359
Income (loss) before income taxes	(583)	1,700	1,117	(1,093)	2,680	1,587
(Benefit from) provision for income taxes	(35)	223	188	(112)	348	236
Net income (loss)	(548)	1,477	929	(981)	2,332	1,351
Income (loss) per share:						
Basic	$(0.01)	$0.03	$0.02	$(0.02)	$0.05	$0.03
Diluted	$(0.01)	$0.03	$0.02	$(0.02)	$0.04	$0.02
Number of shares used in per share calculations:						
Basic	53,748	—	53,748	53,786	—	53,786
Diluted	53,748	1,817	55,565	53,786	2,018	55,804

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table illustrates changes in the Company's segment activities as previously reported prior to, and as adjusted subsequent to, the adoption of the New Revenue Standard effective January 1, 2018.

	Three Months Ended June 30, 2017			Six Months Ended June 30, 2017		
	As Previously Reported	Adoption of New Revenue Standard	As Adjusted	As Previously Reported	Adoption of New Revenue Standard	As Adjusted
	(In thousands)					
Water						
Product revenue	$9,764	$—	$9,764	$20,480	$—	$20,480
Product cost of revenue	2,663	42	2,705	6,185	44	6,229
Product gross profit	$7,101	$(42)	$7,059	$14,295	$(44)	$14,251
Income (loss) from operations	$5,154	$(42)	$5,112	$10,111	$(44)	$10,067
Oil & Gas						
Product revenue	$1,158	$(58)	$1,100	$2,703	$(74)	$2,629
Product cost of revenue	867	—	867	1,955	—	1,955
Product gross profit	$291	$(58)	$233	$748	$(74)	$674
License and development revenue	$1,250	$1,800	$3,050	$2,500	$2,798	$5,298
Income (loss) from operations	(2,216)	1,742	(474)	(3,745)	2,724	(1,021)

The following table illustrates changes in the Condensed Consolidated Statement of Comprehensive Income (Loss) as previously reported prior to, and as adjusted subsequent to, the adoption of the New Revenue Standard effective January 1, 2018.

	Three Months Ended June 30, 2017			Six Months Ended June 30, 2017		
	As Previously Reported	Adoption of New Revenue Standard	As Adjusted	As Previously Reported	Adoption of New Revenue Standard	As Adjusted
	(In thousands)					
Net income (loss)	$(548)	$1,477	$929	$(981)	$2,332	$1,351
Comprehensive income (loss)	(528)	1,477	949	(950)	2,332	1,382

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The following table illustrates changes in the Condensed Consolidated Statement of Cash Flows as previously reported prior to, and as adjusted subsequent to, the adoption of the New Revenue Standard and New Cash Flow Presentation Standard effective January 1, 2018.

	Six Months Ended June 30, 2017			
	As Previously Reported	Adoption of New Revenue Standard	Adoption of New Cash Flow Presentation Standard	As Adjusted
	(In thousands)			
Net income (loss)	$ (981)	$ 2,332	$ —	$ 1,351
Changes in operating assets and liabilities:				
Accounts receivable	(598)	62	—	(536)
Contract assets	(2,297)	74	—	(2,223)
Inventories	(1,701)	44	—	(1,657)
Accrued expenses and other liabilities	(2,185)	(914)	—	(3,099)
Income taxes	64	348	—	412
Contract liabilities	(2,807)	(1,946)	—	(4,753)
Net cash used in operating activities	(5,984)	—	—	(5,984)
Restricted cash	1,128	—	(1,128)	—
Net cash used in investing activities	(21,290)	—	(1,128)	(22,418)
Net change in cash, cash equivalents and restricted cash	(28,083)	—	(1,128)	(29,211)
Cash, cash equivalents and restricted cash, beginning of year	61,364	—	4,384	65,748
Cash, cash equivalents and restricted cash, end of period	33,281	—	3,256	36,537

Recently issued accounting pronouncement not yet adopted

In January 2017, the FASB issued ASU No. 2017-04 ("ASU 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 update 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. The Company expects to adopt this standard on January 1, 2020 and does not expect the adoption of ASU 2017-04 to have a material impact on its financial statements.

In February 2018, the FASB issued ASU No. 2018-02 ("ASU 2018-02"), Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. ASU 2018-02 was issued to address the income tax accounting treatment of the stranded tax effects within other comprehensive income due to the prohibition of backward tracing due to an income tax rate change that was initially recorded in other comprehensive income. This issue came about from the enactment of the U.S. Tax Cuts and Jobs Act of 2017 (the "Tax Act") that changed the Company's income tax rate from 35% to 21%. ASU 2018-02 changed current accounting whereby an entity may elect to reclassify the stranded tax effect from accumulated other comprehensive income to retained earnings. The ASU 2018-02 is effective for periods beginning after December 15, 2018 although early adoption is permitted. The Company does not expect the adoption of ASU 2018-02 to have a material impact on its financial position or results of operations.

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Note 3 — Revenues

Adoption of ASC 606, Revenue from Contracts with Customers

On January 1, 2018, the Company adopted ASC 606 using the full retrospective transition method. The Company recorded a net reduction to opening retained earnings of $0.3 million as of January 1, 2016, due to the cumulative impact of adopting ASC 606. The impact to revenues as a result of applying ASC 606 was an increase of $1.7 million and $2.7 million for the three and six months ended June 30, 2017, respectively.

Revenue Recognition

Revenues are recognized when control of the promised goods or services is transferred to the Company's customers, in an amount that reflects the consideration the Company expects to be entitled to in exchange for those goods or services. At the inception of each contract, performance obligations are identified and the total transaction price is allocated to the performance obligations.

The Company's payment terms vary based on the credit risk of its customer. For certain customer types, the Company requires payment before the products or services are delivered to the customer. The Company performs an evaluation of customer credit worthiness on an individual contract basis to assess whether collectability is reasonably assured at the inception of the contract. As part of this evaluation, the Company considers many factors about the individual customer, including the underlying financial strength of the customer and/or partnership consortium and the Company's prior history or industry-specific knowledge about the customer and its supplier relationships. For smaller projects, the Company requires the customer to remit payment generally within 30 to 60 days after product delivery. In some cases, if credit worthiness cannot be determined, prepayment or other security is required.

Sales commissions are expensed as incurred when product revenue is earned. These costs are recorded within sales and marketing expenses.

The following table presents the Company's revenues disaggregated by geography, based on the shipped to addresses of the Company's customers and revenue source. Sales and usage-based taxes are excluded from revenues.

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
	Water	Oil and Gas	Total	Water	Oil and Gas	Total
	(In thousands)					
Primary geographical market						
Middle East and Africa	$9,289	$290	$9,579	$15,391	$300	$15,691
Americas	1,604	3,358	4,962	2,705	6,107	8,812
Asia	4,657	—	4,657	7,330	—	7,330
Europe	1,566	—	1,566	2,738	—	2,738
Total	$17,116	$3,648	$20,764	$28,164	$6,407	$34,571
Major product/service line						
PX, pumps and turbo devices	$17,116	$—	$17,116	$28,164	$—	$28,164
License and development	—	3,358	3,358	—	6,107	6,107

Oil & gas products	—	290	290	—	300	300
Total	$17,116	$3,648	$20,764	$28,164	$6,407	$34,571

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	Three Months Ended June 30, 2017			Six Months Ended June 30, 2017		
	Water	Oil and Gas	Total	Water	Oil and Gas	Total
	(In thousands)					
Primary geographical market						
Middle East and Africa	$4,274	$1,100	$5,374	$10,348	$2,629	$12,977
Americas	1,215	3,050	4,265	2,288	5,298	7,586
Asia	2,724	—	2,724	5,138	—	5,138
Europe	1,551	—	1,551	2,706	—	2,706
Total	$9,764	$4,150	$13,914	$20,480	$7,927	$28,407
Major product/service line						
PX, pumps and turbo devices	$9,764	$—	$9,764	$20,480	$—	$20,480
License and development	—	3,050	3,050	—	5,298	5,298
Oil & gas products	—	1,100	1,100	—	2,629	2,629
Total	$9,764	$4,150	$13,914	$20,480	$7,927	$28,407

Arrangements with Multiple Performance Obligations and Termination for Convenience

The Company's contracts with customers may include multiple performance obligations. For such arrangements, the Company allocates revenue to each performance obligation based on its relative stand-alone selling price. The Company generally determines standalone selling prices based on the prices charged to customers.

With respect to termination, the Company does not have the ability to cancel the contract for convenience. In general, customers can cancel for convenience upon the payment of a termination fee that covers costs and profit. It is rare for customers to cancel contracts.

Practical Expedients and Exemptions

In the Water segment, the time period between when the Company transfers control of products to the customer and the payment for the products is, in general, less than one year and, therefore, the practical expedient with respect to a financing component has been adopted by the Company.

With respect to taxes, the Company has made the policy election to exclude taxes from the measurement of the transaction price.

The Company does not disclose the value of unsatisfied performance obligations for (i) contracts with an original expected length of one year or less and (ii) contracts for which the Company recognizes revenue at the amount to which the Company has the right to invoice for services performed.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Contract Balances

Contract balances by category are presented in the following table. Prior year amounts have been adjusted for the adoption of ASC 606 on January 1, 2018. See Note 2, "Recent Accounting Pronouncements," for reconciliation of prior year "As Previously Reported" and "As Adjusted" amounts.

	June 30, 2018	December 31, 2017
	(In thousands)	
Trade Receivable	$11,304	$ 12,465
Contract assets:		
Current contract assets	$5,984	$ 1,413
Non-current contract assets	108	4,865
Total contract assets	$6,092	$ 6,278
Current contract liabilities:		
Customer deposits	$1,236	$ 414
Deferred revenue:		
Cost and estimated earnings in excess of billings	444	805
License and development	15,304	14,024
Product	469	550
Service	198	116
Total current contract liability	17,651	15,909
Non-current contract liabilities, deferred revenue		
License and development	33,082	40,469
Product	42	48
Total non-current contract liability	33,124	40,517
Total contract liability	$50,775	$ 56,426

The Company records unbilled receivables as contract assets. Significant changes in contract assets during the period were as follows.

	June 30, 2018	December 31, 2017
	(In thousands)	
Balance, beginning of year	$6,278	$ 2,015
Transferred to receivables	(2,635)	(2,909)
Additional unbilled receivables	2,449	7,172
Balance, end of period	$6,092	$ 6,278

The Company records contract liabilities when cash payments are received or due in advance of the Company's performance. Significant changes in contract liabilities during the period were as follows.

	June 30, 2018	December 31, 2017
	(In thousands)	
Balance, beginning of year	$56,426	$ 62,232
Revenue recognized	(6,155)	(5,892)

Cash received	504	86
Balance, end of period	$50,775	$ 56,426

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Transaction Price Allocated to the Remaining Performance Obligation

The following table includes estimated revenue expected to be recognized in the future related to performance obligations that are unsatisfied or partially unsatisfied.

	June 30, 2018 (In thousands)
Year:	
2018 (remaining six months)	$ 7,917
2019	13,786
2020	14,300
2021	6,969
2022 and thereafter	5,677
Total	$ 48,649

The Company applies the practical expedient in ASC 606, paragraph 10-50-14, and does not disclose information about remaining performance obligations that have original expected durations of one year or less.

The Company applies the practical expedient in ASC 606 paragraph 10-65-1(f)(3), and does not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the Company expects to recognize that amount of revenue for the comparative period ended June 30, 2017.

Contract Costs

The Company recognizes the incremental cost of obtaining contracts as an expense when incurred if the amortization period of the assets that the Company otherwise would have recognized in one year or less. The costs of obtaining contracts are included in sales and marketing expenses.

Product and Service Revenue Recognition - Water Segment

In the Water segment, a contract is established by a written agreement (executed sales order, executed purchase order or stand-alone contract) with the customer with fixed pricing, and a credit risk assessment is completed prior to the signing of the agreement to ensure that collectability is reasonably assured.

The Company does not bundle performance obligations in the Water segment. The Company identifies each performance obligation separately along with its associated relative standalone selling price based on the prices and discounts that the Company would sell a promised good or service separately to a customer.

Generally, performance obligations consist of delivery of products, such as PX energy recovery devices, turbochargers, pumps, and spare parts. These service amounts are deferred as contract liabilities until the services are performed.

The transfer of control for the Company’s products follows transfer of title which typically occurs upon shipment of the equipment in accordance with International Commercial Terms (commonly referred to as “Incoterms”). The specified product performance criteria for the Company’s products pertain to the ability of the Company’s product to meet its published performance specifications and warranty provisions, which the Company’s products have demonstrated on a consistent basis. This factor, combined with historical performance metrics, provides the Company’s management with a reasonable basis to conclude that the products will perform satisfactorily upon commissioning of the plant. Installation is relatively simple, requires no customization, and is performed by the customer under the supervision of the Company’s per