

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended September 30, 2012**
- OR**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

Commission File Number: 001-34112

**Energy Recovery, Inc.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation)

01-0616867  
(IRS Employer Identification No.)

1717 Doolittle Drive, San Leandro, CA  
(Address of Principal Executive Offices)

94577  
(Zip Code)

(510) 483-7370  
(Registrant's Telephone Number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  
Yes  No

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

|                         |                          |                           |                                     |
|-------------------------|--------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer         | <input checked="" type="checkbox"/> |
| Non-accelerated filer   | <input type="checkbox"/> | Smaller reporting company | <input type="checkbox"/>            |

(Do not check if a smaller reporting company)

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

As of October 31, 2012, there were 50,901,527 shares of the registrant's common stock outstanding.

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ENERGY RECOVERY, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2012

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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,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| <b>Current assets:</b>  |                       |                      |
| Cash and cash equivalents   | \$ 18,287             | \$ 18,507            |
| Restricted cash   | 5,207                 | 5,687                |
| Short-term investments  | 11,442                | 11,706               |
| Accounts receivable, net of allowance for doubtful accounts of \$145 and \$248 at September 30, 2012 and December 31, 2011, respectively  | 10,224                | 6,498                |
| Unbilled receivables  | 1,961                 | 1,059                |
| Inventories   | 6,521                 | 7,824                |
| Deferred tax assets, net  | 460                   | 460                  |
| Prepaid expenses and other current assets   | 4,520                 | 4,929                |
| Land and building held for sale   | 1,417                 | 1,660                |
| <b>Total current assets</b>   | <b>60,039</b>         | <b>58,330</b>        |
| Restricted cash, non-current  | 5,101                 | 5,232                |
| Long-term investments   | 3,705                 | 11,198               |
| Unbilled receivables, non-current   | 460                   | —                    |
| Property and equipment, net   | 16,522                | 16,170               |
| Goodwill  | 12,790                | 12,790               |
| Other intangible assets, net  | 6,206                 | 6,991                |
| Other assets, non-current   | 2                     | 2                    |
| <b>Total assets</b>   | <b>\$ 104,825</b>     | <b>\$ 110,713</b>    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                       |                      |
| <b>Current liabilities:</b>   |                       |                      |
| Accounts payable  | \$ 1,865              | \$ 1,506             |
| Accrued expenses and other current liabilities  | 6,625                 | 6,474                |
| Income taxes payable  | 32                    | 21                   |
| Accrued warranty reserve  | 1,018                 | 852                  |
| Deferred revenue  | 2,232                 | 859                  |
| Current portion of long-term debt   | —                     | 85                   |
| Current portion of capital lease obligations  | 24                    | 82                   |
| <b>Total current liabilities</b>  | <b>11,796</b>         | <b>9,879</b>         |
| Capital lease obligations, non-current  | —                     | 18                   |
| Deferred tax liabilities, non-current, net  | 1,678                 | 1,516                |
| Deferred revenue, non-current   | 86                    | 261                  |
| Other non-current liabilities   | 2,229                 | 2,085                |
| <b>Total liabilities</b>  | <b>15,789</b>         | <b>13,759</b>        |
| Commitments and Contingencies (Note 9)  |                       |                      |
| <b>Stockholders' equity:</b>  |                       |                      |
| Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding   | —                     | —                    |
| Common stock, \$0.001 par value; 200,000,000 shares authorized; 52,656,629 and 52,645,129 shares issued at September 30, 2012 and December 31, 2011, respectively; and 50,874,026 and 52,645,129 shares outstanding at September 30, 2012 and December 31, 2011, respectively | 53                    | 53                   |
| Additional paid-in capital  | 116,725               | 114,619              |
| Notes receivable from stockholders  | (24)                  | (23)                 |
| Accumulated other comprehensive loss  | (45)                  | (92)                 |
| Treasury stock, at cost, 1,782,603 and 0 shares repurchased at September 30, 2012 and December 31, 2011, respectively   | (4,000)               | —                    |
| Accumulated deficit   | (23,673)              | (17,603)             |
| <b>Total stockholders' equity</b>   | <b>89,036</b>         | <b>96,954</b>        |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 104,825</b>     | <b>\$ 110,713</b>    |

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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

|  | Three Months Ended<br>September 30, |                    | Nine Months Ended<br>September 30, |                    |
|--|-------------------------------------|--------------------|------------------------------------|--------------------|
|  | 2012                                | 2011               | 2012                               | 2011               |
| Net revenue  | \$ 10,498                           | \$ 4,933           | \$ 27,550                          | \$ 21,932          |
| Cost of revenue  | 4,696                               | 4,214              | 13,836                             | 14,221             |
| Gross profit   | <u>5,802</u>                        | <u>719</u>         | <u>13,714</u>                      | <u>7,711</u>       |
| Operating expenses:                                    |                                     |                    |                                    |                    |
| General and administrative                             | 3,825                               | 3,571              | 10,899                             | 11,953             |
| Sales and marketing                                    | 1,860                               | 2,291              | 5,114                              | 6,370              |
| Research and development                               | 1,495                               | 726                | 3,055                              | 2,626              |
| Amortization of intangible assets                      | 262                                 | 346                | 785                                | 1,037              |
| Restructuring charges                                  | 167                                 | 470                | 277                                | 470                |
| Total operating expenses                               | <u>7,609</u>                        | <u>7,404</u>       | <u>20,130</u>                      | <u>22,456</u>      |
| Loss from operations                                   | (1,807)                             | (6,685)            | (6,416)                            | (14,745)           |
| Interest expense                                       | (1)                                 | (5)                | (6)                                | (30)               |
| Other non-operating income (expense), net              | 36                                  | (127)              | 99                                 | 128                |
| Loss before income taxes                               | (1,772)                             | (6,817)            | (6,323)                            | (14,647)           |
| Provision for (benefit from) income taxes              | 54                                  | 4,509              | (253)                              | 1,775              |
| Net loss   | <u>\$ (1,826)</u>                   | <u>\$ (11,326)</u> | <u>\$ (6,070)</u>                  | <u>\$ (16,422)</u> |
| Basic and diluted net loss per share                   | <u>\$ (0.04)</u>                    | <u>\$ (0.22)</u>   | <u>\$ (0.12)</u>                   | <u>\$ (0.31)</u>   |
| Shares used in basic and diluted per share calculation | <u>50,872</u>                       | <u>52,636</u>      | <u>51,638</u>                      | <u>52,602</u>      |

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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

|  | <b>Three Months Ended</b> |                    | <b>Nine Months Ended</b> |                    |
|--|---------------------------|--------------------|--------------------------|--------------------|
|  | <b>September 30,</b>      |                    | <b>September 30,</b>     |                    |
|  | <b>2012</b>               | <b>2011</b>        | <b>2012</b>              | <b>2011</b>        |
| Net loss                                       | \$ (1,826)                | \$ (11,326)        | \$ (6,070)               | \$ (16,422)        |
| Other comprehensive income (loss), net of tax: |                           |                    |                          |                    |
| Foreign currency translation adjustments       | (5)                       | 10                 | 2                        | (7)                |
| Unrealized gain on investments                 | 13                        | —                  | 45                       | —                  |
| Other comprehensive income (loss)              | 8                         | 10                 | 47                       | (7)                |
| Comprehensive loss                             | <u>\$ (1,818)</u>         | <u>\$ (11,316)</u> | <u>\$ (6,023)</u>        | <u>\$ (16,429)</u> |

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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

|   | Nine Months Ended<br>September 30, |                  |
|---|------------------------------------|------------------|
|   | 2012                               | 2011             |
| <b>Cash Flows From Operating Activities</b>                                 |                                    |                  |
| Net loss  | \$ (6,070)                         | \$ (16,422)      |
| Adjustments to reconcile net loss to net cash used in operating activities: |                                    |                  |
| Depreciation and amortization   | 2,945                              | 3,608            |
| Loss on disposal of fixed assets  | —                                  | 75               |
| Loss on impairment of assets held for sale                                  | 243                                | —                |
| Amortization of premiums/discounts on investments                           | 402                                | —                |
| Interest accrued on notes receivables from stockholders                     | (1)                                | (1)              |
| Share-based compensation  | 2,097                              | 2,020            |
| Loss on foreign currency transactions                                       | 3                                  | 16               |
| Excess tax benefit from share-based compensation arrangements               | —                                  | 6                |
| Deferred income taxes   | 162                                | 2,846            |
| (Recovery of) provision for doubtful accounts                               | (69)                               | 4                |
| Provision for warranty claims   | 283                                | 469              |
| Valuation adjustments for excess or obsolete inventory                      | 20                                 | 63               |
| Other non-cash adjustments  | 45                                 | 18               |
| Changes in operating assets and liabilities:                                |                                    |                  |
| Accounts receivable   | (3,674)                            | 5,837            |
| Unbilled receivables  | (1,361)                            | 119              |
| Inventories   | 1,283                              | (208)            |
| Prepaid and other assets  | 405                                | (247)            |
| Accounts payable  | 60                                 | 131              |
| Accrued expenses and other liabilities                                      | 30                                 | (1,105)          |
| Income taxes payable  | 13                                 | 11               |
| Deferred revenue  | 1,198                              | (1,740)          |
| <b>Net cash used in operating activities</b>                                | <u>(1,986)</u>                     | <u>(4,500)</u>   |
| <b>Cash Flows From Investing Activities</b>                                 |                                    |                  |
| Capital expenditures  | (2,105)                            | (1,841)          |
| Proceeds from sale of capitalized assets                                    | —                                  | 415              |
| Purchase of marketable securities   | (861)                              | —                |
| Maturities of marketable securities   | 8,261                              | —                |
| Restricted cash   | 611                                | (3,746)          |
| <b>Net cash provided by (used in) investing activities</b>                  | <u>5,906</u>                       | <u>(5,172)</u>   |
| <b>Cash Flows From Financing Activities</b>                                 |                                    |                  |
| Repayment of long-term debt   | (85)                               | (96)             |
| Repayment of capital lease obligation                                       | (76)                               | (182)            |
| Net proceeds from issuance of common stock                                  | 7                                  | 50               |
| Repayment of notes receivable from stockholders                             | —                                  | 16               |
| Repurchase of common stock  | (4,000)                            | —                |
| <b>Net cash used in financing activities</b>                                | <u>(4,154)</u>                     | <u>(212)</u>     |
| <b>Effect of exchange rate differences on cash and cash equivalents</b>     | 14                                 | (24)             |
| <b>Net change in cash and cash equivalents</b>                              | (220)                              | (9,908)          |
| <b>Cash and cash equivalents, beginning of period</b>                       | 18,507                             | 55,338           |
| <b>Cash and cash equivalents, end of period</b>                             | <u>\$ 18,287</u>                   | <u>\$ 45,430</u> |

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”, “ERI”, “we”, or “us”) develops, manufactures, and sells high-efficiency energy recovery devices for use in seawater desalination. Our products are sold under the trademarks AquaBold™, AquaSpire™, ERI®, PX®, PEI™, Pressure Exchanger®, PX Pressure Exchanger®, Pump Engineering™, and Quadribaric™. Our energy recovery devices make desalination affordable by capturing and reusing the otherwise lost pressure energy from the concentrated seawater reject stream of the desalination process. We also manufacture and sell high-pressure pumps and circulation pumps for use in desalination. Our products are developed and manufactured in the United States of America (“U.S.”) at our headquarters in San Leandro, California. Additionally, we have direct sales and technical support centers in Madrid, Dubai, and Shanghai.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. Shares of our common stock began trading publicly in July 2008. At September 30, 2012, we had two wholly-owned subsidiaries: Energy Recovery Iberia, S.L. (incorporated in September 2006) and ERI Energy Recovery Ireland Ltd. (incorporated in April 2010).

***Use of Estimates***

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“U.S. GAAP”) requires our management to make judgments, assumptions, and estimates that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Our most significant estimates and judgments involve the determination of revenue recognition, allowance for doubtful accounts, allowance for product warranty, valuation of stock options, valuation 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, including contingent consideration. Actual results could differ materially from those estimates.

***Basis of Presentation***

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

The accompanying condensed consolidated financial statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2011 condensed consolidated balance sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP; however, we believe that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto for the fiscal year ended December 31, 2011 included in our Annual Report on Form 10-K filed with the SEC on March 13, 2012.

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

The presentation of certain assets in our condensed consolidated financial statements has changed from prior periods. Land and building held for sale in connection with our restructuring plan to consolidate our North American operations has been classified as a current asset instead of a long-term asset. Amounts presented as of December 31, 2011 have been reclassified to conform to the current period presentation.

### Recently Adopted Accounting Guidance

In September 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-08, *Intangibles—Goodwill and Other, Testing Goodwill for Impairment*. The revised standard provided entities an option to perform a qualitative assessment to determine whether further impairment testing is necessary. If an entity believes, as a result of its qualitative assessment, that it is more likely than not that the fair value of a reporting entity is less than its carrying amount, then the quantitative impairment test is required. Otherwise, no further testing is required. This standard was effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. We perform an annual impairment test of goodwill during our fourth quarter. Adoption of the new guidance is not expected to have a material impact on our financial statements.

On January 1, 2012, we adopted guidance issued by the FASB under ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. This standard requires that all non-owner changes in stockholders’ equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements and eliminates the option to present other comprehensive income in the statement of changes in equity. We adopted this guidance by presenting comprehensive income (loss) in a separate consecutive financial statement.

On January 1, 2012, we adopted guidance issued by the FASB under ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This standard clarifies the application of certain existing fair value measurement guidance and expands the disclosures for fair value measurement that are estimated using significant unobservable (Level 3) inputs. Adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

### Note 2 — Goodwill and Other Intangible Assets

Goodwill as of September 30, 2012 and December 31, 2011 of \$12.8 million was the result of our acquisition of Pump Engineering, LLC in December 2009. During the nine months ended September 30, 2012, there were no changes in the recognized amount of goodwill.

The components of identifiable other intangible assets, all of which are finite-lived, as of September 30, 2012 and December 31, 2011, respectively, were as follows (in thousands):

|                        | <b>September 30, 2012</b> |                     |                    |                 |
|------------------------|---------------------------|---------------------|--------------------|-----------------|
|                        | <b>Gross</b>              | <b>Accumulated</b>  | <b>Accumulated</b> | <b>Net</b>      |
|                        | <b>Carrying</b>           |                     |                    |                 |
|                        | <b>Amount</b>             | <b>Amortization</b> | <b>Losses</b>      | <b>Amount</b>   |
| Developed technology   | \$ 6,100                  | \$ (1,728)          | \$ —               | \$ 4,372        |
| Non-compete agreements | 1,310                     | (976)               | —                  | 334             |
| Backlog                | 1,300                     | (1,300)             | —                  | —               |
| Trademarks             | 1,200                     | (170)               | —                  | 1,030           |
| Customer relationships | 990                       | (743)               | —                  | 247             |
| Patents                | 585                       | (320)               | (42)               | 223             |
| <b>Total</b>           | <b>\$ 11,485</b>          | <b>\$ (5,237)</b>   | <b>\$ (42)</b>     | <b>\$ 6,206</b> |

  

|                        | <b>December 31, 2011</b> |                     |                    |                 |
|------------------------|--------------------------|---------------------|--------------------|-----------------|
|                        | <b>Gross</b>             | <b>Accumulated</b>  | <b>Accumulated</b> | <b>Net</b>      |
|                        | <b>Carrying</b>          |                     |                    |                 |
|                        | <b>Amount</b>            | <b>Amortization</b> | <b>Losses</b>      | <b>Amount</b>   |
| Developed technology   | \$ 6,100                 | \$ (1,271)          | \$ —               | \$ 4,829        |
| Non-compete agreements | 1,310                    | (861)               | —                  | 449             |
| Backlog                | 1,300                    | (1,300)             | —                  | —               |
| Trademarks             | 1,200                    | (125)               | —                  | 1,075           |
| Customer relationships | 990                      | (594)               | —                  | 396             |
| Patents                | 585                      | (301)               | (42)               | 242             |
| <b>Total</b>           | <b>\$ 11,485</b>         | <b>\$ (4,452)</b>   | <b>\$ (42)</b>     | <b>\$ 6,991</b> |

### Note 3 — Earnings per Share

Basic and diluted net loss per share is based on the weighted average number of common shares outstanding during the period. Potentially dilutive securities are excluded from the calculation of loss per share as their inclusion would be anti-dilutive. The following table shows the computation of basic and diluted loss per share (in thousands, except per share data):

|  | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30 |             |
|--|-------------------------------------|-------------|-----------------------------------|-------------|
|  | 2012                                | 2011        | 2012                              | 2011        |
| <b>Numerator:</b>  |                                     |             |                                   |             |
| Net loss   | \$ (1,826)                          | \$ (11,326) | \$ (6,070)                        | \$ (16,422) |
| <b>Denominator:</b>  |                                     |             |                                   |             |
| Basic and diluted weighted average common shares outstanding | 50,872                              | 52,636      | 51,638                            | 52,602      |
| Basic and diluted net loss per share                         | \$ (0.04)                           | \$ (0.22)   | \$ (0.12)                         | \$ (0.31)   |

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

|                    | Three and Nine Months Ended<br>September 30, |       |
|--------------------|--|-------|
|                    | 2012   | 2011  |
| Stock options      | 6,595  | 4,918 |
| Warrants           | 970  | 970   |
| Restricted awards* | 5  | 16    |

\* Includes restricted stock and restricted stock units.

### Note 4 — Other Financial Information

#### Restricted Cash

We have pledged cash in connection with contingent payments resulting from a business acquisition and letters of credit. We have deposited corresponding amounts into money market and non-interest bearing accounts at three financial institutions for these items as follows (in thousands):

|  | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
| Contingent and other consideration for acquisition | \$ 2,504              | \$ 2,504             |
| Collateral for letters of credit                   | 2,703                 | 3,094                |
| Collateral for equipment promissory note           | —                     | 89                   |
| Current restricted cash                            | \$ 5,207              | \$ 5,687             |
| Contingent and other consideration for acquisition | \$ 1,000              | \$ 1,000             |
| Collateral for letters of credit                   | 4,101                 | 4,232                |
| Non-current restricted cash                        | \$ 5,101              | \$ 5,232             |
| Total restricted cash                              | \$ 10,308             | \$ 10,919            |

#### Inventories

Our inventories consisted of the following (in thousands):

|                 | September 30,<br>2012 | December 31,<br>2011 |
|-----------------|-----------------------|----------------------|
| Raw materials   | \$ 3,447              | \$ 4,683             |
| Work in process | 1,980                 | 1,550                |
| Finished goods  | 1,094                 | 1,591                |
| Inventories     | \$ 6,521              | \$ 7,824             |

### Revenue by Product Category

We manufacture and sell high-efficiency energy recovery devices, high-pressure pumps, and related parts and services under one operating segment (see Note 10 — “Business Segment and Geographic Information”). Although we operate under one segment, we categorize revenue based on the type of energy recovery device and its related products and services. The following table reflects revenue by product category for the periods indicated (in thousands):

|   | Three Months Ended<br>September 30, |                 | Nine Months Ended<br>September 30, |                  |
|---|-------------------------------------|-----------------|------------------------------------|------------------|
|   | 2012                                | 2011            | 2012                               | 2011             |
| PX® devices and related products and services             | \$ 8,663                            | \$ 2,770        | \$ 22,138                          | \$ 14,609        |
| Turbochargers and pumps and related products and services | 1,835                               | 2,163           | 5,412                              | 7,323            |
| Net revenue   | <u>\$ 10,498</u>                    | <u>\$ 4,933</u> | <u>\$ 27,550</u>                   | <u>\$ 21,932</u> |

### Assets Held for Sale

In July 2011, we initiated a restructuring plan to consolidate our North American operations and transfer all manufacturing operations to our manufacturing center and headquarters in San Leandro, California. As a result of this plan, amounts related to the building and land in Michigan were classified as held for sale as of December 31, 2011.

On June 22, 2012, we signed a purchase agreement to sell the land and building held for sale. The sale was expected to be completed in August 2012. The agreement was not finalized as planned and the property has again been listed for sale with a commercial agent. During the three and nine months ended September 30, 2012, we assessed the estimated fair value of the assets held for sale and recorded impairment charges of \$164,000 and \$243,000, respectively, to reflect the current market value of the property.

### Note 5 — Investments

Our short-term and long-term investments are all classified as available-for-sale.

Available-for-sale securities at September 30, 2012 consisted of the following (in thousands):

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Holding Gains | Gross<br>Unrealized<br>Holding<br>Losses | Fair Value       |
|--|-------------------|--------------------------------------|--|------------------|
| State and local government obligations | \$ 1,864          | \$ 4                                 | \$ (1)                                   | \$ 1,867         |
| Corporate notes and bonds              | 9,587             | —                                    | (12)                                     | 9,575            |
| Short-term investments                 | <u>\$ 11,451</u>  | <u>\$ 4</u>                          | <u>\$ (13)</u>                           | <u>\$ 11,442</u> |
| Agency obligations                     | \$ 750            | \$ —                                 | \$ —                                     | \$ 750           |
| State and local government obligations | 757               | —                                    | (6)                                      | 751              |
| Corporate notes and bonds              | 2,220             | —                                    | (16)                                     | 2,204            |
| Long-term investments                  | <u>\$ 3,727</u>   | <u>\$ —</u>                          | <u>\$ (22)</u>                           | <u>\$ 3,705</u>  |
| Total available-for-sale securities    | <u>\$ 15,178</u>  | <u>\$ 4</u>                          | <u>\$ (35)</u>                           | <u>\$ 15,147</u> |

Available-for-sale securities at December 31, 2011 consisted of the following (in thousands):

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Holding Gains | Gross<br>Unrealized<br>Holding<br>Losses | Fair Value       |
|--|-------------------|--------------------------------------|--|------------------|
| Certificates of deposit                | \$ 750            | \$ —                                 | \$ —                                     | \$ 750           |
| Commercial paper                       | 1,000             | —                                    | —  | 1,000            |
| State and local government obligations | 1,611             | —                                    | (3)                                      | 1,608            |
| Corporate notes and bonds              | 8,353             | 1                                    | (6)                                      | 8,348            |
| Short-term investments                 | <u>\$ 11,714</u>  | <u>\$ 1</u>                          | <u>\$ (9)</u>                            | <u>\$ 11,706</u> |
| Agency obligations                     | \$ 750            | \$ —                                 | \$ —                                     | \$ 750           |
| State and local government obligations | 2,032             | 1                                    | (1)                                      | 2,032            |
| Corporate notes and bonds              | 8,422             | 7                                    | (13)                                     | 8,416            |
| Long-term investments                  | <u>\$ 11,204</u>  | <u>\$ 8</u>                          | <u>\$ (14)</u>                           | <u>\$ 11,198</u> |
| Total available-for-sale securities    | <u>\$ 22,918</u>  | <u>\$ 9</u>                          | <u>\$ (23)</u>                           | <u>\$ 22,904</u> |



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, 2012 are shown below by contractual maturity (in thousands):

|  | <b>September 30, 2012</b> |                   |
|--|---------------------------|-------------------|
|  | <b>Amortized Cost</b>     | <b>Fair Value</b> |
| Due in one year or less                | \$ 2,148                  | \$ 2,148          |
| Due after one year through three years | 13,030                    | 12,999            |
| Total available-for-sale securities    | <u>\$ 15,178</u>          | <u>\$ 15,147</u>  |

## **Note 6 — Long-Term Debt and Capital Leases**

### ***Long-Term Debt***

As of September 30, 2012, our long-term debt, which consisted of one equipment promissory note, was fully paid.

### ***Lines of Credit***

On June 5, 2012, we entered into a loan agreement (the “2012 Agreement”) with a financial institution. The 2012 Agreement provides for a total available credit line of \$16.0 million. Under the 2012 Agreement, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total letters of credit issued under the 2012 Agreement may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. At no time may the aggregate of the revolving loans and letters of credit exceed the total available credit line of \$16.0 million. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate plus 0% or a Eurodollar loan that bears interest equal to the adjusted LIBO rate plus 1.25%. Letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a facility fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line. The 2012 Agreement also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding letters of credit collateralized by the line of credit. The 2012 Agreement matures on June 5, 2015 and is collateralized by substantially all of our assets. As of September 30, 2012, there were no advances drawn and \$1.2 million in letters of credit collateralized under the 2012 Agreement’s line of credit.

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

In 2009, we entered into a loan and security agreement (the “2009 Agreement”) with another financial institution. The 2009 Agreement, as amended, provided a total available credit line of \$16.0 million. Under the 2009 Agreement, we were allowed to draw advances of up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for letters of credit, provided that the aggregate of the outstanding advances and collateral did not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incurred interest based on a prime rate index or LIBOR plus 1.375%. The 2009 Agreement was further amended in July 2011 and required us to maintain cash collateral balances equal to at least 101% of the face amount of all outstanding letters of credit collateralized by the line of credit and 100% of the amount of all outstanding advances. The amended 2009 Agreement expired on May 30, 2012. There were no advances drawn under the 2009 Agreement’s credit line at the time it expired. The amount of outstanding letters of credit collateralized under the 2009 Agreement at December 31, 2011 totaled \$6.7 million. As of September 30, 2012, remaining letters of credit issued under the 2009 Agreement, for which we have restricted cash, totaled \$5.5 million.

## Capital Leases

Future minimum payments under capital leases consist of the following (in thousands):

|   | <b>September 30,<br/>2012</b> |
|---|-------------------------------|
| 2012 (remaining three months)                       | \$ 11                         |
| 2013  | 14                            |
| Total future minimum lease payments                 | 25                            |
| Less: amount representing interest                  | (1)                           |
| Present value of net minimum capital lease payments | 24                            |
| Less: current portion                               | (24)                          |
| Long-term portion                                   | \$ —                          |

## Note 7 — Equity

### Stock Repurchase Program

In June 2011, our Board of Directors authorized a stock repurchase program under which up to five million shares of our outstanding common stock could have been repurchased through June 2012 at the discretion of management. There was no stock repurchase activity during the three months ended September 30, 2012. A total of 1,782,603 shares at an aggregate cost of \$4.0 million was repurchased under this authorization which expired on June 30, 2012.

### Share-Based Compensation Expense

For the three and nine months ended September 30, 2012 and 2011, we recognized share-based compensation expense related to employees and consultants as follows (in thousands):

|  | <b>Three Months Ended<br/>September 30,</b> |               | <b>Nine Months Ended<br/>September 30,</b> |                 |
|--|---|---------------|--|-----------------|
|  | <b>2012</b>                                 | <b>2011</b>   | <b>2012</b>                                | <b>2011</b>     |
| Cost of revenue                        | \$ 25                                       | \$ 35         | \$ 90                                      | \$ 112          |
| General and administrative             | 440   | 438           | 1,464                                      | 1,287           |
| Sales and marketing                    | 94  | 180           | 434  | 477             |
| Research and development               | 30  | 53            | 109  | 144             |
| Total share-based compensation expense | <u>\$ 589</u>                               | <u>\$ 706</u> | <u>\$ 2,097</u>                            | <u>\$ 2,020</u> |

As of September 30, 2012, total unrecognized compensation cost related to non-vested share-based awards, net of estimated forfeitures, was \$3.6 million, which is expected to be recognized as expense over a weighted average period of approximately 2.4 years.

In January 2012, we granted 339,695 stock options to certain officers and other employees. The options vest over a four-year period, have a weighted average exercise price of \$2.59 per share, and expire 10 years from the grant date.

In February 2012, we granted 1,380,533 stock options to certain officers and other employees. The options vest over a four-year period, have a weighted average exercise price of \$2.46 per share, and expire 10 years from the grant date.

In March 2012, we granted 35,398 stock options to other employees. The options vest over a four-year period, have a weighted average exercise price of \$2.20 per share, and expire 10 years from the grant date.

In August 2012, we granted 319,956 stock options to the non-employee members of our Board of Directors in accordance with the annual compensation terms approved by the Compensation Committee of the Board of Directors. The options fully vest in June 2013, have a weighted average exercise price of \$2.49 per share, and expire 10 years from the grant date.

## Note 8 — Income Taxes

As of September 30, 2012, our valuation allowance was approximately \$10.3 million. The effective tax rate for the nine months ended September 30, 2012 and 2011 was 4% and 12%, respectively. These effective tax rates differ from the U.S. statutory rate principally due to the effect of state income taxes, non-deductible share-based compensation, credits related to research and development, change in valuation allowance, and recognition of an uncertain tax position relating to amended state tax returns. The change in the effective tax rate from the comparable period in the prior year was principally due to changes in our forecasted pre-tax loss and the application of a valuation allowance.



## Note 9 — Commitments and Contingencies

### *Operating Lease Obligations*

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

|                                     | <b>September 30,<br/>2012</b> |
|-------------------------------------|-------------------------------|
| 2012 (remaining three months)       | \$ 385                        |
| 2013                                | 1,541                         |
| 2014                                | 1,627                         |
| 2015                                | 1,544                         |
| 2016                                | 1,581                         |
| Thereafter                          | 4,492                         |
| Total future minimum lease payments | <u>\$ 11,170</u>              |

### *Product Warranty*

We sell products with a limited warranty for a period ranging from one to six years. We accrue for warranty costs based on estimated product failure rates, historical activity, and expectations of future costs. Periodically, we evaluate and adjust the warranty costs to the extent actual warranty costs vary from the original estimates.

The following table summarizes the activity related to the product warranty liability during the three and nine months ended September 30, 2012 and 2011 (in thousands):

|   | <b>Three Months Ended<br/>September 30,</b> |               | <b>Nine Months Ended<br/>September 30,</b> |               |
|---|---|---------------|--|---------------|
|   | <b>2012</b>                                 | <b>2011</b>   | <b>2012</b>                                | <b>2011</b>   |
| Balance, beginning of period              | \$ 943                                      | \$ 763        | \$ 852                                     | \$ 1,028      |
| Warranty costs charged to cost of revenue | 109   | 216           | 283  | 469           |
| Utilization of warranty                   | (34)  | (235)         | (117)                                      | (753)         |
| Balance, end of period                    | <u>\$ 1,018</u>                             | <u>\$ 744</u> | <u>\$ 1,018</u>                            | <u>\$ 744</u> |

### *Purchase Obligations*

We enter into purchase order arrangements with our vendors. As of September 30, 2012, there are open purchase orders for which we have not yet received the related goods or services. The majority of these purchase order arrangements are related to various raw materials and component parts and are subject to change based on our sales demand forecasts. We have the right to cancel most of these arrangements prior to the date of delivery. As of September 30, 2012, we had approximately \$3.5 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, typically customers, in the ordinary course of business. 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, 2012 and December 31, 2011.

In certain cases, we issue warranty and product performance guarantees to our customers for amounts ranging from 10% to 30% of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication, and operating performance of primarily the PX<sup>®</sup> device. These guarantees are generally in the form of letters of credit or bank guarantees secured by letters of credit, typically remain in place for periods ranging from 12 to 48 months, and relate to the underlying product warranty period. The letters of credit are collateralized by restricted cash and our credit facility. Of the \$6.7 million in outstanding letters of credit at September 30, 2012, \$5.5 million was issued under the 2009 Agreement, \$1.2 million was issued under the 2012 Agreement, and \$42,000 was issued under an earlier agreement. The letters of credit outstanding at September 30, 2012 were collateralized by restricted cash of \$6.8 million.

### Litigation

Note 10 – Commitments and Contingencies, under the caption “Litigation” of our Annual Report on Form 10-K filed with the SEC on March 13, 2012, provides information on certain litigation in which we are involved. Unfavorable rulings, judgments, or settlement terms regarding these litigation matters could have a material adverse impact on our business, financial condition, results of operations, and cash flows. Although none of the aforementioned litigation can be quantified with absolute certainty, we have established reserves covering exposure relating to contingencies, to the extent they are reasonably estimable and probable based on available facts. There have been no material developments to these matters from what was disclosed in our Form 10-K.

See also Note 13 — Subsequent Events.

### Note 10 — Business Segment and Geographic Information

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

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

|                       | Three Months Ended<br>September 30, |                 | Nine Months Ended<br>September 30, |                  |
|-----------------------|-------------------------------------|-----------------|------------------------------------|------------------|
|                       | 2012                                | 2011            | 2012                               | 2011             |
| Domestic revenue      | \$ 1,266                            | \$ 243          | \$ 3,054                           | \$ 2,248         |
| International revenue | 9,232                               | 4,690           | 24,496                             | 19,684           |
| Total revenue         | <u>\$ 10,498</u>                    | <u>\$ 4,933</u> | <u>\$ 27,550</u>                   | <u>\$ 21,932</u> |
| Revenue by country:   |                                     |                 |                                    |                  |
| Israel                | 49%                                 | 1%              | 25%                                | *                |
| United States         | 12%                                 | 5%              | 11%                                | 10%              |
| Australia             | 4%                                  | 5%              | 16%                                | 2%               |
| Saudi Arabia          | 2%                                  | 10%             | 1%                                 | 7%               |
| India                 | *                                   | 17%             | *                                  | 19%              |
| Others **             | 33%                                 | 62%             | 47%                                | 62%              |
| Total                 | <u>100%</u>                         | <u>100%</u>     | <u>100%</u>                        | <u>100%</u>      |

\* Less than 1%.

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

All of our long-lived assets were located in the United States at September 30, 2012 and December 31, 2011.

## Note 11 — Concentrations

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

|  | September 30,<br>2012 | December 31,<br>2011 |
|--|-----------------------|----------------------|
| I.V.M. Minrav Sadyt (a consortium of Minrav Holdings, Ltd and Sadyt, a Valoriza Agua company)  | 29%                   | *                    |
| Via Maris Desalination (a Global Environmental Solutions (GES) company)  | 11%                   | *                    |
| Aquatech Systems (Asia) Pvt. Ltd.  | *                     | 17%                  |
| UTE Desaladora Skikda (an affiliated entity of Geida) (Geida is a consortium of Befesa Aqua, a subsidiary of Abengoa S.A.; Cobra-Tedagua, a subsidiary of ACS Actividades de Construcción y Servicios, S.A.; and Sadyt S.A., a subsidiary of Sacyr Vallehermoso, S.A.) | *                     | 11%                  |
| * Less than 10%.   |                       |                      |

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

|   | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|---|-------------------------------------|------|------------------------------------|------|
|   | 2012                                | 2011 | 2012                               | 2011 |
| I.V.M. Minrav Sadyt (a consortium of Minrav Holdings, Ltd and Sadyt, a Valoriza Agua company)   | 38%                                 | *    | 17%                                | *    |
| Via Maris Desalination (a Global Environmental Solutions (GES) company)   | 10%                                 | *    | *                                  | *    |
| Southern Seawater JV (a joint venture of Tecnicas Reunidas Australia Pty Ltd, Valoriza Water Australia Pty Ltd, A.J. Lucas Operations Pty Ltd, and Worley Parsons Services Pty Ltd) | *                                   | *    | 13%                                | *    |
| Aquatech Systems (Asia) Pvt. Ltd  | *                                   | 12%  | *                                  | *    |
| IDE Technologies Ltd.   | *                                   | *    | *                                  | 18%  |
| * Less than 10%.  |                                     |      |                                    |      |

## Note 12 — Fair Value Measurements

The authoritative guidance for measuring fair value prioritizes the inputs used in measuring fair value into the following hierarchy:

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

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

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

The carrying values of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, and other accrued expenses approximate fair value due to the short-term maturity of those instruments. For our investments in available-for-sale securities, if quoted prices in active markets for identical investments are not available to determine fair value (Level 1), then we use quoted prices for similar assets or inputs other than the quoted prices that are observable either directly or indirectly (Level 2). The investments included in Level 2 consist primarily of certificates of deposits; commercial paper; and municipal, corporate, and agency obligations. The carrying amount of the contingent consideration arising from our acquisition of Pump Engineering, LLC is measured at fair value on a recurring basis using unobservable inputs in which little or no market activity exists (Level 3). The estimated fair value of the contingent consideration is determined based 100% on management's assessment of the weighted probability of payment under various scenarios.

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

|  | September<br>30,<br>2012 | Fair Value Measurement at Reporting Date<br>Using  |   |  |
|--|--------------------------|--|---|--|
|  |                          | Quoted<br>Prices in<br>Active<br>Markets<br>for Identical<br>Assets or<br>Liabilities<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Assets:</b>                           |                          |  |   |  |
| Short-term available-for-sale securities | \$ 11,442                | \$ —   | \$ 11,442   | \$ —   |
| Long-term available-for-sale securities  | 3,705                    | —  | 3,705   | —  |
| Total assets                             | \$ 15,147                | \$ —   | \$ 15,147   | \$ —   |
| <b>Liabilities:</b>                      |                          |  |   |  |
| Contingent consideration*                | \$ 1,524                 | \$ —   | \$ —  | \$ 1,524   |
| Total liabilities                        | \$ 1,524                 | \$ —   | \$ —  | \$ 1,524   |

|  | December<br>31,<br>2011 | Fair Value Measurement at Reporting Date<br>Using  |   |  |
|--|-------------------------|--|---|--|
|  |                         | Quoted<br>Prices in<br>Active<br>Markets<br>for Identical<br>Assets or<br>Liabilities<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Assets:</b>                           |                         |  |   |  |
| Short-term available-for-sale securities | \$ 11,706               | \$ —   | \$ 11,706   | \$ —   |
| Long-term available-for-sale securities  | 11,198                  | —  | 11,198  | —  |
| Total assets                             | \$ 22,904               | \$ —   | \$ 22,904   | \$ —   |
| <b>Liabilities:</b>                      |                         |  |   |  |
| Contingent consideration*                | \$ 1,524                | \$ —   | \$ —  | \$ 1,524   |
| Total liabilities                        | \$ 1,524                | \$ —   | \$ —  | \$ 1,524   |

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

The reconciliation of the beginning and ending balances for assets and liabilities measured on a recurring basis using significant unobservable inputs (Level 3) for the period ended September 30, 2012 were as follows (in thousands):

|                             | Contingent<br>Consideration |
|-----------------------------|-----------------------------|
| Balance, December 31, 2011  | \$ 1,524                    |
| Loss due to change in value | —                           |
| Balance, September 30, 2012 | \$ 1,524                    |

As of September 30, 2012, we had assets held for sale of \$1.4 million related to our Michigan manufacturing facility. The building and land were classified as held for sale as of December 31, 2011 in connection with our restructuring plan to consolidate our North American operations and transfer all manufacturing operations to San Leandro, California. On June 22, 2012, we signed a purchase agreement to sell the land and building held for sale. The fair value of the assets at June 30, 2012 was determined based on the offered purchase price, which was considered a directly observable input (Level 2). Based on these inputs, we recorded impairment charges of \$79,000 during the three months ended June 30, 2012.

The sale was expected to be completed in August 2012. The agreement was not finalized as planned, and the property was again listed for sale with a commercial agent. During the three months ended September 30, 2012, we assessed the estimated fair value of the assets held for sale and recorded impairment charges of \$164,000. The fair value of these assets was determined based on Level 3 inputs, primarily sales data for similar properties.



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

|                      | <b>Fair Value Measurement at Reporting Date</b> |  |  |  |
|----------------------|---|--|--|--|
|                      | <b>Using</b>                                    |  |  |  |
|                      | <b>September 30, 2012</b>                       | <b>Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)</b> | <b>Significant Other Observable Inputs (Level 2)</b> | <b>Significant Unobservable Inputs (Level 3)</b> |
| Assets held for sale | \$ 1,417  | \$ —   | \$ —   | \$ 1,417   |

|                      | <b>Fair Value Measurement at Reporting Date</b> |  |  |  |
|----------------------|---|--|--|--|
|                      | <b>Using</b>                                    |  |  |  |
|                      | <b>December 31, 2011</b>                        | <b>Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)</b> | <b>Significant Other Observable Inputs (Level 2)</b> | <b>Significant Unobservable Inputs (Level 3)</b> |
| Assets held for sale | \$ 1,660  | \$ —   | \$ —   | \$ 1,660   |

**Note 13 — Subsequent Events**

On October 25, 2012, we disclosed on a Form 8-K filing that we had entered into a confidential settlement agreement resulting from an alleged breach of contract claim against one of our suppliers. Without any admission of liability or wrongdoing by the supplier, we received a one-time payment of \$775,000, which will be recognized in the fourth quarter of 2012.

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

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

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

*Forward-looking statements in this report include, without limitation, statements about the following:*

- our belief that the levels of gross profit margin achieved during the second and third quarters of 2012 are sustainable and improvable to the extent that volume remains healthy and we continue to realize cost savings through production efficiencies and enhanced yields;*
- our plan to improve our existing energy recovery devices and to develop and manufacture new and enhanced versions of these devices;*
- our belief that sales of our PX-300™ and PX-Q300™ devices will represent a higher percentage of our net revenue in 2012;*
- our belief that the ceramics components of our PX® devices will result in low life-cycle maintenance cost;*
- our belief that our turbocharger devices have long operating lives;*
- our objective of finding new applications for our technology and developing new products for use outside of desalination, including oil and gas applications;*
- our belief that our products are the most cost-effective energy recovery devices over time;*
- our expectation that our expenses for research and development will increase;*
- our expectation that we will continue to rely on sales of our energy recovery devices for a substantial portion of our revenue;*
- our belief that our current facilities will be adequate for the foreseeable future;*
- our expectation that sales outside of the United States will remain a significant portion of our revenue;*
- our expectation that future sales and marketing expense will increase;*
- our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated liquidity needs for the foreseeable future;*
- our expectation that, as we expand our international sales, a portion of our revenue could continue to be denominated in foreign currencies.*

*All forward-looking statements included in this document are subject to additional risks and uncertainties further discussed under "Part II, Item 1A: Risk Factors" and are based on information available to us as of November 8, 2012. We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements. The factors that could cause our actual results to differ from those included in such forward-looking statements are set forth under the heading "Part II, Item 1A: Risk Factors" and our results disclosed from time to time in our reports on Forms 10-K, 10-Q, and 8-K as well as in our Annual Reports to Stockholders.*

*The following should be read in conjunction with the condensed consolidated financial statements and related notes included in "Part I, Item 1: Financial Statements" of this quarterly report and the consolidated financial statements and related notes included in our Annual Report on Form 10-K as filed on March 13, 2012.*

## **Overview**

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

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

Due to the fact that a single order for our energy recovery devices by a large engineering, procurement, and construction firm for a particular plant may represent significant revenue, we often experience substantial fluctuations in net revenue from quarter to quarter and from year to year. Historically, our engineering, procurement, and construction customers tended to order a significant amount of equipment for delivery in the fourth quarter and, as a result, a significant portion of our annual sales occurred during that quarter. In fiscal year 2011, however, fourth quarter revenue did not reflect as high a percentage of the annual revenue as in past years due to the overall lower percentage of sales to engineering, procurement, and construction firms in 2011.

A limited number of our customers account for a substantial portion of our net revenue and accounts receivable. Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended September 30, 2012, I.V.M. Minrav Sadyt (a consortium of Minrav Holdings, Ltd and Sadyt, a Valoriza Agua company) and Via Maris Desalination (a Global Environmental Solutions (GES) company) accounted for approximately 38% and 10% of our net revenue, respectively. For the three months ended September 30, 2011, Aquatech Systems (Asia) Pvt. Ltd. accounted for 12% of our net revenue. For the nine months ended September 30, 2012, I.V.M. Minrav Sadyt (a consortium of Minrav Holdings, Ltd and Sadyt, a Valoriza Agua company) and Southern Seawater JV (a joint venture of Tecnicas Reunidas Australia Pty Ltd, Valoriza Water Australia Pty Ltd, A.J. Lucas Operations Pty Ltd, and Worley Parsons Services Pty Ltd) accounted for approximately 17% and 13% of our net revenue, respectively. For the nine months ended September 30, 2011, IDE Technologies Ltd. accounted for approximately 18% of our net revenue. No other customers accounted for more than 10% of our net revenue during any of these periods.

During the three and nine months ended September 30, 2012 and 2011, most of our revenue was attributable to sales outside of the United States. We expect sales outside of the United States to remain a significant portion of our net revenue for the foreseeable future.

While our revenue is principally derived from the sale of energy recovery devices, we also derive revenue from the sale of high-pressure and circulation pumps that we manufacture and sell in connection with our energy recovery devices for use in desalination plants. Additionally, we receive incidental revenue from the sale of spare parts and services that we provide to our customers.

In June 2011, our Board of Directors authorized a stock repurchase program under which up to five million shares of our outstanding common stock could have been repurchased through June 2012 at the discretion of management. There was no stock repurchase activity during the three months ended September 30, 2012. A total of 1,782,603 shares at an aggregate cost of \$4.0 million was repurchased under this authorization which expired on June 30, 2012.

In July 2011, we initiated a restructuring plan to consolidate our North American operations and transfer our Michigan-based operations to our manufacturing center and headquarters in San Leandro, California. In connection with this restructuring plan, we classified the land and building located in Michigan as assets held for sale at December 31, 2011. On June 22, 2012, we signed a purchase agreement to sell this land and building. The sale was expected to be completed in August 2012. The agreement was not finalized as planned and the property was again listed for sale with a commercial agent. During the three and nine months ended September 30, 2012, we assessed the estimated fair value of the assets held for sale and recorded impairment charges of \$164,000 and \$243,000, respectively.

Our condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the condensed consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent that there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition, allowance for doubtful accounts, allowance for product warranty, valuation of stock options, valuation 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, including contingent consideration.

### *Third Quarter of 2012 Compared to Third Quarter of 2011*

#### **Results of Operations**

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

|  | <b>Three Months Ended September 30,</b> |       |             |        |   |       |
|--|---|-------|-------------|--------|---|-------|
|  | <b>2012</b>                             |       | <b>2011</b> |        | <b>Change<br/>Increase / (Decrease)</b> |       |
| <b>Results of Operations:*</b>               |   |       |             |        |   |       |
| Net revenue                                  | \$ 10,498                               | 100%  | \$ 4,933    | 100%   | \$ 5,565                                | 113%  |
| Cost of revenue                              | 4,696                                   | 45%   | 4,214       | 85%    | 482                                     | 11%   |
| Gross profit                                 | 5,802                                   | 55%   | 719         | 15%    | 5,083                                   | 707%  |
| Operating expenses:                          |   |       |             |        |   |       |
| General and administrative                   | 3,825                                   | 36%   | 3,571       | 72%    | 254                                     | 7%    |
| Sales and marketing                          | 1,860                                   | 18%   | 2,291       | 46%    | (431)                                   | (19%) |
| Research and development                     | 1,495                                   | 14%   | 726         | 15%    | 769                                     | 106%  |
| Amortization of intangible assets            | 262                                     | 2%    | 346         | 7%     | (84)                                    | (24%) |
| Restructuring charges                        | 167                                     | 2%    | 470         | 10%    | (303)                                   | (64%) |
| Total operating expenses                     | 7,609                                   | 72%   | 7,404       | 150%   | 205                                     | 3%    |
| Loss from operations                         | (1,807)                                 | (17%) | (6,685)     | (136%) | 4,878                                   | 73%   |
| Interest expense                             | (1)                                     | (0%)  | (5)         | (0%)   | 4                                       | 80%   |
| Other non-operating income<br>(expense), net | 36                                      | (0%)  | (127)       | (3%)   | 163                                     | 128%  |
| Loss before income taxes                     | (1,772)                                 | (17%) | (6,817)     | (138%) | 5,045                                   | 74%   |
| Provision for income taxes                   | 54                                      | 1%    | 4,509       | 91%    | (4,455)                                 | (99%) |
| Net loss                                     | \$ (1,826)                              | (17%) | \$ (11,326) | (230%) | \$ 9,500                                | 84%   |

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

#### *Net Revenue*

Our net revenue increased \$5.6 million for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. The increase was primarily due to increased sales of PX<sup>®</sup> devices associated with large mega-project shipments during the third quarter of 2012 compared to the third quarter of 2011, which included no mega-project shipments.

Revenue by product category as a percentage of net revenue was as follows:

|   | <b>Three Months Ended<br/>September 30,</b> |             |
|---|---|-------------|
|   | <b>2012</b>                                 | <b>2011</b> |
| PX® devices and related products and services             | 83%   | 56%         |
| Turbochargers and pumps and related products and services | 17%   | 44%         |
| Net revenue   | 100%  | 100%        |

During the three months ended September 30, 2012 and 2011, a significant portion of our net revenue was attributable to sales outside of the United States. Revenue attributable to domestic and international sales as a percentage of net revenue was as follows:

|                       | <b>Three Months Ended<br/>September 30,</b> |             |
|-----------------------|---|-------------|
|                       | <b>2012</b>                                 | <b>2011</b> |
| Domestic revenue      | 12%   | 5%          |
| International revenue | 88%   | 95%         |
| Net revenue           | 100%  | 100%        |

#### *Gross Profit*

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. For the three months ended September 30, 2012, gross profit as a percentage of net revenue was 55%. For the three months ended September 30, 2011, gross profit as a percentage of net revenue was 15%.

The increase in gross profit as a percentage of net revenue for the three months ended September 30, 2012 as compared to the same period of last year was primarily due to positive operating leverage achieved through increased volume, a product mix that favored PX® devices over turbochargers and pumps, and diminished costs realized through our plant consolidation and vertical integration efforts.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, and the volume of production in our manufacturing plant that determines our operating leverage. Accordingly, we are not able to predict our future gross profit levels with certainty. However, we believe that the levels of gross profit margin achieved during the second and third quarters of 2012 are sustainable and improvable to the extent that volume remains healthy, our product mix favors PX® devices, and we continue to realize cost savings through production efficiencies and enhanced yields.

#### *General and Administrative Expense*

General and administrative expense increased by \$254,000, or 7%, to \$3.8 million for the three months ended September 30, 2012 from \$3.6 million for the three months ended September 30, 2011. As a percentage of net revenue, general and administrative expense decreased to 36% for the three months ended September 30, 2012 from 72% for the three months ended September 30, 2011 primarily due to significantly higher net revenue offset by slightly higher general and administrative expense for the current period.

General and administrative average headcount decreased to 27 in the third quarter of 2012 from 28 in the third quarter of 2011.

Of the \$254,000 increase in general and administrative expense, \$279,000 related to professional and other services, \$100,000 related to compensation and employee-related benefits, \$31,000 related to bad debt expense, and \$26,000 related to other administrative costs. These increases were offset by a decrease of \$182,000 in occupancy costs.

Share-based compensation expense included in general and administrative expense was \$440,000 and \$438,000 for the three months ended September 30, 2012 and 2011, respectively.

### *Sales and Marketing Expense*

Sales and marketing expense decreased by \$431,000, or 19%, to \$1.9 million for the three months ended September 30, 2012 from \$2.3 million for the three months ended September 30, 2011. As a percentage of net revenue, sales and marketing expense decreased to 18% for the three months ended September 30, 2012 from 46% for the three months ended September 30, 2011 primarily due to significantly higher net revenue and lower sales and marketing expense in the current period.

Sales and marketing average headcount decreased to 23 in the third quarter of 2012 from 28 in the third quarter of 2011.

Of the \$431,000 decrease in sales and marketing expense for the three months ended September 30, 2012, \$629,000 related to marketing, occupancy, and other costs and \$175,000 related to compensation and employee-related benefits. The decreases were offset by an increase of \$373,000 related to commissions for sales representatives.

Share-based compensation expense included in sales and marketing expense was \$94,000 and \$180,000 for the three months ended September 30, 2012 and 2011, respectively.

### *Research and Development Expense*

Research and development expense increased by \$769,000, or 106%, to \$1.5 million for the three months ended September 30, 2012 from \$0.7 million for the three months ended September 30, 2011. As a percentage of net revenue, research and development expense decreased to 14% for the three months ended September 30, 2012 from 15% for the three months ended September 30, 2011 primarily due to significantly higher net revenue offset by higher research and development expense for the current period.

Average headcount in our research and development department increased to 16 in the third quarter of 2012 compared to 12 in the third quarter of 2011.

Of the \$769,000 increase in research and development expense for the three months ended September 30, 2012, \$422,000 related to research and development costs associated with accelerated design and prototyping of new devices for the oil and gas market, \$180,000 related to outside consulting and professional fees, \$133,000 related to compensation and employee-related benefits, and \$34,000 related to facility costs.

Share-based compensation expense included in research and development expense was \$30,000 and \$53,000 for the three months ended September 30, 2012 and 2011, respectively.

We anticipate that our research and development expense will continue to increase in the future as we expand and diversify our product portfolio for applications outside of desalination, with a preeminent focus on the oil and gas market.

### *Amortization of Intangible Assets*

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. These intangible assets include developed technology, non-compete agreements, backlog, trademarks, and customer relationships. Amortization expense decreased by \$84,000 during the third quarter of 2012 compared to the third quarter of 2011 due to the full amortization of backlog and one non-compete agreement in 2011.

### *Restructuring Charges*

In July 2011, we initiated a restructuring plan to consolidate our North American operations and transfer our Michigan-based operations to our manufacturing center and headquarters in San Leandro, California. In connection with this restructuring plan, we classified the land and building located in Michigan as assets held for sale at December 31, 2011. On June 22, 2012, we signed a purchase agreement to sell this land and building. The sale was expected to be completed in August 2012. The agreement was not finalized as planned and the property was again listed for sale with a commercial agent.

During the three months ended September 30, 2012, we recorded \$167,000 related to the restructuring plan. Of these charges, \$164,000 related to impairment charges due to our assessment of the estimated fair value of the assets held for sale based on market studies of similar sales in the area and \$3,000 related to other non-recurring charges associated with the restructuring plan.

During the three months ended September 30, 2011, we recorded \$470,000 related to the restructuring plan. Of these charges, \$408,000 related to severance and other personnel costs and \$62,000 related to other exit costs.

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

Non-operating income (expense), net, increased by \$167,000 to income of \$35,000 in the three months ended September 30, 2012 from expense of \$132,000 in the three months ended September 30, 2011. The increase was primarily due to \$1,000 in net foreign currency gains recorded during the third quarter of 2012 compared to \$138,000 in net foreign currency losses recorded during the third quarter of 2011. The \$139,000 favorable impact of net foreign currency gains, higher interest and other income of \$24,000, and lower interest expense of \$4,000 contributed to the favorable change in non-operating income.

#### *Income Taxes*

The income tax provision was \$54,000 in the three months ended September 30, 2012 compared to an income tax provision of \$4.5 million in the three months ended September 30, 2011. As of December 31, 2011, a valuation allowance of approximately \$10.3 million was established to reduce our deferred income tax assets to the amount expected to be realized. As such, no tax benefit related to our pre-tax loss was recognized for the three months ended September 30, 2012, as there was no change in our assessment of the amount of deferred income tax assets expected to be realized.

### ***Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011***

#### **Results of Operations**

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

|   | <b>Nine Months Ended September 30,</b> |       |             |       |   |        |
|---|--|-------|-------------|-------|---|--------|
|   | <b>2012</b>                            |       | <b>2011</b> |       | <b>Change<br/>Increase / (Decrease)</b> |        |
| <b>Results of Operations:*</b>            |  |       |             |       |   |        |
| Net revenue                               | \$ 27,550                              | 100%  | \$ 21,932   | 100%  | \$ 5,618                                | 26%    |
| Cost of revenue                           | 13,836                                 | 50%   | 14,221      | 65%   | (385)                                   | (3%)   |
| Gross profit                              | 13,714                                 | 50%   | 7,711       | 35%   | 6,003                                   | 78%    |
| Operating expenses:                       |  |       |             |       |   |        |
| General and administrative                | 10,899                                 | 40%   | 11,953      | 55%   | (1,054)                                 | (9%)   |
| Sales and marketing                       | 5,114                                  | 19%   | 6,370       | 29%   | (1,256)                                 | (20%)  |
| Research and development                  | 3,055                                  | 11%   | 2,626       | 12%   | 429                                     | 16%    |
| Amortization of intangible assets         | 785                                    | 3%    | 1,037       | 5%    | (252)                                   | (24%)  |
| Restructuring charges                     | 277                                    | 1%    | 470         | 2%    | (193)                                   | (41%)  |
| Total operating expenses                  | 20,130                                 | 73%   | 22,456      | 102%  | (2,326)                                 | (10%)  |
| Loss from operations                      | (6,416)                                | (23%) | (14,745)    | (67%) | 8,329                                   | 56%    |
| Interest expense                          | (6)                                    | (0%)  | (30)        | (0%)  | 24                                      | 80%    |
| Other non-operating income, net           | 99                                     | 0%    | 128         | 1%    | (29)                                    | (23%)  |
| Loss before income taxes                  | (6,323)                                | (23%) | (14,647)    | (67%) | 8,324                                   | 57%    |
| (Benefit from) provision for income taxes | (253)                                  | (1%)  | 1,775       | 8%    | (2,028)                                 | (114%) |
| Net loss                                  | \$ (6,070)                             | (22%) | \$ (16,422) | (75%) | \$ 10,352                               | 63%    |

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

#### *Net Revenue*

Our net revenue increased \$5.6 million for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. The increase was primarily due to increased sales of PX<sup>®</sup> devices in the first nine months of 2012 compared to the first nine months of 2011. Offsetting the increased sales of PX<sup>®</sup> devices were lower sales of turbochargers and pumps and lower sales of related products and services in the first nine months of 2012 compared to the first nine months of 2011.

Revenue by product category as a percentage of net revenue was as follows:

|   | <b>Three Months Ended<br/>September 30,</b> |             |
|---|---|-------------|
|   | <b>2012</b>                                 | <b>2011</b> |
| PX® devices and related products and services             | 80%   | 67%         |
| Turbochargers and pumps and related products and services | 20%   | 33%         |
| Net revenue   | 100%  | 100%        |

During the nine months ended September 30, 2012 and 2011, a significant portion of our net revenue was attributable to sales outside of the United States. Revenue attributable to domestic and international sales as a percentage of net revenue was as follows:

|                       | <b>Nine Months Ended<br/>September 30,</b> |             |
|-----------------------|--|-------------|
|                       | <b>2012</b>                                | <b>2011</b> |
| Domestic revenue      | 11%  | 10%         |
| International revenue | 89%  | 90%         |
| Total revenue         | 100%                                       | 100%        |

#### *Gross Profit*

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. For the nine months ended September 30, 2012, gross profit as a percentage of net revenue was 50%. For the nine months ended September 30, 2011, gross profit as a percentage of net revenue was 35%.

The increase in gross profit as a percentage of net revenue for the nine months ended September 30, 2012 as compared to the same period of last year was primarily due to the product mix in the first nine months of 2012 compared to the first nine months of 2011. Higher sales of PX® devices compared to turbocharger and pump sales had a positive impact on gross profit, as sales of PX® devices have a higher gross profit margin compared to turbochargers and pumps.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, and the volume of production in our manufacturing plant that determines our operating leverage. Accordingly, we are not able to predict our future gross profit levels with certainty. However, we believe that the levels of gross profit margin achieved during the second and third quarters of 2012 are sustainable and improvable to the extent that volume remains healthy, our product mix favors PX® devices, and we continue to realize cost savings through production efficiencies and enhanced yields.

#### *General and Administrative Expense*

General and administrative expense decreased by \$1.1 million, or 9%, to \$10.9 million for the nine months ended September 30, 2012 from \$12.0 million for the nine months ended September 30, 2011. As a percentage of net revenue, general and administrative expense decreased to 40% for the nine months ended September 30, 2012 from 55% for the nine months ended September 30, 2011 primarily due to higher net revenue and lower general and administrative expense in 2012.

General and administrative average headcount decreased to 27 in the first nine months of 2012 from 32 in the first nine months of 2011 largely as a result of reductions in force at our corporate headquarters and the closing of our Michigan-based facility during 2011. In February 2011, our Chief Executive Officer (CEO) announced his retirement, and our Board of Directors appointed a new CEO. During the second quarter of 2011, our Board of Directors appointed a new Chief Financial Officer (CFO). General and administrative costs decreased as a result of the non-recurring expenses related to the retirement of the former CEO and former CFO and the appointment of a new CEO and new CFO in the nine months ended September 30, 2011 along with the impact of our restructuring activities in 2011.

Of the \$1.1 million decrease in general and administrative expense, \$1.2 million related to compensation and employee-related benefits, \$364,000 related to occupancy costs, \$73,000 related to bad debt expense, and \$47,000 related to taxes and other administrative costs. These decreases were offset by an increase of \$627,000 related to professional and other services.

Share-based compensation expense included in general and administrative expense was \$1.5 million and \$1.3 million for the nine months ended September 30, 2012 and 2011, respectively.

#### *Sales and Marketing Expense*

Sales and marketing expense decreased by \$1.3 million, or 20%, to \$5.1 million for the nine months ended September 30, 2012 from \$6.4 million for the nine months ended September 30, 2011. As a percentage of net revenue, sales and marketing expense decreased to 19% for the nine months ended September 30, 2012 compared to 29% for the nine months ended September 30, 2011 primarily due to higher net revenue and lower sales and marketing expense in 2012.

Sales and marketing average headcount decreased to 24 in the first nine months of 2012 from 28 in the first nine months of 2011.

Of the \$1.3 million decrease in sales and marketing expense for the nine months ended September 30, 2012, \$917,000 related to promotional, occupancy, and other costs and \$492,000 related to compensation and employee-related benefits. The decreases were offset by an increase of \$153,000 related to commissions for sales representatives.

Share-based compensation expense included in sales and marketing expense was \$434,000 and \$477,000 for the nine months ended September 30, 2012 and 2011, respectively.

#### *Research and Development Expense*

Research and development expense increased by \$429,000, or 16%, to \$3.1 million for the nine months ended September 30, 2012 from \$2.6 million for the nine months ended September 30, 2011. As a percentage of net revenue, research and development expense decreased to 11% for the nine months ended September 30, 2012 from 12% for the nine months ended September 30, 2011 primarily due to higher net revenue offset by higher research and development expense in 2012.

Average headcount in our research and development department increased to 15 in the first nine months of 2012 compared to 13 in the first nine months of 2011.

Of the \$429,000 increase in research and development expense for the nine months ended September 30, 2012, \$381,000 related to research and development costs associated with accelerated design and prototyping of new devices for the oil and gas market, \$200,000 related to outside consulting and professional fees, and \$33,000 related to facility costs. The increases were offset by \$173,000 related to compensation and employee-related benefits largely due to non-recurring labor costs associated with the test runs of our internally developed ceramics formulations during the first nine months of 2011 and \$12,000 of other costs.

Share-based compensation expense included in research and development expense was \$109,000 and \$144,000 for the nine months ended September 30, 2012 and 2011, respectively.

We anticipate that our research and development expense will continue to increase in the future as we expand and diversify our product portfolio for applications outside of desalination, with a preeminent focus on the oil and gas market.

#### *Amortization of Intangible Assets*

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. These intangible assets include developed technology, non-compete agreements, backlog, trademarks, and customer relationships. Amortization expense decreased by \$252,000 during the first nine months of 2012 compared to the first nine months of 2011 due to the full amortization of backlog and one non-compete agreement in 2011.

### *Restructuring Charges*

In July 2011, we initiated a restructuring plan to consolidate our North American operations and transfer our Michigan-based operations to our manufacturing center and headquarters in San Leandro, California. In connection with this restructuring plan, we classified the land and building located in Michigan as assets held for sale at December 31, 2011. On June 22, 2012, we signed a purchase agreement to sell this land and building. The sale was expected to be completed in August 2012. The agreement was not finalized as planned and the property was again listed for sale with a commercial agent.

During the nine months ended September 30, 2012, we recorded \$277,000 related to the restructuring plan. Of these charges, \$243,000 related to the impairment of the land and building held for sale based on market studies of similar sales in the area and \$34,000 related to other non-recurring charges associated with the restructuring plan.

During the nine months ended September 30, 2011, we recorded \$470,000 related to the restructuring plan. Of these charges, \$408,000 related to severance and other personnel costs and \$62,000 related to other exit costs.

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

Non-operating income (expense), net, decreased by \$5,000 to income of \$93,000 in the nine months ended September 30, 2012 compared to income of \$98,000 in the nine months ended September 30, 2011. The decrease was primarily due to \$54,000 in net foreign currency losses recorded in 2012 compared to \$189,000 in net foreign currency gains recorded in 2011. The \$243,000 unfavorable impact of net foreign currency losses was offset by higher interest income of \$115,000, a \$99,000 favorable change in other income, and lower interest expense of \$24,000.

### *Income Taxes*

The income tax benefit was \$253,000 for the nine months ended September 30, 2012 compared to an income tax provision of \$1.8 million for the nine months ended September 30, 2011. As of December 31, 2011, a valuation allowance of approximately \$10.3 million was established to reduce our deferred income tax assets to the amount expected to be realized. As such, no tax benefit related to our pre-tax loss was recognized for the nine months ended September 30, 2012, as there was no change in our assessment of the amount of deferred income tax assets expected to be realized. The tax benefit recognized for the nine months ended September 30, 2012 related to the recognition of an uncertain tax position due to amended state tax returns.

## **Liquidity and Capital Resources**

### ***Overview***

Our primary source of cash historically has been proceeds from the issuance of common stock, customer payments for our products and services, and borrowings under our credit facility. From January 1, 2005 through September 30, 2012, we issued common stock for aggregate net proceeds of \$84.0 million, excluding common stock issued in exchange for promissory notes. The proceeds from the sales of common stock have been used to fund our operations and capital expenditures.

As of September 30, 2012, our principal sources of liquidity consisted of unrestricted cash and cash equivalents of \$18.3 million that are invested primarily in money market funds and of short-term and long-term investments of \$15.1 million that are primarily invested in marketable debt securities. We invest cash not needed for current operations predominantly in high-quality, investment-grade marketable debt instruments with the intent to make such funds available for operating purposes as needed.

We have unbilled receivables pertaining to customer contractual holdback provisions, whereby we invoice the final installment due under a sales contract 12 to 24 months after the product has been shipped to the customer and revenue has been recognized. The customer holdbacks represent amounts intended to provide a form of security to the customer rather than a form of long-term financing; accordingly, these receivables have not been discounted to present value. At September 30, 2012 and December 31, 2011, we had \$2.4 million and \$1.1 million of unbilled receivables, respectively.

In 2008, we entered into a credit agreement (the “2008 Agreement”) with a financial institution. The 2008 Agreement, as amended, allowed borrowings of up to \$12.0 million on a revolving basis at LIBOR plus 2.75%. This agreement was terminated in the first quarter of 2009. As a result of terminating the 2008 Agreement, we were required to transfer cash to a restricted cash account as collateral for outstanding letters of credit that were collateralized by the credit agreement as of the date of termination. We were also required to restrict cash as collateral for the outstanding balance on an equipment promissory note. As of September 30, 2012, approximately \$44,000 in cash remains restricted under the 2008 Agreement for an outstanding letter of credit of approximately \$42,000. As of September 30, 2012, no cash was restricted for the equipment promissory note, as the note was fully paid in August 2012. The restricted cash related to the outstanding letter of credit is expected to be released in 2013.

In 2009, we entered into a loan and security agreement (the “2009 Agreement”) with another financial institution. The 2009 Agreement, as amended, provided a total available credit line of \$16.0 million. Under the 2009 Agreement, we were allowed to draw advances of up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for letters of credit, provided that the aggregate of the outstanding advances and collateral did not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incurred interest based on a prime rate index or on LIBOR plus 1.375%.

During the periods presented, we provided certain customers with letters of credit to secure our obligations for the delivery and performance of products in accordance with sales arrangements. Some of these letters of credit were issued under our 2009 Agreement. The letters of credit generally terminate within 12 to 48 months from issuance. As of September 30, 2012, the amounts outstanding on letters of credit collateralized under our 2009 Agreement totaled approximately \$5.5 million.

Effective in July 2011, the 2009 Agreement was amended, requiring us to maintain a cash collateral balance equal to at least 101% of the face amount of all outstanding letters of credit collateralized by the line of credit and 100% of the amount of all outstanding advances. As of September 30, 2012, restricted cash related to the letters of credit issued under the 2009 Agreement was approximately \$5.5 million. There were no advances drawn under the 2009 Agreement line of credit as of September 30, 2012. The 2009 Agreement expired at the end of May 2012.

On June 5, 2012, we entered into a loan agreement (the “2012 Agreement”) with another financial institution. The 2012 Agreement provides for a total available credit line of \$16.0 million. Under the 2012 Agreement, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total letters of credit issued under the 2012 Agreement may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. At no time may the aggregate of the revolving loans and letters of credit exceed the total available credit line of \$16.0 million. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate plus 0% or a Eurodollar loan that bears interest equal to the adjusted LIBO rate plus 1.25%. Letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a facility fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line.

The 2012 Agreement also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding letters of credit collateralized by the line of credit. The 2012 Agreement matures on June 5, 2015 and is collateralized by substantially all of our assets. There were no advances drawn under the 2012 Agreement’s line of credit as of September 30, 2012. As of September 30, 2012, the amounts outstanding on letters of credit collateralized under the 2012 Agreement totaled approximately \$1.2 million and restricted cash related to the letters of credit issued under the 2012 Agreement was approximately \$1.2 million.

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

Net cash used in operating activities was \$(2.0) million and \$(4.5) million for the nine months ended September 30, 2012 and 2011, respectively. For the nine months ended September 30, 2012, a net loss of \$(6.1) million was adjusted to \$60,000 by non-cash items totaling \$6.1 million. For the nine months ended September 30, 2011, a net loss of \$(16.4) million was adjusted to \$(7.3) million by non-cash items totaling \$9.1 million. Non-cash adjustments primarily include depreciation and amortization, share-based compensation, and provisions for doubtful accounts, warranty reserves, and excess and obsolete inventory reserves. For the nine months ended September 30, 2012, non-cash items also included the amortization of premiums/discounts on investments, deferred income taxes, and a loss on the impairment of assets held for sale.

The net cash impact from changes in assets and liabilities was approximately \$(2.0) million and \$2.8 million for the nine months ended September 30, 2012 and 2011, respectively. Net changes in assets and liabilities are primarily attributable to changes in inventory as a result of the timing of order processing and product shipments; changes in accounts receivable, deferred revenue, and unbilled receivables as a result of the timing of invoices and collections for large projects; and changes in accounts payable, prepaid expenses and accrued liabilities as a result of the timing of payments to employees, vendors, and other third parties.

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

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

Net cash provided by (used in) investing activities was \$5.9 million and \$(5.2) million for the nine months ended September 30, 2012 and 2011, respectively. The favorable variance of \$11.1 million in cash flows from investing activities for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 was primarily due to the maturity of marketable securities of \$8.3 million and the release of \$4.4 million in restricted cash to collateralize letters of credit offset by the purchase of marketable securities of \$0.9 million, a decrease in the disposal of fixed assets of \$0.4 million, and an increase of \$0.3 million in capital expenditures.

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

Net cash used in financing activities was \$(4.2) million and \$(212,000) for the nine months ended September 30, 2012 and 2011, respectively. The \$4.0 million increase in net cash used in financing activities was primarily due to the use of \$4.0 million to repurchase common stock for treasury, a \$43,000 decrease for stock issued, and a \$16,000 decrease in cash received to repay notes receivable in the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. The unfavorable variances were partially offset by a decrease in debt and capital lease payments during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 of \$117,000 as a result of paying off two capital leases in 2011 and an equipment promissory note in 2012.

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

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

#### ***Contractual Obligations***

We lease facilities under fixed non-cancellable operating leases that expire on various dates through 2019. The total of the future minimum lease payments under these leases as of September 30, 2012 was \$11.2 million. For additional information, see Note 9 — “Commitments and Contingencies” to the unaudited condensed consolidated financial statements.

In the course of our normal operations, we also enter into purchase commitments with our suppliers for various raw materials and components parts. The purchase commitments covered by these arrangements are subject to change based on sales forecasts for future deliveries. As of September 30, 2012, we had approximately \$3.5 million of cancellable open purchase order arrangements related primarily to materials and parts.

We have agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of September 30, 2012, we believe that our exposure related to these guarantees and indemnities as of September 30, 2012 was not material.

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

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

### **Recent Accounting Pronouncements**

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

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

The information in this section should be read in connection with the information on financial market risk related to changes in non-U.S. currency exchange rates and interest rates in Part II, Item 7A, “Quantitative and Qualitative Disclosure About Market Risk,” in our Annual Report on Form 10-K for the year ended December 31, 2011.

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

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

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

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

We have an investment portfolio of fixed income marketable debt securities, including amounts classified as cash equivalents, short-term investments, and long-term investments. At September 30, 2012, our short-term investments and long-term investments totaled approximately \$15.1 million. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. We invest primarily in high-quality, short-term and long-term debt instruments of the U.S. government and its agencies as well as high-quality corporate and municipal issuers. These investments are subject to interest rate fluctuations and will decrease in market value if interest rates increase. To minimize the exposure due to adverse shifts in interest rates, we maintain investments with an average maturity of less than three years.

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

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

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

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

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

(b) *Changes in internal controls.* There were no changes in our internal control over financial reporting during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **Part II — OTHER INFORMATION**

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

We are party to legal proceedings that are described in Note 9 to our condensed consolidated financial statements included in “Item 1. Financial Statements” of this Quarterly Report and such disclosure is incorporated by reference into this “Item 1. Legal Proceedings.” In addition, we disclosed on a Form 8-K filing that we had entered into a confidential settlement agreement resulting from an alleged breach of contract claim against one of our suppliers. Without any admission of liability or wrongdoing by the supplier, we received a one-time payment of \$775,000.

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

***Almost all of our revenue is derived from sales of energy recovery devices and pumps used in reverse osmosis desalination; a decline in demand for desalination or the reverse osmosis method of desalination will reduce demand for our products and will cause our sales and revenue to decline.***

Products for the desalination market have historically accounted for a high percentage of our revenue. We expect that the revenue from these products will continue to account for most of our revenue in the foreseeable future. Any factors adversely affecting the demand for desalination, including changes in weather patterns, increased precipitation in areas of high human population density, new technology for producing fresh water, increased water conservation or reuse, political changes and unrest, changes in the global economy, or changes in industry or governmental regulations would reduce the demand for our energy recovery products and services and would cause a significant decline in our revenue. Similarly, any factors adversely affecting the demand for energy recovery products in reverse osmosis desalination, including new energy technology or reduced energy costs, new methods of desalination that reduce pressure and energy requirements, or improvements in membrane technology would reduce the demand for our energy recovery devices and would cause a significant decline in our revenue. Some of the factors that may affect sales of our energy recovery devices and pumps may be out of our control.

***We depend on the construction of new desalination plants for revenue, and as a result, our operating results have experienced, and may continue to experience, significant variability due to volatility in capital spending, availability of project financing, and other factors affecting the water desalination industry.***

We currently derive substantially all of our revenue from sales of products and services used in desalination plants for municipalities, hotels, resorts, and agricultural operations in dry or drought-ridden regions of the world. The demand for our products may decrease if the construction of desalination plants declines for political, economic, or other factors, especially in these regions. Other factors that could affect the number and capacity of desalination plants built or the timing of their completion include: the availability of required engineering and design resources; a weak global economy; shortage in the supply of credit and other forms of financing; changes in government regulations; permitting requirements, or priorities; and reduced capital spending for desalination. Each of these factors could result in reduced or uneven demand for our products. Pronounced variability or delays in the construction of desalination plants or reductions in spending for desalination could negatively impact our sales and revenue and make it difficult for us to accurately forecast our future sales and revenue, which could lead to increased inventory and use of working capital.

***Our revenue and growth depend upon the continued viability and growth of the seawater reverse osmosis desalination industry using current technology.***

If there is a downturn in the seawater reverse osmosis desalination industry, our sales would be directly and adversely impacted. Changes in seawater reverse osmosis desalination technology could also reduce the demand for our devices. For example, a reduction in the operating pressure used in seawater reverse osmosis desalination plants could reduce the need for, and viability of, our energy recovery devices. Membrane manufacturers are actively working on low-pressure membranes for seawater reverse osmosis desalination that could potentially be used on a large scale to desalinate seawater at a much lower pressure than is currently necessary.

Engineers are also evaluating the possibility of diluting seawater prior to reverse osmosis desalination to reduce the required membrane pressure. Similarly, an increase in the membrane recovery rate would reduce the number of energy recovery devices required and would reduce the demand for our product. A significant reduction in the cost of power may reduce demand for our product or favor a less expensive product from a competitor.

Any of these changes would adversely impact our revenue and growth. Water shortages and demand for desalination can also be adversely affected by water conservation and water reuse initiatives.

***New planned seawater reverse osmosis projects can be cancelled and/or delayed, and cancellations and/or delays may negatively impact our revenue.***

Planned seawater reverse osmosis desalination projects can be cancelled or postponed due to delays in, or failure to obtain, approval, financing, or permitting for plant construction because of political factors, including political unrest in key desalination markets such as the Middle East; adverse and increasingly uncertain financial conditions; or other factors. Even though we may have a signed contract to provide a certain number of energy recovery devices by a certain date, shipments may be suspended or delayed at the request of customers. Such shipping delays negatively impact our results of operations and revenue. As a result of these factors, we have experienced, and may in the future experience, significant variability in our revenue on both an annual and a quarterly basis.

***We rely on a limited number of engineering, procurement, and construction firms for a large portion of our revenue. If these customers delay or cancel their commitments, do not purchase our products in connection with future projects, or are unable to attract and retain sufficient qualified engineers to support their growth, our revenue could significantly decrease, which would adversely affect our financial condition and future growth.***

There are a limited number of large engineering, procurement, and construction firms in the desalination industry, and these customers account for a substantial portion of our net revenue. One or more of these customers represent 10% or more of our total revenue each year, and the customers in this category vary from year to year. See Note 11 — "Concentrations" to the condensed consolidated financial statements regarding the impact of customer concentrations on our condensed consolidated financial statements. Since we do not have long-term contracts with these large customers but rather sell to them on a purchase order or project basis, these orders may be postponed or delayed on short or no notice. If any of these customers reduces or delays its purchases, cancels a project, decides not to specify our products for future projects, fails to attract and retain qualified engineers and other staff, fails to pay amounts due us, experiences financial difficulties, or experiences reduced demand for its services, we may not be able to replace that lost business and our projected revenue may significantly decrease, which will adversely affect our financial condition and future growth.

***We face competition from a number of companies that offer competing energy recovery and pump solutions. If any of these companies produces superior technology or offers more cost-effective products, our competitive position in the market could be harmed and our profits may decline.***

The market for energy recovery devices and pumps for desalination plants is competitive and evolving. We expect competition, especially competition on price and warranty terms, to persist and intensify as the desalination market grows and new competitors enter the market. Some of our current and potential competitors may have significantly greater financial, technical, marketing, and other resources; longer operating histories; or greater name recognition. They may also be able to devote greater resources to the development, promotion, sale, and support of their products and respond more quickly to new technology. These companies may also have more extensive customer bases, broader customer relationships across product lines, or long-standing or exclusive relationships with our current or potential customers. They may also have more extensive products and product lines that would enable them to offer multi-product or packaged solutions as well as competing products at lower prices or with other more favorable terms and conditions. As a result, our ability to sustain our market share may be adversely impacted, which would affect our business, operating results, and financial condition. In addition, if another one of our competitors were to merge or partner with another company, the change in the competitive landscape could adversely affect our continuing ability to compete effectively.

***Global economic conditions could have an adverse effect on our business and results of operations.***

Global economic conditions may negatively impact our business and make forecasting future operating results more difficult and uncertain. A weak global economy may cause our customers to delay product orders or shipments, or delay or cancel planned or new desalination projects, including retrofits, which would reduce our revenue. Turmoil in the financial and credit markets may also make it difficult for our customers to obtain needed project financing, resulting in lower sales. Negative economic conditions may also affect our suppliers, which could impede their ability to remain in business and supply us with parts, resulting in delays in the availability or shipment of our products. In addition, cash, cash equivalents, and short- and long-term investments that we may hold from time to time are typically invested in certificates of deposit, money market funds, government obligations, corporate obligations, and other securities summarized in the notes to the consolidated financial statements included in this report. Given the currently weak global economy, the potential instability of domestic and foreign financial institutions, and external risks such as the European sovereign debt problems, we cannot be assured that we will not experience losses on our investments, which would adversely affect our financial condition. If current economic conditions persist or worsen and negatively impact the desalination industry, our business, financial condition, or results of operations could be materially and adversely affected.

***Our operating results may fluctuate significantly, which makes our future operating results difficult to predict and could cause our operating results to fall below expectations or guidance.***

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. Since a single order for our energy recovery devices may represent substantial revenue, we have experienced significant fluctuations in revenue from quarter to quarter and year to year, and we expect such fluctuations to continue. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our common stock would likely decline.

In addition, factors that may affect our operating results include, among others:

- fluctuations in demand, sales cycles, and pricing levels for our products and services;
- the cyclical nature of equipment purchasing for planned reverse osmosis desalination plants;
- changes in customers' budgets for desalination plants and the timing of their purchasing decisions;
- adverse changes in the local or global financing conditions facing our customers;
- delays or postponements in the construction of desalination plants;
- our ability to develop, introduce, and timely ship new products and product enhancements that meet customer demand and contractual and technical requirements, including scheduled delivery dates, performance guarantees, product certifications, and warranty terms;
- the ability of our customers to obtain other critical plant components such as high-pressure pumps or membranes;
- our ability to implement scalable internal systems for reporting, order processing, product delivery, purchasing, billing, and general accounting, among other functions;
- our ability to maintain efficient factory throughput in our new facility and minimize overhead given significant variability in orders from quarter to quarter and year to year;
- unpredictability of governmental regulations and political decision-making as to the approval or building of a desalination plant;
- our ability to control costs, including our operating expenses;
- our ability to purchase critical raw materials from third-party suppliers;
- our ability to compete against other companies that offer energy recovery solutions;
- our ability to attract and retain highly skilled employees, particularly those with relevant industry experience; and
- general economic conditions in our domestic and international markets, including conditions that affect the valuation of the U.S. Dollar against other currencies.

***If we are unable to collect unbilled receivables, our operating results will be adversely affected.***

Our contracts with large engineering, procurement, and construction firms generally contain holdback provisions that delay final installment payments by up to 24 months after the product has been shipped and revenue has been recognized. Typically, between 10% and 20%, and in some instances up to 30%, of the revenue we recognize pursuant to our customer contracts is subject to such holdback provisions and is accounted for as unbilled receivables until we deliver invoices for payment. Such holdbacks can result in relatively high current and non-current unbilled receivables. If we are unable to invoice and collect these performance holdbacks or if our customers fail to make these payments when due under the sales contracts, our results of operations will be adversely affected.

***If we lose key personnel upon whom we are dependent, we may not be able to execute our strategies. Our ability to increase our revenue will depend on hiring highly skilled professionals with industry-specific experience, particularly given the unique and complex nature of our devices.***

Given the specialized nature of our business, we must hire highly skilled professionals for certain positions with industry-specific experience. Given the nature of the reverse osmosis desalination industry, the number of qualified candidates for certain positions is limited. Our ability to grow depends on recruiting and retaining skilled employees with relevant experience, competing with larger, often better known companies, and offering competitive total compensation packages. Our failure to retain existing or attract future talented and experienced key personnel could harm our business.

***The future success of our business may depend on our ability to diversify into new markets outside of desalination while continuing to market, enhance, and scale existing desalination products.***

We believe that developing new products for applications outside of desalination is a necessary strategy to accelerate future growth in our business as we continue to market, enhance, and scale existing desalination products.

While new or enhanced products and services have the potential to meet specified needs of new or existing markets, pricing may not meet customer expectations, and our products may not compete favorably with products and services of current or potential competitors. New products may be delayed or cancelled if they do not meet specifications, performance requirements, or quality standards, or perform as expected in a production environment. Product designs also may not scale as expected. We may have difficulty finding new markets for our existing technology or developing or acquiring new products for new markets. Customers may not accept or be slow to adopt new products and services, and potential new markets may be too costly to penetrate. In addition, we may not be able to offer our products and services that meet customer expectations without decreasing our prices and eroding our margins. We may also have difficulty executing plans to break into new markets, expanding our operations to successfully manufacture new products, or scaling our operations to accommodate increased business. If we are unable to develop competitive new products, open new markets, and scale our business to support increased sales and new markets, our business and results of operations will be adversely affected.

We have hired and promoted individuals to new executive positions and undertaken other activities to pursue new markets beyond desalination. We may incur significant personnel and development expenses in these efforts without assurance as to when or if new products will contribute to revenue or be profitable.

***Our plans to manufacture ceramic components may prove to be more costly or less reliable than outsourcing .***

We previously outsourced the production of our ceramic components to a limited number of ceramic vendors. In 2011, to diversify our supply of ceramics, ensure the availability of a reliable source of quality ceramic components, and retain more control over our intellectual property, we validated the internal production capability of our own ceramics plant at our headquarters in San Leandro, California to manufacture most, if not all, ceramic components used in PX<sup>®</sup> devices. We also completed in 2011 the closure of our manufacturing plant in Michigan and integration of all production operations in San Leandro. We anticipate that internal production capacity at one location will reduce costs, improve efficiencies and quality, and enhance research and development efforts.

If we are less efficient at producing our ceramic components or are unable to achieve required yields that are equal to or greater than the vendors to which we previously outsourced, then our cost of manufacturing may be adversely affected. If we are unable to ramp up the internal production of our ceramics parts or manufacture these parts cost-effectively and/or if for any reason we are not able to purchase sufficient raw materials on a timely basis, we may be exposed to capacity shortages, and our business and financial results, including our cost of revenue and margins, may be adversely affected.

We do not own sources of, or mine, ceramic raw materials and rely on a limited number of vendors to supply ceramic raw materials for our PX® products. If any of our ceramic suppliers were to have financial difficulties, cancel or materially change their commitments with us, or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products and we are unable to make up that shortfall through other sources, we could lose customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results, and financial condition.

***The durable nature of the PX® device may reduce or delay potential aftermarket revenue opportunities.***

Our PX® devices utilize ceramic components that have to date demonstrated high durability, high corrosion resistance, and long life in seawater reverse osmosis desalination applications. Because most of our PX® devices have been installed for a limited number of years, it is difficult to accurately predict their performance or endurance over a longer period of time. In the event that our products are more durable than expected, our opportunity for aftermarket revenue may be deferred.

***Our sales cycle can be long and unpredictable, and our sales efforts require considerable time and expense. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate.***

Our sales efforts involve substantial education of our current and prospective customers about the use and benefits of our energy recovery products. This education process can be time-consuming and typically involves a significant product evaluation process. While the sales cycle for our OEM customers, which are involved with smaller desalination plants, averages one to three months, the average sales cycle for our international engineering, procurement, and construction firm customers, which are involved with larger desalination plants, ranges from nine to 16 months and has, in some cases, extended up to 24 months. This long sales cycle makes quarter-by-quarter revenue predictions difficult and results in our investing significant resources well in advance of orders for our products.

***We have historically experienced significant fluctuations in our results of operations on a quarter-to-quarter basis and expect that such fluctuations will continue, making it difficult for us and the market to anticipate future results.***

We have historically experienced a variety of factors that cause our quarterly results of operations to fluctuate significantly. In some past years, customer-buying patterns led to a significant portion of our sales occurring in the fourth quarter, with the risk that delays, cancellations, or other adverse events in the fourth quarter had a substantial negative impact on annual results. More recently, our results have fluctuated or decreased due to adverse timing of larger orders during the year, the effects of a global decline in new desalination project construction stemming from global economic and financial pressures, and competition. It is difficult for us and the market to anticipate our future results, and our stock price may be adversely affected by the risks discussed in this paragraph.

***We depend on a limited number of suppliers for some of our components. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed.***

We rely on a limited number of suppliers for vessel housings, stainless steel castings, and alumina powder for our PX® devices and castings for our turbochargers and pumps. Our reliance on a limited number of manufacturers for these supplies involves a number of risks, including reduced control over delivery schedules, quality assurance, manufacturing yields, production costs, and lack of guaranteed production capacity or product supply. We do not have long-term supply agreements with these suppliers and instead secure these supplies on a purchase order basis. Our suppliers have no obligation to supply products to us for any specific period, in any specific quantity, or at any specific price, except as set forth in a particular purchase order. Our requirements represent a small portion of the total production capacities of these suppliers, and our suppliers may reallocate capacity to other customers, even during periods of high demand for our products. We have in the past experienced, and may in the future experience, quality control issues and delivery delays with our suppliers due to factors such as high industry demand or the inability of our vendors to consistently meet our quality or delivery requirements. If our suppliers were to cancel or materially change their commitments to us or fail to meet quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results, and financial condition. We may qualify additional suppliers in the future, which would require time and resources. If we do not qualify additional suppliers, we may be exposed to increased risk of capacity shortages due to our dependence on current suppliers.

***We are subject to risks related to product defects, which could lead to warranty claims in excess of our warranty provisions or result in a significant or a large number of warranty or other claims in any given year.***

We have historically provided a warranty for certain products for a period of one to two years and provided up to a six-year warranty for the ceramic components of our PX<sup>®</sup>-branded products. We test our products in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal latent defects in our products, which may not become apparent until after the products have been sold into the market, or will replicate the harsh, corrosive, and varied conditions of the desalination and other plants in which they are installed. In addition, certain components of our turbochargers and pumps are custom-made and may not scale or perform as required in production environments. Accordingly, there is a risk that we may have significant warranty claims or breach supply agreements due to product defects. We may incur additional cost of revenue if our warranty provisions do not reflect the actual cost of resolving issues related to defects in our products. If these additional expenses are significant, they could adversely affect our business, financial condition, and results of operations. While the number of warranty claims has not been significant to date, we have only offered up to a six-year warranty on the ceramic components of our PX<sup>®</sup> products in new sales agreements executed after August 7, 2007, and we have only offered high-pressure pumps and turbochargers since December 2009 when we acquired Pump Engineering, LLC. We cannot quantify the error rate of our products and the ceramic components of our PX<sup>®</sup> products with statistical accuracy and cannot assure that a large number of warranty claims will not be filed in a given year. As a result, our cost of revenue may increase if a significant or large number of warranty or other claims are filed in any specific year, particularly towards the end of any given warranty period.

***If we are unable to protect our technology or enforce our intellectual property rights, our competitive position could be harmed, and we could be required to incur significant expenses to enforce our rights.***

Our competitive position depends on our ability to establish and maintain proprietary rights in our technology and to protect our technology from copying by others. We rely on trade secret, patent, copyright, and trademark laws, as well as confidentiality agreements with employees and third parties, all of which may offer only limited protection. We hold a limited number of U.S. patents and patents outside the U.S. that are counterparts to several of the U.S. patents, and when their terms expire, we could become more vulnerable to increased competition. We do not hold issued patents in many of the countries where competing products are used, though we do have pending applications in countries where we have substantial sales activity. Accordingly, the protection of our intellectual property in some of those countries may be limited. We also do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented, or invalidated. Moreover, while we believe our remaining issued patents are essential to the protection of our technology, the rights granted under any of our issued patents or patents that may be issued in the future may not provide us with proprietary protection or competitive advantages, and as with any technology, competitors may be able to develop similar or superior technologies now or in the future. In addition, our granted patents may not prevent misappropriation of our technology, particularly in foreign countries where intellectual property laws may not protect our proprietary rights as fully as those in the United States. This may render our patents impaired or useless and ultimately expose us to currently unanticipated competition. Protecting against the unauthorized use of our products, trademarks, and other proprietary rights is expensive, difficult, and in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights or to determine the validity and scope of the proprietary rights of others. Intellectual property litigation could result in substantial costs and diversion of management resources, either of which could harm our business.

***Claims by others that we infringe their proprietary rights could harm our business.***

Third parties could claim that our technology infringes their intellectual property rights. In addition, we or our customers may be contacted by third parties suggesting that we obtain a license to certain of their intellectual property rights they may believe we are infringing. We expect that infringement claims against us may increase as the number of products and competitors in our market increases and overlaps occur. In addition, to the extent that we gain greater visibility, we believe that we will face a higher risk of being the subject of intellectual property infringement claims. Any claim of infringement by a third party, even those without merit, could cause us to incur substantial costs defending against the claim and could distract our management from our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment against us could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms, or at all. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Any of these events could seriously harm our business. Third parties may also assert infringement claims against our customers. Because we generally indemnify our customers if our products infringe the proprietary rights of third parties, any such claims would require us to initiate or defend protracted and costly litigation on their behalf in one or more jurisdictions, regardless of the merits of these claims. If any of these claims succeeds, we may be forced to pay damages on behalf of our customers.

***We are currently involved in legal proceedings, and may be subject to additional future legal proceedings, that may result in material adverse outcomes.***

In addition to intellectual property litigation risks discussed above, we are involved, and may become involved in the future, in various commercial and other disputes as well as related claims and legal proceedings that arise from time to time in the course of our business. We believe that we have substantial defenses in the matters currently pending. However, the process of settling or litigating claims is subject to uncertainties, and our views of these matters may change in the future. We are not able in all matters to estimate the amount or range of loss that could result from an outcome adverse to us. We could in the future incur judgments or enter into settlements of claims that could have a material adverse effect on our results of operations and financial condition.

***Our business entails significant costs that are fixed or difficult to reduce in the short term while demand for our products is variable and subject to downturns, which may adversely affect our operating results.***

Our business requires investments in facilities, equipment, R&D, and training that are either fixed or difficult to reduce or scale in the short term. At the same time, the market for our products is variable and has experienced downturns due to factors such as economic recessions, increased precipitation, uncertain global financial markets, and political changes, many of which are outside of our control. During periods of reduced product demand, we may experience higher relative costs and excess manufacturing capacity, resulting in high overhead and lower gross profit margins while causing cash flow and profitability to decline. Similarly, although we believe that our existing manufacturing facilities are capable of meeting current demand and demand for the foreseeable future, the continued success of our business depends on our ability to expand our manufacturing, research and development, and testing facilities to meet market needs. If we are unable to respond timely to an increase in demand, our revenue, gross profit margin, cash flow, and profitability may be adversely affected.

***If we need additional capital to fund future growth, it may not be available on favorable terms, or at all.***

We have historically relied on outside financing to fund our operations, capital expenditures, and expansion. In our initial public offering in July 2008, we issued approximately 10,000,000 shares of common stock at \$8.50 per share before underwriting discount and issuing expenses. We may require additional capital from equity or debt financing in the future to fund our operations or respond to competitive pressures or strategic opportunities. We may not be able to secure such additional financing on favorable terms or at all. The terms of additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities, or other securities convertible into equity, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new securities that we issue could have rights, preferences, or privileges senior to those of existing or future holders of our common stock. If we are unable to obtain necessary financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges or opportunities could be significantly limited.

***If foreign and local government entities no longer guarantee and subsidize, or are willing to engage in, the construction and maintenance of desalination plants and projects, the demand for our products would decline and adversely affect our business.***

Our products are used in seawater reverse osmosis desalination plants, which are often constructed and maintained with local, regional, or national government guarantees and subsidies, including tax-free bonds. The rate of construction of desalination plants depends on each governing entity's willingness and ability to obtain and allocate funds for such projects, which may be affected by the currently fragile global financial system and credit market. In addition, some desalination projects in the Middle East and North Africa have been funded by budget surpluses resulting from once-high crude oil and natural gas prices. Since prices for crude oil and natural gas vary, governments in those countries may not have the necessary funding for such projects and may cancel the projects or divert funds allocated for them to other projects. Political unrest, coups, or changes in government administrations, such as recent political changes and unrest in the Middle East, may result in policy or priority changes that may also cause governments to cancel, delay, or re-contract planned or ongoing projects. Government embargoes may also prohibit sales into certain countries. As a result, the demand for our products could decline and negatively affect our revenue base, our overall profitability, and the pace of our expected growth.

***Our products are highly technical and may contain undetected flaws or defects that could harm our business and our reputation and adversely affect our financial condition.***

The manufacture of our products is highly technical and some designs and components of our turbochargers and pumps are custom-made. Our products may contain latent defects or flaws. We test our products prior to commercial release, and during such testing have discovered, and may in the future discover, flaws and defects that need to be resolved prior to release. Resolving these flaws and defects can take a significant amount of time and prevent our technical personnel from working on other important tasks. In addition, our products have contained, and may in the future contain, one or more flaws that were not detected prior to commercial release to our customers. Some flaws in our products may only be discovered after a product has been installed and used by customers. Any flaws or defects discovered in our products after commercial release could result in loss of revenue or delay in revenue recognition, loss of customers, and increased service and warranty costs, any of which could adversely affect our business, operating results, and financial condition. In addition, we could face claims for product liability, tort, or breach of warranty. Our contracts with our customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld or, for reasons of good long-term customer relations, we may not be willing to enforce. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention and adversely affect the market's perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results, and financial condition could be harmed.

***Our international sales and operations subject us to additional risks that may adversely affect our operating results.***

Historically, we have derived a significant portion of our revenue from customers whose seawater reverse osmosis desalination facilities are outside of the United States. Many of these projects are located in emerging growth countries with relatively young or unstable market economies or changing political environments. These countries may be affected significantly by global economic conditions and the liquidity of credit markets. We also rely on sales and technical support personnel stationed in Europe, Asia, and the Middle East, and we expect to continue to add personnel in other countries. Governmental changes, political unrest or reforms, or changes in the business, regulatory, or political environments of the countries in which we sell our products or have staff could have a material adverse effect on our business, financial condition, and results of operations.

Sales of our products have to date been denominated principally in U.S. Dollars. If the U.S. Dollar strengthens against most other currencies, it will effectively increase the price of our products in the currency of the countries in which our customers are located. This may result in our customers seeking lower-priced suppliers, which could adversely impact our revenue, margins, and operating results. A larger portion of our international revenue may be denominated in foreign currencies in the future, which would subject us to increased risks associated with fluctuations in foreign exchange rates.

Our international contracts and operations subject us to a variety of additional risks, including:

- political and economic uncertainties;
- uncertainties related to the application of local contract and other laws, including reduced protection for intellectual property rights;
- trade barriers and other regulatory or contractual limitations on our ability to sell and service our products in certain foreign markets;
- difficulties in enforcing contracts, beginning operations as scheduled, and collecting accounts receivable, especially in emerging markets;
- increased travel, infrastructure, and legal compliance costs associated with multiple international locations;
- competing with non-U.S. companies not subject to the U.S. Foreign Corrupt Practices Act;
- difficulty in attracting, hiring, and retaining qualified personnel; and
- instability in the capital markets and banking systems worldwide, especially in developing countries, which may limit the availability of project financing for the construction of desalination plants.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks successfully could harm our international operations and reduce our international sales, which in turn could adversely affect our business, operating results, and financial condition.

***If we fail to manage future growth effectively, our business would be harmed.***

Future growth in our business, if it occurs, will place significant demands on our management, infrastructure, and other resources. To manage any future growth, we will need to hire, integrate, and retain highly skilled and motivated employees. We will also need to continue to improve our financial and management controls, reporting and operational systems, and procedures. If we do not effectively manage our growth, our business, operating results, and financial condition would be adversely affected.

***Our failure to achieve or maintain adequate internal control over financial reporting in accordance with SEC rules or prevent or detect material misstatements in our annual or interim consolidated financial statements in the future could materially harm our business and cause our stock price to decline.***

As a public company, SEC rules require that we maintain internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and preparation of published financial statements in accordance with generally accepted accounting principles, or GAAP, in the United States. Accordingly, we are required to document and test our internal controls and procedures to assess the effectiveness of our internal control over financial reporting. In addition, our independent registered public accounting firm is required to report on the effectiveness of our internal control over financial reporting. In the future, we may identify material weaknesses and deficiencies that we may not be able to remediate in a timely manner. Our acquisition of Pump Engineering, LLC and possible future acquisitions may increase this risk by expanding the scope and nature of operations over which we must develop and maintain internal control over financial reporting. If there are material weaknesses or deficiencies in our internal control, we will not be able to conclude that we have maintained effective internal control over financial reporting, or our independent registered public accounting firm may not be able to issue an unqualified report on the effectiveness of our internal control over financial reporting. As a result, our ability to report our financial results on a timely and accurate basis may be adversely affected, and investors may lose confidence in our financial information, which in turn could cause the market price of our common stock to decrease. We may also be required to restate our financial statements from prior periods. In addition, testing and maintaining internal control will require increased management time and resources. Any failure to maintain effective internal control over financial reporting could impair the success of our business and harm our financial results, and an investor could lose all or a significant portion of his/her investment. If we have material weaknesses in our internal control over financial reporting, the accuracy and timing of our financial reporting may be adversely affected.

***Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.***

We prepare our financial statements to conform to GAAP. These accounting principles are subject to interpretation by the SEC and various other bodies. A change in these policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Changes to these rules or the interpretation of our current practices may adversely affect our reported financial results or the manner in which we conduct our business.

***Our past acquisition and future acquisitions could disrupt our business, impact our margins, cause dilution to our stockholders, or harm our financial condition and operating results.***

We acquired privately-held Pump Engineering, LLC in late 2009, and in the future, we may invest in other companies, technologies, or assets. We may not realize the expected benefits from our past or future acquisitions. We may not be able to find other suitable acquisition candidates, and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we cannot ensure that they will ultimately strengthen our competitive or financial position or that they will not be viewed negatively by customers, financial markets, investors, or the media. Acquisitions could also result in shareholder dilution or significant acquisition-related charges for restructuring, share-based compensation, and the amortization of purchased technology and intangible assets. Expenses resulting from impairment of acquired goodwill, intangible assets, and purchased technology could also increase over time if the fair value of those assets decreases. A future change in our market conditions, a downturn in our business, or a long-term decline in the quoted market price of our stock may result in a reduction of the fair value of acquisition-related assets. Any such impairment of goodwill or intangible assets could harm our operating results and financial condition. In addition, when we make an acquisition, we may have to assume some or all of that entity's liabilities, which may include liabilities that are not fully known at the time of the acquisition. Future acquisitions may reduce our cash available for operations and other uses. If we continue to make acquisitions, we may require additional cash or use shares of our common stock as payment, which would cause dilution to our existing stockholders.

Acquisitions, including our 2009 acquisition of Pump Engineering, LLC, entail a number of risks that could harm our ability to achieve their anticipated benefits. We could have difficulties integrating and retaining key management and other personnel, aligning product plans and sales strategies, coordinating research and development efforts, supporting customer relationships, aligning operations, and integrating accounting, order processing, purchasing, and other support services. Since acquired companies have different accounting and other operational practices, we may have difficulty harmonizing order processing, accounting, billing, resource management, information technology, and other systems company-wide. We may also have to invest more than anticipated in product or process improvements. Especially with acquisitions of privately held or non-US companies, we may face challenges developing and maintaining internal controls consistent with the requirements of the Sarbanes-Oxley Act and US public accounting standards. Acquisitions may also disrupt our ongoing operations, divert management from day-to-day responsibilities, and disrupt other strategic, research and development, marketing, or sales efforts. Geographic and time zone differences and disparate corporate cultures may increase the difficulties and risks of an acquisition. If integration of our acquired businesses or assets is not successful or disrupts our ongoing operations, acquisitions may increase our expenses, harm our competitive position, adversely impact our operating results and financial condition, and fail to achieve anticipated revenue, cost, competitive, or other objectives.

***Insiders and principal stockholders will likely have significant influence over matters requiring stockholder approval.***

Our directors, executive officers, and other principal stockholders beneficially own, in the aggregate, a substantial amount of our outstanding common stock. Although they do not have majority control of the outstanding stock, these stockholders will likely have significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets.

***Anti-takeover provisions in our charter documents and under Delaware law could discourage, delay, or prevent a change in control of our company and may affect the trading price of our common stock.***

Provisions in our amended and restated certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated certificate of incorporation and amended and restated bylaws include provisions that:

- authorize our Board of Directors to issue, without further action by the stockholders, up to 10,000,000 shares of undesignated preferred stock;
- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;
- specify that special meetings of our stockholders can be called only by our Board of Directors, the chairman of the board, the chief executive officer, or the president;
- establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our Board of Directors;
- establish that our Board of Directors is divided into three classes, Class I, Class II, and Class III, with each class serving staggered terms;
- provide that our directors may be removed only for cause;
- provide that vacancies on our Board of Directors may be filled only by a majority vote of directors then in office, even though less than a quorum;
- specify that no stockholder is permitted to cumulate votes at any election of directors; and
- require a super-majority of votes to amend certain of the above-mentioned provisions.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. Section 203 generally prohibits us from engaging in a business combination with an interested stockholder subject to certain exceptions.

***We may experience difficulties implementing our enterprise resource planning system.***

We have initiated a project to upgrade our enterprise resource planning (“ERP”) system to streamline our business processes and allow for cost-efficient scalability, flexibility, and improved management reporting and analysis. Further, we anticipate that our new ERP system, once implemented, will accommodate our future needs as we continue to evolve our business in a changing marketplace. Our new ERP system will be critical to our ability to accurately maintain books and records, record transactions, provide important information to our management, and prepare our financial statements. The design and implementation of the new ERP system has required, and will continue to require, the investment of significant financial and human resources. The total cost needed to implement the new ERP system may turn out to be more than we currently anticipate. In addition, we may not be able to successfully implement the new ERP system without experiencing difficulties nor can we guarantee that the new ERP system will support our business operations after the system goes live. Any disruptions, delays, or deficiencies in the design and implementation of the new ERP system could adversely affect our ability to process orders, ship products, provide services and customer support, send invoices and track payments, fulfill contractual obligations, or otherwise operate our business, which could, in turn, adversely affect our results of operations, financial condition, and cash flows, as well as our internal controls over financial reporting.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

*Purchases of Equity Securities by the Issuer and Affiliated Purchasers*

There was no stock repurchase activity during the three months ended September 30, 2012.

**Item 6. Exhibits**

**Exhibit No.    Description**

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

\*XBRL (Extensible Business Reporting Language) information is furnished and not filed herewith, is not a part of a registration statement or Prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

## SIGNATURES

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

Registrant: Energy Recovery, Inc.

By: /s/ THOMAS S. ROONEY, JR. President and Chief Executive Officer November 8, 2012  
**Thomas S. Rooney, Jr.** (Principal Executive Officer)

/s/ ALEXANDER J. BUEHLER Chief Financial Officer November 8, 2012  
**Alexander J. Buehler** (Principal Financial Officer)

## Exhibit List

| <u>Exhibit No.</u> | <u>Description</u>  |
|--------------------|---|
| 31.1               | Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.        |
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\*XBRL (Extensible Business Reporting Language) information is furnished and not filed herewith, is not a part of a registration statement or Prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER  
PURSUANT TO EXCHANGE ACT RULE 13a-14(a) OR 15d-14(a), AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES OXLEY ACT OF 2002**

I, Thomas S. Rooney, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Energy Recovery, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2012

/s/ THOMAS S. ROONEY, JR.

Name: Thomas S. Rooney, Jr.  
Title: President and Chief Executive Officer  
(Principal Executive Officer)

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER  
PURSUANT TO EXCHANGE ACT RULE 13a-14(a) OR 15d-14(a), AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES OXLEY ACT OF 2002**

I, Alexander J Buehler, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Energy Recovery, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 8, 2012

/s/ ALEXANDER J. BUEHLER

Name: Alexander J. Buehler  
Title: Chief Financial Officer  
(Principal Financial Officer)

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER,  
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE  
SARBANES-OXLEY ACT OF 2002\***

Pursuant to the requirement set forth in Rule 13a-14(b) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), and Section 1350 of Chapter 63 of Title 18 of the United States Code, Thomas S. Rooney, Jr., President and Chief Executive Officer of Energy Recovery, Inc. (the "Company"), and Alexander J. Buehler, Chief Financial Officer of the Company, each hereby certify that, to the best of their knowledge:

1. The Company's Quarterly Report on Form 10-Q for the period ended September 30, 2012, to which this Certification is attached as Exhibit 32.1 (the "Quarterly Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Exchange Act, and
2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Quarterly Report and results of operations of the Company for the period covered by the Quarterly Report.

/s/ THOMAS S. ROONEY, JR.

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President and Chief Executive Officer

Dated: November 8, 2012

/s/ ALEXANDER J.

BUEHLER

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Chief Financial Officer

Dated: November 8, 2012

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\* This certification accompanies the Form 10-Q to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Energy Recovery, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

