TARGETED GENETICS CORP /WA/
Form 4
September 11, 2009

FORM 4

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL
OMB Number: 3235-0287
Expires: January 31, 2005
Estimated average burden hours per response... 0.5

(Print or Type Responses)

1. Name and Address of Reporting Person *
MARXE AUSTIN W & GREENHOUSE DAVID M
(Last) (First) (Middle)
C/O SPECIAL SITUATIONS FUNDS, 527 MADISON AVENUE, SUITE 2600
(Street)
NEW YORK, NY 10022
(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
TARGETED GENETICS CORP /WA/ [TGEN]

3. Date of Earliest Transaction (Month/Day/Year)
09/09/2009

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer
(Check all applicable)
_____ Director __X__ 10% Owner
_____ Officer (give title below) _____ Other (specify below)

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	09/09/2009		S		100,000	D	$ 0.5006	2,255,481	I	By Limited Partnerships
Common Stock	09/09/2009		S		60,000 (1)	D	$ 0.5261	2,195,481 (1)	I (1)	By Limited Partnerships (1)

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control

SEC 1474 (9-02)

number.

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
MARXE AUSTIN W & GREENHOUSE DAVID M C/O SPECIAL SITUATIONS FUNDS 527 MADISON AVENUE, SUITE 2600 NEW YORK, NY 10022		X		

Signatures

Austin W. Marxe	09/11/2009
**Signature of Reporting Person	Date
David M. Greenhouse	09/11/2009
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) This is a joint filing by Austin W. Marxe (Marxe) and David M. Greenhouse (Greenhouse). They share voting and investment control over all securities owned by Special Situations Fund III QP, L.P (SSFQP) and Special Situations Life Sciences Fund, L.P. (LS), respectively. 1,654,234 shares of Common Stock are owned by SSFQP and 541,247 shares of Common Stock are owned by LS. The interest of Marxe and Greenhouse in the shares of Common Stock owned by SSFQP and LS is limited to the extent of his pecuniary interest.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. t-size:9pt;">Balance at December 31, 2016

56,884

$
57

(3,722
)

$
(16,210
)

$
139,676

$
(118
)

$
(54,913
)

$
68,492

Net income
—

—

—

—

—

—

$
18,354

18,354

Unrealized loss on investments
—

—

—

—

—

(64
)

—

(64
)
Foreign currency translation adjustments
—

—

—

—

—

57

—

57

Explanation of Responses:

Issuance of common stock
1,284

1

—

—

5,237

—

—

5,238

Repurchase of common stock for treasury
—

—

(541
)

(4,276
)

—

—

—

(4,276
)
Employee stock-based compensation
—

—

—

—

4,093

—

—

4,093

Balance at December 31, 2017
58,168

$
58

(4,263
)

$
(20,486
)

$
149,006

$
(125
)

$
(36,559
)

$
91,894

Explanation of Responses:

Net income
—

—

—

—

—

—

$
22,093

22,093

Unrealized gain on investments
—

—

—

—

—

4

—

4

Foreign currency translation adjustments
—

—

—

—

—

(12
)

—

(12
)
Issuance of common stock
1,228

1

—

—

4,138

—

—

4,139

Repurchase of common stock for treasury
—

—

(1,193
)

(10,000
)

—

—

—

(10,000
)
Employee stock-based compensation
—

—

—

—

5,260

—

—

5,260

Balance at December 31, 2018
59,396

$
59

(5,456
)

$
(30,486
)

$
158,404

$
(133
)

$
(14,466
)

$
113,378

See Accompanying Notes to Consolidated Financial Statements

(1) Due to the full retrospective adoption of ASC 606 as defined in Note 2,"Recent Accounting Pronouncements", of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplemental Data" of this Annual Report on Form 10K, the balances for the years ended 2017 and 2016 were recast.

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ENERGY RECOVERY, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	2018	2017	2016
	(In thousands)		
Cash Flows From Operating Activities:			
Net income	$22,093	$18,354	$3,719
Adjustments to reconcile net income to net cash provided by operating activities:			
Stock-based compensation	5,240	4,087	3,263
Depreciation and amortization	3,869	3,666	3,680
Amortization of premiums on investments	362	460	174
Provision for warranty claims	326	246	208
Reversal of accruals related to expired warranties	(180)	(200)	(236)
Unrealized (gain) loss on foreign currency translation	(10)	144	13
Provision for doubtful accounts	336	55	76
Adjustments for excess or obsolete inventory	197	201	(361)
Deferred income taxes	(10,385)	(8,865)	(459)
Loss on disposal of fixed assets	408	—	—
Other non-cash adjustments	—	(196)	(131)
Changes in operating assets and liabilities:			
Accounts receivable	1,917	(761)	(244)
Contract assets	2,196	(4,263)	(130)
Inventories	(1,872)	(1,250)	2,287
Prepaid and other assets	(682)	(39)	(402)
Accounts payable	(2,274)	2,118	(360)
Accrued expenses and other liabilities	87	611	(262)
Income taxes payable	(447)	385	398
Contract Liabilities	(13,616)	(11,858)	(6,268)
Net cash provided by operating activities	7,565	2,895	4,965
Cash Flows From Investing Activities:			
Maturities of marketable securities	81,268	49,106	7,535
Purchases of marketable securities	(86,192)	(80,641)	(46,552)
Capital expenditures	(5,235)	(7,376)	(1,112)
Net cash used in investing activities	(10,159)	(38,911)	(40,129)
Cash Flows From Financing Activities:			
Net proceeds from issuance of common stock	4,291	5,508	6,600
Tax payment for employee shares withheld	(150)	(270)	—
Repayment of long-term debt	(27)	(11)	(10)
Repurchase of common stock	(10,000)	(4,276)	(9,375)
Net cash (used in) provided by financing activities	(5,886)	951	(2,785)
Effect of exchange rate differences on cash and cash equivalents	(8)	(57)	(41)
Net change in cash and cash equivalents and restricted cash	(8,488)	(35,122)	(37,990)
Cash and cash equivalents and restricted cash, beginning of year	30,626	65,748	103,738
Cash and cash equivalents and restricted cash, end of year	$22,138	$30,626	$65,748
Supplemental disclosure of cash flow information:			
Cash paid for interest	$1	$2	$3
Cash received for income tax refunds	$13	$16	$2

Cash paid for income taxes	$610	$57	$51
Supplemental disclosure of non-cash transactions:			
Purchases of property and equipment in trade accounts payable and accrued expenses and other liabilities	$30	$475	$66
Non-cash lease liabilities arising from obtaining right of use assets	$10,411	$—	$—

See Accompanying Notes to Consolidated Financial Statements

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Description of Business and Significant Accounting Policies

Energy Recovery, Inc. and its wholly-owned subsidiaries (the “Company,” “Energy Recovery,” “our,” “us,” or “we”) is an energy solutions provider to industrial fluid flow markets worldwide. The Company’s core competencies are fluid dynamics and advanced material science. The Company’s products make industrial processes more operationally and capital expenditure efficient. The Company’s solutions convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. The Company’s solutions are marketed and sold in fluid flow markets, such as water, oil & gas, and chemical processing, under the trademarks ERI®, PX®, Pressure Exchanger®, PX Pressure Exchanger®, VorTeq™, MTeq™, IsoBoost®, IsoGen®, AT™, and AquaBold™. The Company owns, manufactures, and/or develops its solutions, in whole or in part, in the United States of America, (“U.S.”) and the Republic of Ireland (“Ireland”).

Basis of Presentation

The Company’s Consolidated Financial Statements include the accounts of Energy Recovery, Inc. and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Reclassifications and Retroactive Adjustments

Certain prior year amounts have been reclassified in the Consolidated Statements of Cash Flows and certain Notes to Consolidated Financial Statements to conform to the current year presentation. In addition, as of January 1, 2018 the Company adopted “ASU 2014-09”, “ASU 2016-08” and “ASU 2016-10” (the combination is also known as “ASC 606” or “New Revenue Standard”) using the full retrospective transition method, and the Company early adopted ASU No. 2016-02 (“ASU 2016-02”), Leases (Topic 842), also referred to as “ASC 842” or “New Lease Standard,” The Company also adopted ASU 2016-18 (“ASU 2016-18”), Statement of Cash Flows (Topic 230): Restricted Cash, also referred to as “New Cash Flow Presentation Standard” on January 1, 2018. See Note 2, “Recent Accounting Pronouncements,” of the Notes to Consolidated Financial Statements in Part II, Item 8, “Financial Statements and Supplemental Data,” of this Annual Report on Form 10-K regarding the impact of these recent accounting pronouncements on our Consolidated Financial Statements.

Use of Estimates

The preparation of Consolidated Financial Statements in conformity with United States (“U.S.”) generally accepted accounting principles (“U.S. GAAP”) requires the Company’s management to make judgments, assumptions, and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying Notes to Consolidated Financial Statements.

The accounting policies that reflect the Company’s more significant estimates and judgments and that the Company believes are the most critical to aid in fully understanding and evaluating its reported financial results are revenue recognition; capitalization of research and development assets; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill and acquired intangible assets; valuation adjustments for excess and obsolete inventory; deferred taxes and valuation allowances on deferred tax assets; and evaluation and measurement of contingencies. Those estimates could change, and as a result, actual results could differ materially from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original or remaining maturity of three months or less at the time of purchase to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value. The Company’s cash and cash equivalents are maintained primarily in demand deposit accounts with large financial institutions and in institutional money market funds. The Company monitors the creditworthiness of the financial institutions and institutional money market funds in which the Company invests its surplus funds. The Company has experienced no credit losses from its cash investments.

Allowances for Doubtful Accounts

The Company records a provision for doubtful accounts based on historical experience and a detailed assessment of the collectability of its accounts receivable. In estimating the allowance for doubtful accounts, the Company considers, among

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

other factors, the aging of the accounts receivable, its historical write-offs, the credit worthiness of each customer, and general economic conditions. Account balances are charged off against the allowance when the Company believes that it is probable that the receivable will not be recovered. Actual write-offs may be in excess of the Company's estimated allowance.

Short-Term and Long-Term Investments

The Company's short-term and long-term investments consist primarily of investment-grade debt securities, all of which are classified as available-for-sale. Available-for-sale securities are carried at fair value. Amortization or accretion of premium or discount is included in other income (expense) on the Consolidated Statements of Operations. Changes in the fair value of available-for-sale securities are reported as a component of accumulated other comprehensive loss within stockholders' equity on the Consolidated Balance Sheet. Realized gains and losses on the sale of available-for-sale securities are determined by specific identification of the cost basis of each security. Short-term investments mature within 12 months and long-term investments mature greater than 12 months.

Inventories

Inventories are stated at the lower of cost (using the first-in, first-out "FIFO" method) or net realizable value. The Company calculates inventory valuation adjustments for excess and obsolete inventory based on current inventory levels, movement, expected useful lives, and estimated future demand of the products and spare parts.

Property and Equipment

Property and equipment is recorded at cost and reduced by accumulated depreciation. Depreciation expense is recognized over the estimated useful lives of the assets using the straight-line method. Estimated useful lives are three to ten years. Certain equipment used in the development and manufacturing of ceramic components is depreciated over estimated useful lives of up to 10 years. Leasehold improvements represent remodeling and retrofitting costs for leased office and manufacturing space and are depreciated over the shorter of either the estimated useful lives or the term of the lease. Software purchased for internal use consists primarily of amounts paid for perpetual licenses to third-party software providers and installation costs. Software is depreciated over the estimated useful lives of three to five years. Tangible assets acquired for research and development ("R&D") activities and have alternative use are capitalized over the useful life of the acquired asset. Estimated useful lives are periodically reviewed, and when appropriate, changes are made prospectively. When certain events or changes in operating conditions occur, asset lives may be adjusted and an impairment assessment may be performed on the recoverability of the carrying amounts. Maintenance and repairs are charged directly to expense as incurred.

Goodwill and Other Intangible Assets

The purchase price of an acquired company is allocated between intangible assets and the net tangible assets of the acquired business with the residual purchase price recorded as goodwill. The determination of the value of the intangible assets acquired involves certain judgments and estimates. These judgments can include, but are not limited to, the cash flows that an asset is expected to generate in the future and the appropriate weighted average cost of capital.

Acquired intangible assets with determinable useful lives are amortized on a straight-line or accelerated basis over the estimated periods benefited, ranging from one to 20 years. Acquired intangible assets with contractual terms are amortized over their respective legal or contractual lives. Customer relationships and other non-contractual intangible assets with determinable lives are amortized over periods ranging from five to 20 years.

The Company evaluates the recoverability of long-lived assets by comparing the carrying amount of an asset to estimated future net undiscounted cash flows generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets. The evaluation of recoverability involves estimates of future operating cash flows based upon certain forecasted assumptions, including, but not limited to, revenue growth rates, gross profit margins, and operating expenses over the expected remaining useful life of the related asset. A shortfall in these estimated operating cash flows could result in an impairment charge in the future.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Goodwill is not amortized, but is evaluated annually for impairment at the reporting unit level or when indicators of a potential impairment are present. The Company estimates the fair value of the reporting unit using the discounted cash flow and market approaches. Forecast of future cash flows are based on the Company's best estimate of future net sales and operating expenses, based primarily on expected category expansion, pricing, market segment, and general economic conditions.

As of December 31, 2018 and 2017, acquired intangibles, including goodwill, relate to the acquisition of Pump Engineering, LLC during the fourth quarter of 2009. See Note 7, "Goodwill and Intangible Assets," of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplemental Data," of this Annual Report on Form 10-K for further discussion of intangible assets.

Fair Value of Financial Instruments

The Company's financial instruments include cash and cash equivalents, restricted cash, investments in marketable securities, accounts receivable, accounts payable, and debt. The carrying amounts for these financial instruments reported in the Consolidated Balance Sheets approximate their fair values. See Note 6, "Investments and Fair Value Measurements," of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplemental Data," of this Annual Report on Form 10-K for further discussion of fair value.

Revenue Recognition

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

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

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

See Note 3, "Revenues" of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplemental Data," of this Annual Report on Form 10-K ,for more detail on product and service revenue recognition - Water segment, cost-to-total cost ("CTC") revenue recognition- Oil and Gas segment, license and development revenue recognition - Oil and Gas segment.

Research and Development ("R&D") Expense and Capitalization of R&D Assets

R&D expense consists of costs incurred for internal projects and for technology licensed to third parties. These costs include the Company's direct and research-related overhead expenses, which include salaries and other personnel-related expenses (including stock-based compensation), occupancy-related costs, depreciation of facilities, as well as external costs for equipment and supplies. Costs to acquire technologies that are utilized in research and development and that have no alternative future use are expensed when incurred. All R&D costs are expensed as incurred and are included in operating expenses.

The costs of materials that are acquired for research and development activities and have no alternative future uses (in research and development projects or otherwise) are expensed as incurred. With respect to tangible assets acquired or constructed for R&D activities, if the costs of materials that are acquired or constructed for a particular research and development project have alternative future uses (in other research and development projects or otherwise), they are capitalized as an asset and the cost of depreciation is charged to expense.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Warranty Costs

The Company sells products with a limited warranty for a period ranging from 18 months to five years. The Company accrues for warranty costs based on estimated product failure rates, historical activity, and expectations of future costs. Periodically, the Company evaluates and adjusts the warranty costs to the extent that actual warranty costs vary from the original estimates.

Stock-based Compensation

The Company measures and recognizes stock-based compensation expense based on the fair value measurement for all stock-based awards made to its employees and directors, including restricted stock units ("RSUs"), and employee stock options over the requisite service period (typically the vesting period of the awards). The fair value of RSUs based on the Company's stock price on the date of grant. The fair value of stock options is calculated on the date of grant using the Black-Scholes option pricing model, which requires a number of complex assumptions including expected life, expected volatility, risk-free interest rate, and dividend yield. The estimation of awards that will ultimately vest requires judgment, and to the extent that actual results or updated estimates differ from our current estimates, such amounts are recorded as a cumulative adjustment in the period in which the estimates are revised. See Note 12, "Stock-Based Compensation," for further discussion of stock-based compensation.

Foreign Currency

The Company's reporting currency is the U.S. dollar. The functional currency of the Company's Irish subsidiaries is the U.S. dollar, while the functional currency of the Company's other foreign subsidiaries is their respective local currencies. The asset and liability accounts of the Company's foreign subsidiaries are translated from their local currencies at the rates in effect on the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the period. Gains and losses resulting from the translation of the Company's subsidiary balance sheets are recorded as a component of accumulated other comprehensive income (loss). Gains and losses from foreign currency transactions are recorded in other income (expense) in the Consolidated Statements of Operations.

Income Taxes

Current and non-current tax assets and liabilities are based upon an estimate of taxes refundable or payable for each of the jurisdictions in which the Company is subject to tax. In the ordinary course of business, there is inherent uncertainty in quantifying income tax positions. The Company assesses income tax positions and records tax benefits for all years subject to examination based upon the Company's evaluation of the facts, circumstances, and information available at the reporting dates. For those tax positions where it is more likely than not that a tax benefit will be sustained, the Company records the largest amount of tax benefit with a greater than 50% likelihood of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where it is not more likely than not that a tax benefit will be sustained, no tax benefit is recognized in the financial statements. When applicable, associated interest and penalties are recognized as a component of income tax expense. Accrued interest and penalties are included within the related tax asset or liability on the Consolidated Balance Sheets.

Deferred income taxes are provided for temporary differences arising from differences in bases of assets and liabilities for tax and financial reporting purposes. Deferred income taxes are recorded on temporary differences using enacted tax rates in effect for the year in which the temporary differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Significant judgment is required in determining whether and to what extent any valuation allowance is needed on the Company’s deferred tax assets. In making such a determination, the Company considers all available positive and negative evidence including recent results of operations, scheduled reversals of deferred tax liabilities, projected future income, and available tax planning strategies. See Note 10, “Income Taxes,” of the Notes to Consolidated Financial Statements in Part II, Item 8, “Financial Statements and Supplemental Data,” of this Annual Report on Form 10-K for further discussion of tax valuation allowances.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

On December 22, 2017, President Trump signed into law the Tax Act, which significantly changed existing U.S. tax laws. Following the enactment of the Tax Act, the SEC staff issued SAB 118, which provided guidance on accounting for the tax effects of the Tax Act. SAB 118 provided a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company's accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements. If a company cannot determine a provisional estimate to be included in the financial statements, it should continue to apply ASC 740 on the basis of the provisions of the tax law that were in effect immediately before the enactment of the Tax Act. Our adjustments were final in 2017. See Note 10, "Income Taxes," of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplementary Data," of this Annual Report on Form 10-K for a discussion of our income tax accounting related to the Tax Act.

The Company's operations are subject to income and transaction taxes in the U.S. and in foreign jurisdictions. Significant estimates and judgments are required in determining the Company's worldwide provision for income taxes. Some of these estimates are based on interpretations of existing tax laws or regulations. The ultimate amount of tax liability may be uncertain as a result.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Recent Accounting Pronouncements

Recently adopted accounting pronouncements

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

The update also requires more detailed disclosures to enable readers of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. ASC 606 permits the use of either the full retrospective or cumulative effect transition (modified retrospective) method upon adoption.

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

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

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

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

Oil & Gas Segment - License and Development Revenue. License and development revenue associated with the up-front non-refundable $75.0 million exclusivity payment received in connection with the VorTeq license agreement (the "VorTeq License Agreement") that the Company entered into with a technology corporation (the "VorTeq Licensee") under ASC 605 was recognized on a straight-line basis over the 15-year term of the license, while the two subsequent milestone payments of $25.0 million that could each be earned under the VorTeq License Agreement were to be recognized in full when achieved under milestone accounting.

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

- revenue recognition over time based on an input measure of progress based on a cost driver, which management has determined is the best estimate of the progress made on the project during the period from inception until full commercialization, for the amount allocated to the exclusive Missile (as defined in Note 15, “VorTeq Partnership and License Agreement”) license, and research and development services, and

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ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

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

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

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

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

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

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

See Note 15, “VorTeq Partnership and License Agreement” for additional discussion on the VorTeq License Agreement, and Note 3, “Revenues,” for further discussion of revenue recognition.

In February 2016, the FASB issued ASU No. 2016-02 (“ASU 2016-02”), Leases (Topic 842): which supersedes ASC 840, Leases (Topic 840), and provides principles for the recognition, measurement, presentation and disclosure of leases for both lessees and lessors. The FASB has continued to clarify this guidance through the issuance of additional ASUs. The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification determines whether lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease, respectively. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than twelve months regardless of classification. Leases with a term of 12 months or less will be accounted for similar to existing guidance for operating leases.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

In November 2016, the FASB issued ASU 2016-18 ("ASU 2016-18"), Statement of Cash Flows (Topic 230): Restricted Cash, also referred to as "New Cash Flow Presentation Standard." ASU 2016-18 is intended to reduce diversity in practice in the classification and presentation of changes in restricted cash on the Consolidated Statement of Cash Flows. ASU 2016-18 requires that the Consolidated Statement of Cash Flows explain the change in total cash and equivalents and amounts generally described as restricted cash or restricted cash equivalents when reconciling the beginning-of-period and end-of-period total amounts. The standard also requires reconciliation between the total cash and equivalents and restricted cash presented on the Consolidated Statement of Cash Flows and the cash and cash equivalents balance presented on the Consolidated Balance Sheet. ASU 2016-18 is effective retrospectively on January 1, 2018. The Company adopted ASU 2016-18 on January 1, 2018. The Company recast its Consolidated Statements of Cash Flows for the prior periods presented based on the restricted cash balance on the balance sheet date and has provided a reconciliation of cash, cash equivalents and restricted cash in Note 5, "Other Financial Information."

In January 2016, the FASB issued ASU No. 2016-01 ("ASU 2016-01"), Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 modifies certain aspects of the recognition, measurement, presentation, and disclosure of financial instruments. For public entities, ASU 2016-01 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017. The Company adopted ASU 2016-01 on January 1, 2018. The adoption of ASU 2016-01 did not have a material impact on the Company's financial position or results of operations.

In August 2016, the FASB issued ASU No. 2016-15 ("ASU 2016-15"), Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 impacts all entities that are required to present a statement of cash flows under ASC 230, Statement of Cash Flows. The amendment provides guidance on eight specific cash flow issues. For public entities, ASU 2016-15 is effective for fiscal periods beginning after December 15, 2017 and interim periods within those years. Adoption should be applied using a retrospective transition method to each period presented. The Company adopted ASU 2016-15 on January 1, 2018. The adoption of ASU 2016-15 did not have a material impact on the Company's financial position or results of operations.

In October 2016, the FASB issued ASU 2016-16 ("ASU 2016-16"), Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory. ASU 2016-16 requires recognition of the current and deferred income tax effects of an intra-entity asset transfer, other than inventory, when the transfer occurs, as opposed to legacy GAAP, which requires companies to defer the income tax effects of intra-entity asset transfers until the asset has been sold to an outside party. The income tax effects of intra-entity inventory transfers will continue to be deferred until the inventory is sold. ASU 2016-16 is effective on January 1, 2018, with early adoption permitted. The update is required to be adopted on a modified retrospective basis with the cumulative-effect adjustment recorded to retained earnings as of the beginning of the period of adoption. The Company adopted ASU 2016-16 on January 1, 2018. The adoption of ASU 2016-16 did not have a material impact on the Company's financial position or results of operations.

In May 2017, the FASB issued ASU No. 2017-09, Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting. ASU 2017-09 provides guidance about which changes to the terms or conditions of a share-base payment award require an entity to apply modification accounting under ASC 718, Compensation – Stock Compensation. ASU 2017-09 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The Company adopted ASU 2017-09 on January 1, 2018. The adoption of ASU 2017-09 did not have an impact on the Company’s financial position or results of operations.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Impact of Recently Adopted Accounting Pronouncements

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

	Twelve Months Ended December 31, 2017			Twelve Months Ended December 31, 2016		
	As Previously Reported	Adoption of New Revenue Standard	As Adjusted	As Previously Reported	Adoption of New Revenue Standard	As Adjusted
	(In thousands, except for per share data)					
Product revenue	$58,156	$(133)	$58,023	$49,715	$ —	$49,715
Product cost of revenue	19,061	—	19,061	17,849	—	17,849
Product gross profit	$39,095	$(133)	$38,962	$31,866	$ —	$31,866
License and development revenue	$5,000	$6,106	$11,106	$5,000	$ 3,069	$8,069
Income from operations	3,276	5,973	9,249	357	3,069	3,426
Income before income taxes	3,956	5,973	9,929	644	3,069	3,713
(Benefit from) provision for income taxes	(8,394)	(31)	(8,425)	(390)	384	(6)
Net income	12,350	6,004	18,354	1,034	2,685	3,719
Income per share:						
Basic	$0.23	$0.11	$0.34	$0.02	0.05	$0.07
Diluted	$0.22	$0.11	$0.33	$0.02	0.05	$0.07
Number of shares used in per share calculations:						
Basic	53,701	—	53,701	52,341	—	52,341
Diluted	55,612	—	55,612	55,451	—	55,451

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

	Twelve Months Ended December 31, 2017			Twelve Months Ended December 31, 2016		
	As Previously Reported	Adoption of New Revenue Standard	As Adjusted	As Previously Reported	Adoption of New Revenue Standard	As Adjusted
	(In thousands)					
Water						
Product revenue	$54,301	$ —	$54,301	$47,545	$ —	$47,545
Product cost of revenue	16,032	—	16,032	16,353	—	16,353
Product gross profit	$38,269	$ —	$38,269	$31,192	$ —	$31,192
Income from operations	$29,386	$ —	$29,386	$23,073	$ —	$23,073
Oil & Gas						
Product revenue	$3,855	$ (133)	$3,722	$2,170	$ —	$2,170
Product cost of revenue	3,029		3,029	1,496	—	1,496
Product gross profit	$826	$ (133)	$693	$674	$ —	$674
License and development revenue	$5,000	$ 6,106	$11,106	$5,000	$ 3,069	$8,069
Income (loss) from operations	(10,184)	5,973	(4,211)	(7,016)	3,069	(3,947)

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

	Twelve Months Ended December 31, 2017			Twelve Months Ended December 31, 2016		
	As Previously Reported	Adoption of New Revenue Standard	As Adjusted	As Previously Reported	Adoption of New Revenue Standard	As Adjusted
	(In thousands)					
Net income	$12,350	$ 6,004	$ 18,354	$1,034	$ 2,685	$ 3,719
Comprehensive income	12,343	6,004	18,347	980	2,685	3,665

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

	Twelve Months Ended December 31, 2017			
	As Previously Reported	Adoption of New Revenue Standard	Adoption of New Cash Flow Presentation Standard	As Adjusted
	(In thousands)			
Net income	$12,350	$6,004	$ —	$18,354
Changes in operating assets and liabilities:				
Accounts receivable	(761)	—	—	(761)
Contract assets	(4,396)	133	—	(4,263)
Inventories	(1,250)	—	—	(1,250)
Prepaid and other assets	(39)	—	—	(39)
Accounts payable	2,118			2,118
Accrued expenses and other liabilities	364	247	—	611
Income taxes	416	(31)	—	385
Contract liabilities	(5,505)	(6,353)	—	(11,858)
Net cash used in operating activities	2,895	—	—	2,895
Restricted cash	1,538	—	(1,538)	—
Net cash used in investing activities	(37,373)	—	(1,538)	(38,911)
Net change in cash, cash equivalents and restricted cash	(33,584)	—	(1,538)	(35,122)
Cash, cash equivalents and restricted cash, beginning of year	61,364	—	4,384	65,748
Cash, cash equivalents and restricted cash, end of period	27,780	—	2,846	30,626

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Twelve Months Ended December 31, 2016			
	As Previously Reported	Adoption of New Revenue Standard	Adoption of New Cash Flow Presentation Standard	As Adjusted
	(In thousands)			
Net income	$ 1,034	$ 2,685	$ —	$ 3,719
Changes in operating assets and liabilities:				
Accounts receivable	(244)	—	—	(244)
Contract assets	(130)	—	—	(130)
Inventories	2,287	—	—	2,287
Prepaid and other assets	(402)	—	—	(402)
Accounts payable	(360)	—	—	(360)
Accrued expenses and other liabilities	1,259	(1,521)	—	(262)
Income taxes	14	384	—	398
Contract liabilities	(4,720)	(1,548)	—	(6,268)
Net cash used in operating activities	4,965	—	—	4,965
Restricted cash	(577)	—	577	—
Net cash used in investing activities	(40,706)	—	577	(40,129)
Net change in cash, cash equivalents and restricted cash	(38,567)	—	577	(37,990)
Cash, cash equivalents and restricted cash, beginning of year	99,931	—	3,807	103,738
Cash, cash equivalents and restricted cash, end of period	61,364	—	4,384	65,748

Recently issued accounting pronouncements not yet adopted

In June 2016, the FASB issued ASU 2016-13 (“ASU 2016-13”), “Financial Instruments - Credit Losses” (Topic 326). The FASB issued this update to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The amendments in this update replace the existing guidance of incurred loss impairment methodology with an approach that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The updated guidance is effective for annual periods beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption of the update is permitted in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company expects to adopt this standard on January 1, 2020 and does not expect the adoption of ASU 2016-13 to have a material impact on its financial statements.

In January 2017, the FASB issued ASU No. 2017-04 (“ASU 2017-04”), Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. ASU 2017-04 eliminates Step 2 of the goodwill impairment quantitative test and allows for the determination of impairment by comparing the fair value of the reporting unit with its carrying amount. The amendments in this update should be applied on a prospective basis. For public entities which are SEC filers, this amendment is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for testing dates after January 1, 2017. The Company expects to adopt this standard on January 1, 2020 and does not expect the adoption of ASU 2017-04 to have a material impact on its financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 3 — Revenues

Adoption of ASC 606, Revenue from Contracts with Customers

On January 1, 2018, the Company adopted ASC 606 using the full retrospective transition method. The Company recorded a net reduction to opening retained earnings of $0.3 million as of January 1, 2016, due to the cumulative impact of adopting ASC 606. The impact to revenues as a result of applying ASC 606 was an increase of $6.0 million, and $3.0 million, for the years 2017 and 2016 respectively.

Revenue Recognition

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

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

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

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

	Year Ended December 31, 2018		
	Water	Oil and Gas	Total
	(In thousands)		
Primary geographical market			
Middle East and Africa	$35,593	$514	$36,107
Americas	6,388	13,490	19,878
Asia	11,955	—	11,955
Europe	6,575	—	6,575
Total	$60,511	$14,004	$74,515

Major product/service line			
PX, pumps and turbo devices	$60,511	$6	$60,517
License and development	—	13,490	13,490
Oil & gas products	—	508	508
Total	$60,511	$14,004	$74,515

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	Year Ended December 31, 2017			Year Ended December 31, 2016		
	Water	Oil and Gas	Total	Water	Oil and Gas	Total
	(In thousands)					
Primary geographical market						
Middle East and Africa	$26,190	$3,708	$29,898	$19,436	$2,170	$21,606
Americas	7,023	11,120	18,143	5,419	8,069	13,488
Asia	12,974	—	12,974	17,397	—	17,397
Europe	8,114	—	8,114	5,293	—	5,293
Total	$54,301	$14,828	$69,129	$47,545	$10,239	$57,784
Major product/service line						
PX, pumps and turbo devices	$54,301	$15	$54,316	$47,545	$10	$47,555
License and development	—	11,106	11,106	—	8,069	8,069
Oil & gas products	—	3,707	3,707	—	2,160	2,160
Total	$54,301	$14,828	$69,129	$47,545	$10,239	$57,784

Arrangements with Multiple Performance Obligations and Termination for Convenience

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

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

Practical Expedients and Exemptions

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

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

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

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Explanation of Responses:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Contract Balances

Contract balances by category are presented in the following table. Prior year amounts have been adjusted for the adoption of ASC 606 on January 1, 2018. See Note 2, "Recent Accounting Pronouncements,"of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplemental Data," of this Annual Report on Form 10-K for reconciliation of prior year "As Previously Reported" and "As Adjusted" amounts.

	December 31, 2018	December 31, 2017
	(In thousands)	
Trade Receivable	$10,212	$ 12,465
Contract assets:		
Current contract assets	4,083	6,278
Total contract assets	$4,083	$ 6,278
Current contract liabilities:		
Customer deposits	$706	$ 414
Deferred revenue:		
Cost and estimated earnings in excess of billings	264	805
License and development	14,518	14,024
Product	548	550
Service	234	116
Total current contract liability	16,270	15,909
Non-current contract liabilities, deferred revenue		
License and development	26,485	40,469
Product	54	48
Total non-current contract liability	26,539	40,517
Total contract liability	$42,809	$ 56,426

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

	December 31, 2018	December 31, 2017
	(In thousands)	
Balance, beginning of year	$6,278	$ 2,015
Transferred to receivables	(8,865)	(2,909)
Additional unbilled receivables	6,670	7,172
Balance, end of period	$4,083	$ 6,278

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

	December 31,	December 31,

	2018	2017
	(In thousands)	
Balance, beginning of year	$56,426	$62,232
Revenue recognized	(13,493)	(5,892)
Cash received	(124)	86
Balance, end of period	$42,809	$56,426

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Transaction Price Allocated to the Remaining Performance Obligation

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

	December 31, 2018 (In thousands)
Year:	
2019	$ 14,544
2020	14,480
2021	6,328
2022 and thereafter	5,677
Total	$ 41,029

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

The Company applies the practical expedient in ASC 606 paragraph 10-65-1(f)(3), and does not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when the Company expects to recognize that amount of revenue for the comparative period ended December 31, 2017.

Contract Costs

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

Product and Service Revenue Recognition - Water Segment

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

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

Generally, performance obligations consist of delivery of products, such as PX energy recovery devices, turbochargers, pumps, and spare parts. Service obligation amounts which are not material, are deferred as contract liabilities until the services are performed.

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

The Company does not provide its customers with a right of product return; however, the Company will accept returns of products that are deemed to be damaged or defective when delivered that are covered by the terms and conditions of the product warranty. Product warranty is provided consistent with the industry and is considered to be an assurance warranty, not a separate performance obligation. Product returns and warranty charges have not been significant.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Revenue allocable to the Company’s product is limited to the amount that is not contingent upon the delivery of additional items or meeting specified performance conditions. The Company adheres to consistent pricing in the stand-alone sale of products and services.

For large projects, stand-alone contracts are utilized. For these contracts, consistent with industry practice, the Company’s customers typically require their suppliers, including the Company, to accept contractual holdback provisions (also referred to as a retention payment) whereby the final amounts due under the sales contract are remitted over extended periods of time or alternatively, stand-by letters of credit are issued. These retention payments are generally 10% or less of the total contract amount and are due and payable upon the passage of time, generally up to 24 to 36 months from the date of product delivery. These retention payments are generally replaced by bank guarantees which have had no history of being exercised, and they align with the product warranty period. Given that they are not material in the context of the contract, they are not considered to be a financing component. The Company has no performance obligation and they are recorded as contract assets.

Shipping and handling charges billed to customers is a pass-through from the freight forwarder and is included in product revenue. The cost of shipping to customers is included in cost of revenue.

Cost-to-Total Cost (“CTC”) Revenue Recognition - Oil & Gas Segment

IsoBoost and IsoGen systems are highly engineered, customized solutions that are designed and manufactured over an extended period of time and are built specifically to meet a customer’s specifications. Given the facts and circumstances of these projects, the Company concluded that the CTC method of accounting is appropriate for IsoBoost and IsoGen systems. In the event that a purchase order for an IsoBoost or IsoGen system does not meet these facts and circumstances, then the CTC method of accounting does not apply. The Company had one CTC contract for IsoBoost turbochargers in fiscal years 2016 through 2018, which was completed in 2018, and last units were shipped in the first quarter of 2019. A standard assurance type warranty was provided.

Revenue from fixed price contracts is recognized with progress measured in the ratio of costs incurred to estimated final costs. Contract costs include all direct material and labor costs related to contract performance. Pre-contract costs with no future benefit were expensed in the period in which they were incurred. Since the financial reporting of these contracts depends on estimates, which are assessed continually during the term of the contract, recognized revenues and profit are subject to revisions as the contract progresses to completion. Revisions in profit estimates are reflected in the period in which the facts that give rise to the revisions become known, using the cumulative catchup method. If material, the effects of any changes in estimates are disclosed in the notes to the consolidated financial statements. When estimates indicate that a loss will be incurred on a contract, a provision for the expected loss is recorded in the period in which the loss becomes evident. No loss has been incurred to date. Revenue is recognized only to the extent costs have been recognized in the same period.

Cost and estimated earnings on uncompleted contracts is presented in the following table.

		December 31, 2017		
	December 31, 2018	As Previously Reported	Adoption of New Revenue	As Adjusted

			Standard	
	(In thousands)			
Estimated earnings to date	$6,477	$6,000	$ (133)	$ 5,867
Estimated costs to date	(5,289)	(4,525)	—	(4,525)
Subtotal	1,188	1,475	(133)	1,342
Net billings to date	(108)	2,718	—	2,718
Total	$1,080	$4,193	$ (133)	$ 4,060
Included in accompanying balance sheets:				
Unbilled project costs	$1,343	$4,998	$ (133)	$ 4,865
Cost and estimated earnings in excess of billings	(263)	(805)	—	(805)
Total	$1,080	$4,193	$ (133)	$ 4,060

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ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unbilled project costs and Cost and estimated earnings in excess of billings are included in Contract assets and Contract liabilities on the Condensed Consolidated Balance Sheets, respectively.

License and Development Revenue Recognition - Oil & Gas Segment

License and development revenue is comprised of revenue recognition over time of the upfront non-refundable $75.0 million exclusivity fee received in connection with the VorTeq License Agreement, as well as the revenue recognition over time of the two milestone payments of $25.0 million each when uncertainty of receipt is resolved and receipt of each milestone payment is considered probable.

The VorTeq License Agreement is comprised of a 15-year exclusive license for the Company’s VorTeq technology (“VorTeq”). In performing the obligations under the license, the Company provides research and development services to commercialize the technology in accordance with the Key Performance Indicators (“KPIs”), defined in the VorTeq License Agreement. After commercialization is achieved, payments will be received for the supply and servicing of certain components of the VorTeq. All payments are non-refundable. See Note 15, “VorTeq Partnership and License Agreement.”of the Notes to Consolidated Financial Statements in Part II, Item 8, “Financial Statements and Supplemental Data,” of this Annual Report on Form 10-K for further details.

The Company recognizes license and development revenue in accordance with ASC 606. Revenue is recognized when control of the promised goods or services is transferred to customers. Stand-alone selling price was established at the inception of the VorTeq License Agreement by taking the transaction to market on a non-exclusive basis, and pricing in an exclusivity premium. Since the VorTeq License Agreement included an up-front non-refundable payment at the inception of the VorTeq License Agreement and future products and services are provided after initial commercialization, the Company completed an analysis and concluded that there was no material right included in the pricing of the VorTeq License Agreement.

Performance obligations, such as the exclusive license to the Missile technology and upgrades prior to and subsequent to the date of full commercial launch, have been identified. Value has been allocated to the performance obligations and revenue is recognized over time based on the input measure of progress of the cost of salaries and wages related to the project prior to full commercialization, and ratably for the unspecified upgrades for the period subsequent to full commercialization until the expiration of the VorTeq License Agreement.

Once commercial launch is achieved and cartridges are provided under the contract, revenue from those royalty payments will be recognized in accordance with ASC 842, with the Company as the lessor. It is expected that the cartridge leases will be classified as operating leases, and lease revenue will be recognized as earned.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 4 — Income Per Share

Net income is divided by the weighted average number of common shares outstanding during the year to calculate basic net income per common share. Basic earnings per share exclude any dilutive effects of stock options and RSUs.

Diluted net income per common share reflects the potential dilution that would occur if outstanding stock options to purchase common stock were exercised for common stock, using the treasury stock method, and the common stock underlying outstanding restricted award was issued. Diluted earnings per share for the years ended December 31, 2018, 2017 and 2016, includes the dilutive effects of stock options and RSUs. Certain common stock issuable under stock options and RSUs have been omitted from the 2018, 2017 and 2016 diluted net income per share calculations because their inclusion is considered anti-dilutive.

The computation of basic and diluted net income per share is presented in the following table.

	Year Ended December 31,		
	2018	2017	2016
	(In thousands, except per share amounts)		
Numerator:			
Net income	$22,093	$18,354	$3,719
Denominator:			
Basic weighted average common shares outstanding	53,764	53,701	52,341
Weighted average effect of dilutive stock awards	1,574	1,911	3,110
Diluted weighted average common shares outstanding	55,338	55,612	55,451
Net income per share:			
Basic	$0.41	$0.34	$0.07
Diluted	$0.40	$0.33	$0.07

The potential common shares were excluded from the computation of diluted net income per share as their effect would have been anti-dilutive is presented in the following table.

	Year Ended December 31,		
	2018	2017	2016
	(In thousands)		
Anti-dilutive shares excluded from net income per share calculation	2,176	1,810	2,987

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ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 5 — Other Financial Information

Cash, Cash Equivalents and Restricted Cash

The Company pledged cash in connection with certain stand-by letters of credit and company credit cards. The Company deposited corresponding amounts into accounts at several financial institutions. See Note 8, “Long-term Debt and Lines of Credit,” of the Notes to Consolidated Financial Statements in Part II, Item 8, “Financial Statements and Supplemental Data,” of this Annual Report on Form 10-K for additional discussion related to the Company’s stand-by letters of credit and restricted cash requirements.

The Company’s cash, cash equivalents, and restricted cash are presented in the table below.

	December 31, 2018	December 31, 2017
	(In thousands)	
Cash and cash equivalents	$21,955	$ 27,780
Restricted cash	183	2,846
Total cash, cash equivalents, and restricted cash	$22,138	$ 30,626

Allowance for Doubtful Accounts

The allowance for doubtful accounts activities are presented in the table below.

	Allowance for Doubtful Accounts (In thousands)
As of December 31, 2015	166
Additions	76
Changes in Estimates	(112)
Deductions	—
As of December 31, 2016	$ 130
Additions	55
Changes in Estimates(1)	(77)
Deductions(2)	(5)
As of December 31, 2017	103
Additions	336
Changes in Estimates(1)	(43)
As of December 31, 2018	$ 396

(1) Collections of previously reserved accounts

(2) Uncollectible accounts written off, net of recoveries

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Inventories

Inventories are stated at the lower of cost (using the first-in, first-out method) or net realizable value and are presented by category in the following table.

	December 31, 2018	December 31, 2017
	(In thousands)	
Raw materials	$2,238	$ 1,899
Work in process	2,689	2,191
Finished goods	2,211	1,424
Inventories, net	$7,138	$ 5,514

Valuation adjustments for excess and obsolete inventory, reflected as a reduction of inventory at December 31, 2018 and 2017 was $0.7 million and $0.7 million, respectively.

Prepaid and Other Current Assets

Prepaid expenses and other current assets by category are presented in the following table.

	December 31, 2018	December 31, 2017
	(In thousands)	
Interest receivable	$478	$ 439
Supplier advances	591	124
Insurance	238	256
Software license	161	193
Prepaid and refundable VAT and import duty	289	—
Income tax refund	465	—
Other prepaid expenses and current assets	588	330
Total prepaid and other current assets	$2,810	$ 1,342

Property and Equipment

Property and equipment held for use by category are presented in the following table.

	December 31, 2018	December 31, 2017
	(In thousands)	
Machinery and equipment	$23,675	$ 20,813
Leasehold improvements	10,458	10,458
Software	3,013	2,985
Office equipment, furniture, and fixtures	2,970	2,699
Automobiles	199	114
Construction in progress	945	466
Total property and equipment	41,260	37,535
Less: accumulated depreciation and amortization	(26,641)	(24,142)
Property and equipment, net	$14,619	$ 13,393

Construction in progress costs at December 31, 2018 and 2017 primarily relates to R&D equipment received but not placed in service.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Depreciation expense related to all depreciable property and equipment is presented in the following table.

	Years Ended December 31,		
	2018	2017	2016
	(In thousands)		
Depreciation expense	$3,228	$3,035	$3,049

Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities by category are presented in the following table.

	December 31, 2018	December 31, 2017
	(In thousands)	
Payroll and commissions payable	$5,843	$ 6,071
Other accrued expenses and current liabilities	2,176	1,877
Total accrued expenses and other current liabilities	$8,019	$ 7,948

Accumulated Other Comprehensive Loss

There were no reclassifications of amounts out of Accumulated Other Comprehensive Loss, as there have been no sales of securities or translation adjustments that impacted other comprehensive loss during the years presented. The tax impact of the changes in Accumulated Other Comprehensive Loss was not material.

Advertising Expense

Advertising expense is charged to operations during the year in which it is incurred. Total advertising expense was not material for the years ended December 31, 2018, 2017 and 2016.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 6 — Investments and Fair Value Measurements

Available-for-Sale Investments

The Company’s investments are all classified as available-for-sale. As of December 31, 2018, $73.4 million was classified as short-term and $1.3 million was classified as long-term. At December 31, 2017, all available-for-sale-investments were classified as short-term. There were no sales of available-for-sale investments during the years ended December 31, 2018 and 2017.

Available-for-sale investments as of December 31, 2018 and 2017 are presented in the following tables.

	December 31, 2018			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
	(In thousands)			
Short-term investments				
U.S. Treasury securities	$8,102	$ 1	$ (2)	$8,101
Corporate notes and bonds	65,324	1	(88)	65,237
Total short-term investments	$73,426	$ 2	$ (90)	$73,338
Long-term investments				
Corporate notes and bonds	$1,269	$ —	$ —	$1,269
Total long-term investments	$1,269	$ —	$ —	$1,269
Total available-for-sale investments	$74,695	$ 2	$ (90)	$74,607

	December 31, 2017			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
	(In thousands)			
U.S. Treasury securities	$16,755	$ —	$ (14)	$16,741
Corporate notes and bonds *	53,367	—	(77)	53,290
Municipal notes and bonds	247	—	—	247
Total available-for-sale investments	$70,369	$ —	$ (91)	$70,278

* $0.3 million of corporate bonds were classified as cash & cash equivalents.

The Company monitors investments for other-than-temporary impairment. It was determined that unrealized gains and losses at December 31, 2018 and 2017, are temporary in nature, because the changes in market value for these securities resulted from fluctuating interest rates, rather than a deterioration of the credit worthiness of the issuers. The Company is unlikely to experience gains or losses if these securities are held to maturity. In the event that the Company disposes of these securities before maturity, it is expected that the realized gains or losses, if any, will be immaterial.

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ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 December 31, 2018 are shown by contractual maturity in the following table.

	December 31, 2018	
	Amortized Cost	Fair Value
	(In thousands)	
Due in one year or less	$73,426	$73,338
Due in greater than one year	1,269	1,269
	$74,695	$74,607

Fair Value of Financial Instruments

The Company follows the authoritative guidance for fair value measurements and disclosures that, among other things, defines fair value, establishes a consistent framework for measuring fair value, and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. Fair value is defined as an exit price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability.

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, un-billed receivables, cost and estimated earnings in excess of billings, accounts payable, and other accrued expenses approximate fair value due to the short-term maturity of those instruments. For the Company’s 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 the Company uses quoted prices for similar assets or inputs other than quoted prices that are observable either directly or indirectly (Level 2). The investments included in Level 2 consist of corporate notes and bonds, municipal notes and bonds and U.S. Treasury securities.

The fair value of financial assets and liabilities measured on a recurring basis is presented in the following tables.

		Fair Value Measurement at Reporting Date Using		
	December 31, 2018	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
	(In thousands)			
Assets:				
Cash equivalents				
Money market securities	$6,661	$6,661	$—	$ —
Total cash equivalents	6,661	6,661	—	—

Short-term investments				
U.S. Treasury securities	8,101	—	8,101	—
Corporate notes and bonds	65,237	—	65,237	—
Total short-term investments	73,338	—	73,338	—
Long-term investments				
Corporate notes and bonds	$1,269	$—	$1,269	$ —
Total long-term securities				
Total assets	$81,268	$6,661	$74,607	$ —

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	December 31, 2017	Fair Value Measurement at Reporting Date Using Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
	(In thousands)			
Assets:				
Cash equivalents				
Money market securities	$—	$—	$—	$ —
Corporate notes and bonds	258	—	258	—
Total cash equivalents	258	—	258	—
Short-term investments				
U.S. Treasury securities	16,741	—	16,741	—
Corporate notes and bonds	$53,032	$—	$53,032	$ —
Municipal notes and bonds	247	—	247	—
Total short-term investments	70,020	—	70,020	—
Total assets	$70,278	$—	$70,278	$ —

During the years ended December 31, 2018 and 2017, the Company had no transfers of financial assets and liabilities between Level 1 and Level 2.

The fair value and gross unrealized losses on the available-for-sale securities that have been in a continuous unrealized loss position, aggregated by type of investment instrument as of December 31, 2018 and 2017 are summarized in the following table. Available-for-sale investments that were in an unrealized gain position have been excluded from the following table.

	December 31, 2018		December 31, 2017	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(In thousands)			
U.S. Treasury securities	$8,101	$ (2)	$10,162	$ (14)
Corporate notes and bonds	61,809	(88)	53,222	(77)
Municipal notes and bonds	—	—	247	—
Total available-for-sale investments	$69,910	$ (90)	$63,631	$ (91)

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ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 7 — Goodwill and Intangible Assets

Goodwill

The net carrying amount of goodwill as of December 31, 2018 and 2017 was $12.8 million. Goodwill resulted from the Company's acquisition of Pump Engineering, LLC in December 2009. The Company's annual impairment test performed as of July 1, 2018 determined that goodwill was not impaired. As of December 31, 2018 and 2017, no impairment of goodwill has been recorded in the accompanying Consolidated Financial Statements.

Other Intangible Assets

The components of identifiable intangible assets, all of which are finite-lived, as of the date indicated were as follows in the table below. All intangible assets are amortized on a straight-line basis over their useful life.

	December 31, 2018				
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount	Weighted Average Useful Life
	(In thousands, except for weighted average useful life)				
Developed technology	$6,100	$ (5,541)	$ —	$ 559	10
Patents	585	(462)	(42)	81	18
Total	$6,685	$ (6,003)	$ (42)	$ 640	

	December 31, 2017				
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount	Weighted Average Useful Life
	(In thousands, except for weighted average useful life)				
Developed technology	$6,100	$ (4,931)	$ —	$ 1,169	10
Patents	585	(443)	(42)	100	18
Total	$6,685	$ (5,374)	$ (42)	$ 1,269	

Accumulated impairment losses for patents at December 31, 2018 and 2017 include impairment losses from 2007 and 2010. No other impairment of intangible assets was identified during the periods presented for intangible assets.

Amortization of intangibles was $0.6 million for each of the years ended December 31, 2018, 2017 and 2016.

Future estimated amortization expense as of December 31, 2018 on intangible assets is presented in the following table.

	Future Amortization (In thousands)
Year:	
2019	$ 576
2020	16
2021	12

2022	11	
2023	11	
Thereafter	14	
Total	$	640

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 — Long-term Debt and Lines of Credit

Installment Loan

In March 2015, the Company entered into a loan agreement with a financial institution for a $55 thousand fixed-rate installment loan with an annual interest rate of 6.35%. The note is secured by the asset purchased. The loan is payable in equal monthly installments with a maturity date of April 2, 2020. The loan was fully paid off in 2018.

Long-term debt as of December 31, 2018 and 2017 is presented in the following table.

	December 31, 2018	December 31, 2017
	(In thousands)	
Loan payable	$ —	$ 27
Less: current portion	—	(11)
Total long-term debt	$ —	$ 16

Loans and Stand-by Letters of Credit

Loan and Pledge Agreement

On January 27, 2017, the Company entered into a loan and pledge agreement (the “Loan and Pledge Agreement”) with a financial institution (“Financial Institution 2”). The Loan and Pledge Agreement provides for a committed revolving credit line of $16.0 million and an uncommitted revolving credit line of $4.0 million. The Loan and Pledge Agreement was amended on March 17, 2017, to increase the permitted indebtedness under the agreement and to modify certain revolving loan credit options. No other provisions of the Loan and Pledge Agreement were amended. The Loan and Pledge Agreement was further amended on March 30, 2018 to extend the termination date of the Loan and Pledge Agreement from March 31, 2018 to March 31, 2020. No other provisions of the Loan and Pledge Agreement were amended at that time. The Loan and Pledge Agreement was further amended on August 24, 2018 to permit the Company to incur indebtedness owed to a foreign subsidiary in an aggregate amount not to exceed $66.0 million, which amount is subordinated to any amounts outstanding under the Loan and Pledge Agreement. As of December 31, 2018, no debt was outstanding under the Loan and Pledge Agreement, however, the standby letters of credit outstanding with Financial Institution 2 are deducted from the total revolving credit line.

Stand-by Letters of Credit

In connection with a previous loan agreement, entered into in June 2012 and terminated in June 2017, Financial Institution 1 issued stand-by letters of credit to the Company that were subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility was subject to a facility fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line. The loan agreement required the Company to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. With the termination of the loan agreement, the cash collateral requirement was increased to 105% on all stand-by letters of credit and corporate credit cards at Financial Institution 1.

In September 2016, Financial Institution 2 issued stand-by letters of credit to the Company that were subject to customary fees and expenses for issuance or renewal. Initially, Financial Institution 2 required a cash collateral equal to the full outstanding amount of the stand-by letters of credit until the Loan and Pledge Agreement was put in place on January 27, 2017. As of that same date, this cash collateral requirement was removed when the Company entered into a loan and pledge agreement with Financial Institution 2 (see Loan and Pledge Agreement above) and replaced with pledged U.S. Investments held at Financial Institution 2 equal to the full outstanding amount of the stand-by letters of credit. These stand-by letters of credit are subject to fees, in an amount equal to 0.7% per annum of the face amount of the letter of credit, that are payable quarterly and are non-refundable.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In October 2016, the Company entered into stand-by letters of credit with a financial institution ("Financial Institution 3"). Financial Institution 3's stand-by letters of credit were secured by a cash collateral balance required equal to the full outstanding amount of the stand-by letters of credit.

The financial institutions where the outstanding amounts of stand-by letters of credit are collateralized by restricted cash or pledged U.S. investments are presented in the following table.

	December 31, 2018	December 31, 2017
	(In thousands)	
Financial Institution 1	$92	$ 1,687
Financial Institution 2	8,680	7,745
Financial Institution 3	—	990
Total	$8,772	$ 10,422

The Company's total restricted cash balances by financial institution are presented in the following table.

	December 31, 2018	December 31, 2017
	(In thousands)	
Financial Institution 1	$97	$ 1,771
Financial Institution 2 [(1)]	—	—
Financial Institution 3	—	990
Financial Institution 4	86	85
Total	$183	$ 2,846

[(1)] Financial Institution 2 requires pledged U.S. Investments in lieu of restricted cash balances as of January 27, 2017.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 — Commitments and Contingencies

Operating Lease Obligations

The Company leases office facilities and equipment under operating leases that expire on various dates through 2028.

In April 2018, the Company renegotiated the lease of approximately of 170,000 square feet of space in San Leandro, California, with the lessor (“New Doolittle Lease”). The New Doolittle Lease is effective from April 2018 through December 2028 and has a renewal term of one additional period of five years. The initial monthly rent is approximately $135 thousand with an annual increase of 3% and a total of nine months of rent abatement. Under the new lease standard, ASC 842, which was early-adopted by the company in 2018, the New Doolittle Lease was accounted for as a modification with changes in lease term and consideration. As a result, the Company re-measured the lease liability using the updated discount rate using secured borrowing discount rate and revised lease payments and recognized the amount of $10.4 million as an increase to the lease liability, with a corresponding adjustment to the right-of-use asset.

In October 2017, the Company entered into a sublease agreement for office space in Houston, Texas. The sublease agreement is for a term of 3 years commencing in November 2017.

Rent and lease expense related to all of the Company’s leased property is presented in the following table.

	Twelve Months Ended December 31, 2018	Twelve Months Ended December 31, 2017	Twelve Months Ended December 31, 2016
Operating lease cost	$ 1,888	$ 1,699	$ 1,422

Other information related to the operating leases are presented in the following table.

	Twelve Months Ended December 31, 2018	Twelve Months Ended December 31, 2017	Twelve Months Ended December 31, 2016
Cash payments	$ 964	$ 1,395	$ 1,337

The weighted average remaining lease term and discount rate as of December 31, 2018 related to the operating leases are presented in the following table.

Weighted average remaining lease term	9.8 years
Weighted average discount rate	6.95 %

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The Company leases facilities under fixed non-cancellable operating leases that expire on various dates through December 2028. Maturities of lease liabilities as of December 31, 2018 are presented in the following table:

	Lease Amounts (In thousands)
Year:	
2019	$ 1,855
2020	1,653
2021	1,811
2022	1,714
2023	1,922
Thereafter	8,122
Imputed interest	(3,595)
Total	$ 13,482

On January 10, 2019, the Company entered into an industrial lease agreement pursuant to which the Company has leased approximately 25,200 square feet to be constructed office and warehouse space and approximately 4.5 acres of yard space in Katy, Texas, for a new commercial development center for oil & gas field testing and training. The Company’s monthly base rent obligation is approximately $26,000 for the first year of the Lease and increases three percent annually thereafter. In addition, the Company will pay its share of operating expenses, which is currently estimated to be approximately $12,000 per month. The initial term of the Lease is one hundred twenty (120) months after the commencement date, and the Company has two options to extend the Lease by an additional five-year term, which must be exercised by written notice at least six months prior to the end of the relevant term.

Warranty

Changes in the Company’s accrued product warranty reserve are presented in the following table.

	Years Ended December 31,		
	2018	2017	2016
	(In thousands)		
Balance, beginning of year	$366	$406	$461
Warranty costs charged to cost of revenue	340	246	208
Utilization charges against reserve	(48)	(86)	(27)
Release of accrual related to expired warranties	(180)	(200)	(236)
Balance, end of year	$478	$366	$406

Purchase Obligations

The Company has purchase order arrangements with its vendors for which the Company has not received the related goods or services as of December 31, 2018. These arrangements are subject to change based on the Company’s sales demand forecasts, and the Company has the right to cancel the arrangements prior to the date of delivery. The majority of these purchase order arrangements were related to various raw materials and components parts. As of December 31, 2018, the Company had approximately $8.0 million of open cancellable purchase order arrangements related primarily to materials and parts.

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ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Guarantees

The Company enters into indemnification provisions under its agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities, generally limited to personal injury and property damage caused by the Company's 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 the Company's general liability insurance to the extent provided by the policy limitations. The Company has 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, the Company had no liabilities recorded for these agreements as of December 31, 2018 and 2017.

In certain cases, the Company issues warranty and product performance guarantees to its customers for amounts generally equal to 10% or less of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication, and operating performance of our devices. These guarantees are generally stand-by letters of credit that typically remain in place for periods ranging up to 36 months. All stand-by letters of credit at December 31, 2018 and 2017, were $8.8 million and $10.4 million, respectively. See Note 8, "Long-term Debt and Lines of Credit," of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplemental Data," of this Annual Report on Form 10-K for additional information about the Company's stand-by letters of credit arrangements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 10 — Income Taxes

The Company's U.S. and foreign components of consolidated income before income taxes and the benefit from income taxes is presented in the following table.

	Years Ended December 31,		
	2018	2017 (1)	2016 (1)
	(In thousands)		
Income (loss) before income taxes:			
U.S.	$12,139	$11,549	$6,158
Foreign	(699)	(1,620)	(2,445)
Total income before income taxes	$11,440	$9,929	$3,713
Current tax provision (benefit):			
Federal	$(297)	$441	$—
State	(2)	12	16
Foreign	25	18	46
Current tax provision (benefit)	$(274)	$471	$62
Deferred tax (benefit) provision:			
Federal	$(9,773)	$(9,025)	$248
State	(606)	(1,141)	3
Foreign	—	1,270	(319)
Total deferred tax benefit	$(10,379)	$(8,896)	$(68)
Total benefit for income taxes	$(10,653)	$(8,425)	$(6)

(1) Due to the full retrospective adoption of ASC 606 as defined in Note 2,"Recent Accounting Pronouncements", of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplemental Data" of this Annual Report on Form 10K, the balances for the years ended 2017 and 2016 are recast.

On December 22, 2017, President Trump signed into law the Tax Act, which significantly changed existing U.S. tax laws. Following the enactment of the Tax Act, the SEC staff issued SAB 118, which provided guidance on accounting for the tax effects of the Tax Act. SAB 118 provided a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company's accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements. If a company cannot determine a provisional estimate to be included in the financial statements, it should continue to apply ASC 740 on the basis of the provisions of the tax law that were in effect immediately before the enactment of the Tax Act. Our adjustments were final in 2017.

The Company has evaluated the impact of the new global intangible low taxed income (GILTI) and has concluded that the impact to the Company of the GILTI is immaterial.

The tax benefit of $10.7 million for the year ended December 31, 2018, included a $12.3 million U.S. federal and state deferred tax benefit related to the income tax effects of a tax election related to a change to the Company's international tax structure in Ireland that was effective Q2 2018. This election resulted in a deferred tax asset related to tax expense previously recorded on earnings and profits under the Tax Act on deferred revenue not yet recognized under US GAAP. The 2018 tax results also reflect an $800k tax benefit from stock based compensation tax deductions in excess of the related book expense. For more details on the impact of tax credits and other factors that impact the Company's annual income tax expense, please see the reconciliation of the statutory federal income tax rate to the effective tax rate table below.

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The tax benefit of $8.4 million for the year ended December 31, 2017, consisted of a net $10.1 million U.S. federal and state deferred tax benefit after taking into consideration a valuation allowance release on all but $1.4 million of our U.S. federal and state deferred tax assets, less a valuation allowance for the Irish deferred tax assets of $1.3 million less U.S. federal, state and foreign current tax expense of $0.4 million. In addition, as a result of enactment of the legislation, during the fourth quarter of 2017, the Company incurred a one-time income tax expense of $7.0 million related to the deemed repatriation tax on accumulated foreign earnings (of which $0.3 million is a cash charge and the remaining $6.7 million represents a non-cash discrete tax expense largely from the utilization of net operating loss carryovers). The Company also incurred a non-cash income tax expense of $2.5 million related to the re-measurement of certain deferred tax assets and liabilities based on the tax rates from the Tax Act. For more details on the impact of tax credits and other factors that impact the Company's annual income tax expense, please see the reconciliation of the statutory federal income tax rate to the effective tax rate table below.

A reconciliation of income taxes computed at the statutory federal income tax rate to the effective tax rate implied by the accompanying Statements of Operations is presented in the following table.

	Years Ended December 31,		
	2018	2017 (1)	2016 (1)
U.S. federal taxes at statutory rate	21 %	34 %	34 %
State income tax, net of federal benefit	(6)%	1 %	— %
Deemed repatriation transition tax	— %	71 %	— %
Deferred tax re-measurement - Change in tax rates	1 %	24 %	— %
Foreign rate differential	(1)%	(10)%	45 %
Change in tax status of foreign operations	(102)%	— %	— %
Stock-based compensation	(3)%	(6)%	— %
Non-deductible expenses	1 %	1 %	2 %
Federal research credits	(6)%	(4)%	(11)%
Valuation allowance	3 %	(197)%	(70)%
Other	(1)%	1 %	— %
Effective tax rate	(93)%	(85)%	— %

(1) Due to the full retrospective adoption of ASC 606 as defined in Note 2,"Recent Accounting Pronouncements", of the Notes to Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplemental Data" of this Annual Report on Form 10K, the balances for the years ended 2017 and 2016 are recast.

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The Company’s total deferred tax assets and liabilities is presented in the following table.

	December 31, 2018	December 31, 2017(1)
	(In thousands)	
Deferred tax assets:		
Net operating loss carry forwards	$5,636	$ 5,918
Accruals and reserves	12,157	2,847
Research and development credit carry forwards	4,609	3,957
Acquired intangibles	859	909
Charitable contributions	24	11
Total deferred tax assets	23,285	13,642
Valuation allowance	(2,850)	(3,411)
Net deferred tax assets	20,435	10,231
Deferred tax liabilities:		
Depreciation on property and equipment	(937)	(650)
Unrecognized gain on translation of foreign currency	(9)	(5)
Goodwill	(1,171)	(1,643)
Total deferred tax liabilities	(2,117)	(2,298)
Net deferred tax assets	$18,318	$ 7,933
As reported on the balance sheet:		
Non-current assets	$18,318	$ 7,933
Non-current liabilities	—	—
Net deferred tax assets	$18,318	$ 7,933

(1) Due to the full retrospective adoption of ASC 606 as defined in Note 2,”Recent Accounting Pronouncements”, of the Notes to Consolidated Financial Statements in Part II, Item 8, “Financial Statements and Supplemental Data” of this Annual Report on Form 10K, the balances for the years ended 2017 and 2016 are recast.

The Company had gross deferred tax assets of approximately $23.3 million and $13.6 million at December 31, 2018 and 2017, respectively, relating principally to accrued expenses and tax effects of net operating loss and tax credit carry-forwards. In asserting the recoverability of deferred tax assets, management considers whether it is more likely than not that the assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible.

The Company assesses the available positive and negative evidence to estimate if sufficient future taxable income will be generated to use the existing deferred tax assets. In making such a determination, we consider all available positive and negative evidence including recent results of operations, scheduled reversals of deferred tax liabilities, projected future income, and available tax planning strategies. A significant piece of objective positive evidence evaluated was the cumulative profit incurred in the U.S. and the cumulative losses incurred in Ireland over the three-year period ended December 31, 2018.

On the basis of this evaluation, as of December 31, 2018, the Company recognizes all of its U.S. federal and state deferred tax assets with the exception that the Company continues to maintain a valuation allowance on its California R&D credit carryovers of approximately $1.7 million. The Company will maintain a valuation allowance on its California R&D credit carryovers because it is more likely than not that the Company will continue to annually generate more California R&D tax credits than it utilizes, resulting in no net reduction of credits. The Company's policy with respect to California R&D credits is that they are utilized on a last-in first-out basis.

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In addition, as of December 31, 2018, the Company is reporting a full valuation allowance on its Irish entity's deferred tax assets totaling $1.2 million. The valuation allowance represents a provision for uncertainty as to the realization of tax benefits from these deferred income tax assets. The Company will continue to evaluate the tax benefit uncertainty and will adjust, if warranted, the valuation allowance in future periods to the extent that the Company's deferred income tax assets become more likely than not to be realizable.

The Company continues to assert that the accumulated foreign earnings of its subsidiaries in Spain and Canada are permanently reinvested. Due to the Tax Act, any future repatriation of the earnings of its subsidiaries in Spain and Canada would not be subject to U.S. federal income tax. The Company has estimated that the foreign withholding taxes and U.S. state income taxes related to a potential future repatriation of these earnings would be immaterial.

The following table presents the Company's Federal, California, and foreign net operating loss carryforwards.

	December 31, 2018	December 31, 2017
	(In thousands)	
Federal	$16,838	$ 14,227
California	12,681	12,081
Ireland	9,363	16,644
Total net operating loss carryforwards	$38,882	$ 42,952

The net operating loss carryforwards, if not utilized, will begin to expire in 2019 for Federal, and 2031 for California. Utilization of the net operating loss carryforward may be subject to a substantial annual limitation due to the ownership change limitations provided by the U.S. Internal Revenue Code ("IRC") and similar California provisions. The annual limitation will result in the expiration of the net operating loss carryforwards before utilization. The Company has estimated the amount which may ultimately be realized and recorded deferred tax assets accordingly. The Ireland net operating loss carryforwards does not have an expiration date.

The following table presents the Company's Federal and California R&D credit, minimum tax credit and foreign tax credit carryforwards.

	December 31, 2018	December 31, 2017
	(In thousands)	
Federal	$2,925	$ 2,572
California	2,132	1,753
Total credit carryforwards	$5,057	$ 4,325

The federal R&D credit carryforwards, if not utilized, will start to expire in 2030. The foreign tax credit carryforwards will begin to expire in 2026. The federal minimum tax credit carryforward will be refunded if not utilized no later than 2021. The California credit carryforwards do not expire. Utilization of the credit carryforwards may be subject to a substantial annual limitation due to the ownership change limitations provided by the IRC and similar California provisions.

Accounting for uncertain tax positions is based on judgment regarding the largest amount that is greater than 50% likely of being realized upon the ultimate settlement with a taxing authority. The aggregate changes in the balance of the gross unrecognized tax benefits is presented in the following table.

	December 31, 2018	December 31, 2017	December 31, 2016
	(In thousands)		
Unrecognized tax benefits as of December 31,	$911	$ 603	394
Increases related to prior year tax position	—	117	—
Increases related to current year tax position	251	191	209
Unrecognized tax benefits as of December 31,	$1,162	$ 911	603

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As of December 31, 2018, the Company had $1.2 million of unrecognized tax benefits, $0.6 million of which, if recognized, would affect our effective tax rate.

The Company adopted the accounting policy that interest and penalties are classified as part of its income taxes. There are no accrued interest or penalties associated with any unrecognized tax benefits.

There are currently no examinations for Federal, California taxing authorities, and foreign tax authorities. The Company believes that, as of December 31, 2018, the gross unrecognized tax benefits will not materially change in the next twelve months. The Company believes that it has adequately provided for any reasonably foreseeable outcomes related to any tax audits and that any settlement will not have a material adverse effect on the consolidated financial position or results of operations. However, there can be no assurances as to the possible outcomes.

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Note 11 — Stockholder’s Equity

Preferred Stock

The Company has the authority to issue 10,000,000 shares of $0.001 par value preferred stock. The Board of Directors has the authority, without action by the Company’s stockholders, to designate and issue shares of preferred stock in one or more series. The Board of Directors is also authorized to designate the rights, preferences, and voting powers of each series of preferred stock, any or all of which may be greater than the rights of the common stock including restrictions of dividends on the common stock, dilution of the voting power of the common stock, reduction of the liquidation rights of the common stock, and delaying or preventing a change in control of the Company without further action by the Company’s stockholders. To date, the Board of Directors has not designated any rights, preferences, or powers of any preferred stock, and as of December 31, 2018 and 2017, no shares of preferred stock were issued or outstanding.

Common Stock

The Company has the authority to issue 200,000,000 shares of $0.001 par value common stock. Subject to the preferred rights of the holders of shares of any class or series of preferred stock as provided by the Board of Directors with respect to any such class or series of preferred stock, the holders of the common stock shall be entitled to receive dividends, as and when declared by the Board of Directors. In the event of any liquidation, dissolution, or winding up of the Company, whether voluntary or involuntary, after the distribution or payment to the holders of shares of any class or series of preferred stock as provided by the Board of Directors with respect to any such class or series of preferred stock, the remaining assets of the Company available for distribution to stockholders shall be distributed among and paid to the holders of common stock ratably in proportion to the number of shares of common stock held by them.

At December 31, 2018, 59,396,020 shares were issued and 53,940,085 shares were outstanding. At December 31, 2017, 58,168,433 shares were issued and 53,905,600 shares were outstanding.

Stock Repurchase Program

The Company accounts for stock repurchases using the cost method. The aggregate cost includes fees charged in connection with acquiring the outstanding common stock.

On March 7, 2018, the Board of Directors authorized a stock repurchase program under which the Company, at the discretion of management, may repurchase up to $10.0 million in aggregate cost of the Company’s outstanding common stock (the “March 2018 Authorization”). Under the March 2018 Authorization, purchases of shares of common stock may be made through September 30, 2018, from time to time in the open market, or in privately negotiated transactions, in compliance with applicable state and federal securities laws. The timing and amounts of any purchases will be based on market conditions and other factors including price, regulatory requirements, and capital availability. The March 2018 Authorization does not obligate the Company to acquire any specific number of shares in any period, and may be expanded, extended, modified or discontinued at any time without prior notice. Under the March 2018 Authorization, as of September 30, 2018, the Company repurchased 1,193,102 shares at an aggregate cost of $10.0 million. The March 2018 Authorization expired in September 2018 and there was no repurchase authorization in place at December 31, 2018.

In March 2017, the Board of Directors authorized a stock repurchase program under which the Company, at the discretion of management, could repurchase up to $15.0 million in aggregate cost of the Company's outstanding common stock through September 30, 2017 (the "March 2017 Authorization"). As of December 31, 2017, 541,177 shares, at an aggregate cost of $4.3 million had been repurchased under the March 2017 Authorization.

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In January 2016, the Board of Directors authorized a stock repurchase program under which the Company, at the discretion of management, could repurchase up to $6.0 million in aggregate cost of the Company's outstanding common stock through June 30, 2016 (the "January 2016 Authorization"). In May 2016, the Board of Directors rescinded the January 2016 Authorization and authorized a new stock repurchase program under which the Company, at the discretion of management, could repurchase up to $10.0 million in aggregate cost of the Company's outstanding common stock through October 31, 2016 (the "May 2016 Authorization"). At December 31, 2016, 673,700 shares, at an aggregate cost of $4.1 million, had been repurchased under the January 2016 Authorization and 568,500 shares, at an aggregate cost of $5.3 million, had been repurchased under the May 2016 Authorization. The May 2016 Authorization expired in October 2016 and there was no repurchase authorization in place at December 31, 2016.

Under the Company's stock repurchase programs, from March 2012 through December 31, 2018, the Company spent an aggregate $30.3 million to repurchase 5.5 million shares. In addition to repurchases under the Company's stock repurchase programs, during the years ended December 31, 2018, and 2017, the Company spent $0.2 million and $0.3 million respectively, to settle employee tax withholding obligations due upon the vesting of RSUs and withheld an equivalent value of shares from the shares provided to the employees upon vesting.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 12 — Stock-Based Compensation

Stock Option Plans

In June 2016, the stockholders approved the 2016 Incentive Plan (the “2016 Plan”), that permits the grant of stock options, stock appreciation rights (“SARs”), restricted stock (“ RSUs”), performance units, performance shares, and other stock-based awards to employees, officers, directors, and consultants. Prior to the approval of the 2016 Plan, the Company maintained the Amended and Restated 2008 Equity Incentive Plan (the “2008 Plan”). Stock option awards granted under the Plan and the 2008 Plan, generally vest over four years and expire no more than 10 years after the date of grant. Subject to adjustments, as provided in the 2016 Plan, the number of shares of common stock initially authorized for issuance under the 2016 Plan was 4,441,083 shares (which consist of 3,830,000 new share awards plus 611,083 share awards that were authorized and unissued under the 2008 Plan) plus up to 7,635,410 shares that were set aside for awards granted under the 2008 Plan that are subsequently forfeited. The 2016 Plan supersedes all previously issued stock incentive plans (including the 2008 Plan) and is currently the only available plan from which awards may be granted.

Shares available for grant under the Plan were 2,603,183 shares and 3,945,653 shares at December 31, 2018 and 2017, respectively.

Stock-based Compensation Expense

Stock-based compensation expense related to the fair value measurement of awards granted to employees by financial line and by type of award is presented in the following table.

	Years Ended December 31,		
	2018	2017	2016
	(In thousands)		
Stock-based compensation expense by financial line:			
Cost of revenue	$87	$158	$113
General and administrative	3,266	2,218	$2,057
Sales and marketing	694	821	$524
Research and development	1,193	890	$569
Total stock-based compensation expense	$5,240	$4,087	$3,263
Stock-based compensation expense by type of award:			
Options	$3,873	$3,331	$3,005
RSUs	1,367	756	$258
Total stock-based compensation expense	$5,240	$4,087	$3,263

The Company estimates forfeitures at the time of grant and revises those estimates periodically in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and records stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. If the Company’s actual forfeiture rate is materially different from its estimate, the stock-based compensation expense could be significantly different from what the Company has recorded in the current period.

The estimated forfeiture rates used in determining the expense in the table above are presented in the following table.

	For years ended December 31,		
	2018	2017	2016
4-year options	14.866%	16.275%	13.513%
1-year options	—%	—%	—%

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Share-based compensation cost related to unvested stock options and RSU's will generally be amortized on a straight-line basis over the remaining average service period. The following table presents the unamortized compensation cost and weighted average service period of all unvested outstanding awards as of December 31, 2018.

	Unamortized Compensation Costs	Weighted Average Service Period
	(In thousands)	(In years)
Stock options	$ 5,065	2.5
RSUs	2,128	2.2

Vested Stock Options and RSUs

The total grant date fair value of stock options and RSUs vested during the period are presented in the following table.

	Years Ended December 31,				
	2018		2017		2016
	(In thousands)				
Stock options	$	3,607	$	3,375	2,977
RSUs	841		783		—
Total grant date fair value of stock options and RSUs vested during the period	$	4,448	$	4,158	2,977

Stock Option Activity

The following table summarizes the stock option activity under the 2016 Plan and 2008 Plan.

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in Years)	Aggregate Intrinsic Value [(1)]
	(In thousands, except for weighted average exercise price and weighted average remaining contractual life)			
Balance, December 31, 2015	7,198	3.97		
Granted	904	8.63		
Exercised	(1,936)	3.41		14,665
Forfeited	(283)	5.30		
Balance, December 31, 2016	5,883	4.81		
Granted	677	9.57		
Exercised	(1,226)	4.49		6,798
Forfeited	(242)	6.60		
Balance, December 31, 2017	5,092	$ 5.43	6.6	$ 17,735

Granted	1,232	$ 7.96		
Exercised	(1,160)	$ 3.73		
Forfeited	(183)	$ 3.98		
Balance, December 31, 2018	4,982	$ 6.36	6.56	$ 6,572
Vested and exercisable as of December 31, 2018	3,193	$ 5.44	5.39	$ 6,124
Vested and exercisable as of December 31, 2018 and expected to vest thereafter	4,759	$ 6.27	6.44	$ 6,560

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair value of the Company's common stock at the time of exercise. The aggregate intrinsic value at December 31, 2018 is calculated as the difference between the exercise price of the underlying options and the fair value of the Company's common stock as of the end of the period.

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Restricted Stock Units

RSUs awarded in 2016 vest 25% on the first anniversary of the grant date and 1/48th monthly thereafter dependent upon continued employment. RSUs awarded in 2017 vest 25% annually over the 4 years from date of grant and is dependent upon continued employment. RSUs awarded in 2018 vest 25% annually over the 4 years from date of grant and is dependent upon continued employment. As RSUs vest, the units will be settled in shares of common stock based on a one-to-one ratio. The units were valued based on the market price on the date of grant.

The following table summarizes the RSU activity under the 2016 Plan.

	Shares	Weighted Average Grant-Date Fair Value
	(In thousands, except for weighted average grant-date fair value)	
Balance, December 31, 2015	—	—
Awarded	214	8.65
Balance, December 31, 2016	214	8.65
Awarded	162	10.14
Vested	(91)	8.65
Forfeited	(11)	8.52
Balance, December 31, 2017	274	9.54
Awarded	280	9.54
Vested	(90)	9.33
Balance, December 31, 2018	463	8.49

Fair Value Assumptions

Stock Options

The fair value of stock options granted to employees is based on the Black-Scholes option pricing model. To determine the inputs for the Black-Scholes option pricing model, the Company is required to develop several assumptions, which are highly subjective. The Company determines these assumptions as follows:

Expected Term: The Company uses its historical data to determine the expected term of options based on historical exercise data. As there was no historical exercise data for non-employee directors, the Company determines the expected term based on the simplified method.

Expected Volatility: The Company determines expected volatility based on its historical data and the corresponding expected term that was determined using the Company’s historical exercise data.

Risk-Free Interest Rate: The risk-free rate is based on U.S. Treasury issues with remaining terms similar to the expected term on the stock options granted.

Dividend Yield: The Company has never declared or paid any cash dividends and do not plan to pay cash dividends in the foreseeable future; therefore, the Company uses an expected dividend yield of zero in the valuation model.

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The estimated grant date fair values of stock options granted to employees were calculated using the Black-Scholes option pricing model based on the assumptions in the following table.

	For years ended December 31,		
	2018	2017	2016
Weighted average expected life (years)	4.19	4.50	4.38
Weighted average expected volatility	67.41%	80.22%	80.35%
Risk-free interest rate	2.48% – 3.01%	1.64% – 1.99%	1.03% – 1.32%
Weighted average dividend yield	—%	—%	—%

Restricted Stock Units

The fair value of RSUs granted to employees is based on the Company's common stock price on the date of grant.

Awards Granted in 2019

On January 31, 2019 and February 1, 2019, the Company granted options and RSUs to certain officers. and on February 12, 2019, the Company granted options and RSUs to other employees. The options and RSUs granted are presented in the following table.

January 31, 2019 Grants	Shares	Exercise Price	Vesting Term[(1)]	Expiration from Date of Grant
Options	228,571	$ 7.60	4 years	10 years
RSUs	136,510	7.60	4 years	**
Total	365,081			

February 2, 2019 Grants	Shares	Exercise Price	Vesting Term[(1)]	Expiration from Date of Grant
Options	95,622	$ 7.87	4 years	10 years
RSUs	19,059	$ 7.87	4 years	**
Total	114,681			

February 12, 2019 Grants	Shares	Exercise Price	Vesting Term[(1)]	Expiration from Date of Grant
Options	67,888	$ 7.70	4 years	10 years
RSUs	228,228	$ 7.70	4 years	**
Total	296,116			

** Not applicable.

(1) Any unvested options and RSUs are forfeited upon the employee's termination.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13 — Business Segment

The Company is an energy solutions provider to industrial fluid flow markets worldwide. The Company manufactures and sells high-efficiency ERDs and pumps as well as related products and services. The Company's chief operating decision-maker ("CODM") is the chief executive officer ("CEO").
The Company's reportable operating segments consist of the Water segment and the Oil & Gas segment. These segments are based on the industries in which the products are sold, the type of energy recovery device sold, and the related products and services. The Water segment consists of revenue associated with products sold for use in reverse osmosis water desalination, as well as the related identifiable expenses. The Oil & Gas segment consists of product revenue associated with products sold for use in gas processing, chemical processing, and hydraulic fracturing and license and development revenue associated with hydraulic fracturing, as well as related identifiable expenses. Operating income for each segment excludes other income and expenses and certain expenses managed outside the operating segment. Costs excluded from operating income include various corporate expenses such as income taxes and other separately managed general and administrative expenses not related to the identified segments. Assets and liabilities are reviewed at the consolidated level by the CODM and are not accounted for by segment. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating income (loss).

The summary of financial information by segment is presented in the following tables.

	Year Ended December 31, 2018		
	Water	Oil &Gas	Total
	(In thousands)		
Product revenue	$60,512	$513	$61,025
Product cost of revenue	17,211	662	17,873
Product gross profit	43,301	(149)	43,152
License and development revenue	—	13,490	13,490
Operating expenses:			
General and administrative	2,078	1,771	3,849
Sales and marketing	5,783	1,264	7,047
Research and development	1,711	15,276	16,987
Amortization of intangibles	629	—	629
Operating expenses	10,201	18,311	28,512
Operating income (loss)	$33,100	$(4,970)	28,130
Less: Corporate operating expenses			18,152
Consolidated operating income			9,978
Non-operating income			1,462
Income before income taxes			$11,440

Explanation of Responses:

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	Year Ended December 31, 2017		
	Water	Oil &Gas	Total
	(In thousands)		
Product revenue	$54,301	$3,722	$58,023
Product cost of revenue	16,032	3,029	19,061
Product gross profit	38,269	693	38,962
License and development revenue	—	11,106	11,106
Operating expenses:			
General and administrative	1,401	1,565	2,966
Sales and marketing	5,787	2,228	8,015
Research and development	1,064	12,217	13,281
Amortization of intangibles	631	—	631
Operating expenses	8,883	16,010	24,893
Operating income (loss)	$29,386	$(4,211)	25,175
Less: Corporate operating expenses			15,926
Consolidated operating income			9,249
Non-operating income			680
Income before income taxes			$9,929

	Year Ended December 31, 2016		
	Water	Oil &Gas	Total
	(In thousand)		
Product revenue	$47,545	$2,170	$49,715
Product cost of revenue	16,353	1,496	17,849
Product gross profit	31,192	674	31,866
License and development revenue	—	8,069	8,069
Operating expenses:			
General and administrative	1,081	1,000	2,081
Sales and marketing	5,076	2,985	8,061
Research and development	1,331	8,705	10,036
Amortization of intangibles	631	—	631
Operating expenses	8,119	12,690	20,809
Operating income (loss)	$23,073	$(3,947)	19,126
Less: Corporate operating expenses			15,700

Consolidated operating income	3,426
Non-operating income	287
Income before income taxes	$3,713

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Depreciation and amortization expense by segment and corporate is presented in the following table.

	Years Ended December 31,		
	2018	2017	2016
	(In thousands)		
Water	$2,060	$2,723	$3,043
Oil & Gas	1,377	448	244
Corporate	432	495	393
Total depreciation and amortization	$3,869	$3,666	$3,680

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 14 — Geographical Information and Concentrations

Product Revenue

The following geographic information includes product revenue to the Company's U.S. and international customers based on the customers' requested delivery locations, except for certain cases in which the customer directed the Company to deliver its 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.

	Years Ended December 31,					
	2018		2017		2016	
	(In thousands, except for percentages)					
Product revenue by geographic location:						
United States	$1,645		$1,706		$1,203	
International	59,380		56,317		48,512	
Total product revenue	$61,025		$58,023		$49,715	
Product revenue by country:						
Egypt	17	%	15	%	8	%
Saudi Arabia	31		13		14	
China	8		9		13	
Others(1)	44	%	63	%	65	%
Total	100	%	100	%	100	%

(1) Includes remaining countries not separately disclosed. No country in this line item individually accounted for more than 10% of the Company's product revenue during any of the years presented.

Product Revenue - Customer Concentration

Product revenue from customers representing 10% or more of product revenue varies from period to period. For the year ended December 31, 2018, two customers represented 15% and 11% of the Company's product revenue. For the year ended December 31, 2017 no customer represented 10% or more of the Company's product revenue, and for the year ended December 31, 2016, one customer represented 11% of the Company's product revenues.

License and Development

One international Oil & Gas segment customer accounts for 100% of the Company's license and development revenue for the years ended December 31, 2018, 2017 and 2016.

Customers

The Company's accounts receivable is derived from sales to customers located around the world. The Company generally does not require collateral to support customer receivables, but frequently requires export letters of credit securing payment. The Company performs ongoing evaluations of its customers' financial condition and periodically reviews credit risk associated with receivables. An allowance for doubtful accounts is determined with respect to receivable amounts that we have determined to be doubtful of collection using specific identification of doubtful accounts and an aging of receivables analysis based on invoice due dates. Actual collection losses may differ from the Company’s estimates, and such differences could be material to the financial position, results of operations, and cash flows. Uncollectible receivables are written off against the allowance for doubtful accounts when all efforts to collect them have been exhausted, while recoveries are recognized when they are received.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Customers accounting for 10% or more of the Company's combined accounts receivable and contract assets by segment are presented in the following table.

	Segment	December 31, 2018	December 31, 2017
Customer A	Water	**	16 %
Customer B	Water	**	10
Customer C	Water	**	11
Customer D	Water	**	**
Customer E	Water	20 %	**
Customer F	Water	11 %	**
Customer G	Oil & Gas	26	26

** Less than 10%

Vendor Concentration

Vendors accounting for 10% or more of the Company's combined accounts payable by segment are presented in the following table.

	Segment	December 31, 2018	December 31, 2017
Vendor A	Oil & Gas	**	11 %
Vendor B	Oil & Gas	10 %	**

** Less than 10%

Long-lived Assets

All of the Company's long-lived assets were located in the U.S. at December 31, 2018 and 2017.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 15 — VorTeq Partnership and License Agreement

The Company’s VorTeq technology enables oilfield service hydraulic fracturing operators to isolate their high-pressure hydraulic fracturing pumps from fracturing fluid thereby reducing operating and capital costs. In 2014, the Company entered into a strategic partnership with Liberty Oil Field Services (“Liberty”) to pilot and conduct field trials with the VorTeq. Through this agreement, Liberty has the rights to lease up to 20 VorTeq Missiles (defined below) for a period of up to five years following commercialization.

On October 14, 2015, the Company and the VorTeq Licensee entered into the VorTeq License Agreement, which provides the VorTeq Licensee with exclusive worldwide rights to the Company’s VorTeq technology for use in hydraulic fracturing onshore applications. The VorTeq License Agreement provides an exception for Liberty’s contractual rights to utilize the VorTeq. In performing the obligations under the agreement, the Company provides research and development services to commercialize the technology in accordance with the KPIs, defined in the VorTeq License Agreement. After commercialization is achieved, royalty payments will be received for the supply and servicing of cartridges. All payments are non-refundable.

The VorTeq is made up of Pressure Exchanger cartridges, housed in a high-pressure manifold (the “Missile”) though which a motive fluid is used to pressurize hydraulic fracturing fluid, which is processed and sent down the well bore. The VorTeq License Agreement includes up to $125.0 million in upfront consideration paid in stages: (i) a $75.0 million non-refundable upfront exclusivity payment; and (ii) two milestone payments of $25.0 million each upon achievement of successful tests in accord with KPIs specified in the VorTeq License Agreement (“Milestone Payment 1 and 2”). Milestone Payment 1 of $25.0 million is payable upon a successful five stage yard test at the VorTeq Licensee’s test facility. The Milestone Payment 2 of $25.0 million is payable upon a successful twenty stage hydraulic fracturing at one of the VorTeq Licensee’s customer’s live wells. The achievement of each milestone and the receipt of each of the related payments are subject to a high degree of uncertainty.

After initial commercialization, the VorTeq Licensee will begin paying ongoing recurring royalty fees to the Company for supply and service of the cartridges based on the number of VorTeqs in operation which is subject to the greater of a minimum adoption curve or the adoption rate of the technology. During the period, from initial commercialization to full commercialization, the technology will be deployed commercially; and through continuous improvement and cost refinement, the efficiency and effectiveness of the product will fully stabilize. The exclusive nature of the agreement terminates if the VorTeq Licensee does not meet the specified minimum adoption curves. In the event the Company is not able to achieve full commercialization under the terms of the VorTeq License Agreement, the exclusivity right of the VorTeq Licensee under the VorTeq License Agreement continues throughout the term.

See Note 2, “Recent Accounting Pronouncements,” and Note 3, “Revenues,” of the Notes to Consolidated Financial Statements in Part II, Item 8, “Financial Statements and Supplemental Data,” of this Annual Report on Form 10-K for further discussion of revenue recognition.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 16 — Litigation

The Company is named in and subject to various proceedings and claims in connection with our business. The Company is contesting the allegations in these claims, and the Company believes that there are meritorious defenses in each of these matters. The outcome of matters the Company has been, and currently are, involved in cannot be determined at this time, and the results cannot be predicted with certainty. There can be no assurance that these matters will not have a material adverse effect on our results of operations in any future period and a significant judgment could have a material adverse impact on our financial condition, results of operations and cash flows. The Company may in the future become involved in additional litigation in the ordinary course of its business, including litigation that could be material to its business.

The Company considers all claims on a quarterly basis and based on known facts assesses whether potential losses are considered reasonably possible, probable and estimable. Based upon this assessment, the Company then evaluates disclosure requirements and whether to accrue for such claims in its consolidated financial statements. The Company records a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular case.

On September 10, 2014, the Company terminated the employment of its Senior Vice President, Sales, Borja Blanco, on the basis of breach of duty of trust and conduct leading to conflict of interest. On October 24, 2014, Mr. Blanco filed a labor claim against ERI Iberia in Madrid, Spain, challenging the fairness of his dismissal and seeking compensation (“Case 1”). A hearing was held on November 13, 2015, after which the labor court ruled that it did not have jurisdiction over the matter. Mr. Blanco appealed and the appeals court reversed the labor court’s finding and instructed the labor court to make a ruling on the merits on November 21, 2017. On February 14, 2018, the Company received notice that the labor court issued a ruling in favor of Mr. Blanco declaring the termination an unjustified dismissal and ordered the Company to pay a dismissed severance. The Company appealed the decision on February 21, 2018. The Company denies any allegations of wrongdoing and intends to continue to vigorously defend against this lawsuit. Based on currently available information and review with outside counsel, the Company has estimated and accrued a potential loss.

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

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 17 — Supplementary Data — Quarterly Financial Data (unaudited)

The following tables present certain unaudited consolidated quarterly financial information for each of the four fiscal quarters in the periods ended December 31, 2018 and December 31, 2017. Due to the Company's full retrospective adoption of ASC 606, period numbers for years 2017 are recast. This quarterly information has been prepared on the same basis as the audited Consolidated Financial Statements and includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the information for the periods presented. The results for these quarterly periods are not necessarily indicative of the operating results for a full year or any future period.

2018 QUARTERLY FINANCIAL DATA [(1)]
(unaudited)

	Three Months Ended			
	March 31, 2018	June 30, 2018	September 30, 2018	December 31, 2018
	(In thousands, except per share amounts)			
Product revenue	$11,058	$17,406	$ 18,578	$ 13,983
Product cost of revenue	3,314	5,976	5,022	3,561
Product gross profit	7,744	11,430	13,556	10,422
License and development revenue	2,749	3,358	3,661	3,723
Operating expenses:				
General and administrative	5,837	4,927	5,266	5,446
Sales and marketing	1,912	1,858	1,873	1,903
Research and development	3,917	3,605	4,270	5,220
Amortization of intangible assets	158	158	158	156
Total operating expenses	$11,824	$10,548	$ 11,567	$ 12,725
Income (loss) from operations	$(1,331)	$4,240	$ 5,650	$ 1,420
Provision for (benefit from) income taxes[(2)]	$(357)	$(11,122)	$ 1,339	$ (516)
Net income (loss)	$(726)	$15,743	$ 4,658	$ 2,421
Income (loss) per share:				
Basic	$(0.01)	$0.29	$ 0.09	$ 0.04
Diluted	$(0.01)	$0.28	$ 0.08	$ 0.04

(1) Quarterly results may not add up to annual results due to rounding.

(2) During second quarter of 2018, the Company recognized an income tax benefit of $11.1 million, which included a $12.1 million discrete tax benefit. This discrete tax benefit includes an $11.9 million tax benefit related to the income tax effects of a tax election related to a change to the Company's international tax structure in Ireland that was effective Q2 2018.

ENERGY RECOVERY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2017 QUARTERLY FINANCIAL DATA [(1)]
(unaudited)

	Three Months Ended			
	March 31, 2017(2)	June 30, 2017(2)	September 30, 2017(2)	December 31, 2017(2)
	(In thousands, except per share amounts)			
Product revenue	$12,245	$10,864	$ 13,860	$21,054
Product cost of revenue	4,612	3,572	4,217	6,660
Product gross profit	7,633	7,292	9,643	14,394
License and development revenue	2,248	3,050	3,197	2,611
Operating expenses:				
General and administrative	4,408	3,927	4,034	4,985
Sales and marketing	2,453	2,174	2,061	2,703
Research and development	2,509	3,077	3,038	4,819
Amortization of intangible assets	158	158	157	158
Total operating expenses	$9,528	$9,336	$ 9,290	$12,665
Income (loss) from operations	$353	$1,006	$ 3,550	$4,340
Provision for (benefit from) income taxes[(2)]	48	188	310	(8,971)
Net income	$422	$929	$ 3,472	$13,531
Income per share:				
Basic	$0.03	$0.02	$ 0.06	$0.25
Diluted	$0.02	$0.02	$ 0.06	$0.24

(1) Quarterly results may not add up to annual results due to rounding.
(2) Due to the full retrospective adoption of ASC 606, period numbers for the year 2017 are recast.

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Item 9 — Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

On April 13, 2018, the Company's principal accountant, BDO USA, LLP, was dismissed. Such dismissal was recommended and approved by the Audit Committee of the Board of Directors (the "Audit Committee"). The Audit Committee engaged Deloitte & Touche LLP as the Company's new principal accountant on May 2, 2018. During the preceding two years, BDO USA, LLP's reports on financial statement did not contain an adverse opinion or a disclaimer of opinion, was not qualified or modified as to uncertainty, audit scope, or accounting principles. There were no disagreements with BDO USA, LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure within the Company's two most recent fiscal years and any subsequent interim periods preceding the former principal accountant's dismissal.

Item 9A — Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management has evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, or "Exchange Act") as of the end of the period covered by this Annual Report on Form 10-K. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to management as appropriate to allow for timely decisions regarding required disclosure.

Our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, and our Chief Executive Officer and Chief Financial Officer have concluded that these controls and procedures are effective at the "reasonable assurance" level. Our management, including the Chief Executive Officer and Chief Financial Officer, believes that a control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control system are met, and that no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

Management's Annual Report on Internal Control Over Financial Reporting and Attestation Report of the Registered Public Accounting Firm

Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over the Company's financial reporting. Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2018. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control — Integrated Framework (2013). Based on the assessment using those criteria, management concluded that, as of December 31, 2018, our internal control over financial reporting was effective.

Attestation Report of the Registered Public Accounting Firm

The Company's independent registered public accountants, Deloitte & Touche LLP, audited the Consolidated Financial Statements included in this Annual Report on Form 10-K and have issued an audit report on the Company's internal control over financial reporting. The report on the audit of internal control over financial reporting appears in

Part II, Item 8, “Financial Statements and Supplementary Data,” in this Annual Report on Form 10-K.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B — Other Information

None.

PART III

Item 10 — Directors, Executive Officers and Corporate Governance

The information required by this Item is included in and incorporated by reference from our definitive proxy statement (the “Proxy Statement”) which will be filed with the Securities and Exchange Commission prior to April 30, 2018. The Proxy Statement is for our Annual Meeting of Stockholders which will be held on June 14, 2018.

Item 11 — Executive Compensation

The information required by this Item is included in and incorporated by reference from the Proxy Statement under the captions “Election of Directors,” “Director Compensation,” “Compensation Discussion and Analysis” and “Report of the Compensation Committee of the Board of Directors on Executive Compensation.”

Item 12 — Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The following table sets forth equity compensation plan information as of December 31, 2018.

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants, and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants, and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in the First Column)
Equity compensation plans approved by security holders (1)	5,444,804	6.5	2,603,183
Equity compensation plans not approved by security holders	None	Not applicable	Not applicable

(1) Represents shares of the Company’s common stock issuable upon exercise of options outstanding under the following equity compensation plans: the 2006 Stock Option/Stock Issuance Plan, the 2008 Equity Incentive Plan, the Amended and Restated 2008 Equity Incentive Plan, and the 2016 Incentive Plan.

The information under the caption “Security Ownership of Certain Beneficial Owners and Management” in the Proxy Statement is incorporated herein by reference.

Item 13 — Certain Relationships and Related Transactions and Director Independence

The information required by this Item is included in and incorporated by reference from the Proxy Statement under the caption “Related Person Policies and Transactions.”

Item 14 — Principal Accounting Fees and Services

The information required by this item is included in and incorporated by reference from the Proxy Statement under the caption “Principal Accountant Fees and Services.”

With the exception of the information specifically incorporated by reference in Part III to this Annual Report on Form 10-K from the Proxy Statement, the Proxy Statement shall not be deemed to be filed as part of this report.

PART IV

Item 15 — Exhibits and Financial Statement Schedules

(a) The following documents are included as part of this Annual Report on Form 10-K:

(1) Financial Statements. The financial statements included in Part II, Item 8 of this document are filed as part of this Annual Report on Form 10 K.

(2) Financial Statement Schedule. See Note Not Used, “Allowance for Doubtful Accounts,” of the Notes to Consolidated Financial Statements in Part II, Item 8, “Financial Statements and Supplementary Data,” of this Annual Report on Form 10-K. Schedules not listed have been omitted because information required to be set forth therein is not applicable or is shown in the financial statements or notes thereto.

(3) Exhibit Index. See Exhibit Index immediately following the Signature page for a list of Exhibits filed or incorporated by reference as a part of this Report.

(b) Exhibit. See Exhibits listed under Item 15(a)(3).

(c) Financial Statement Schedules. All financial statement schedules are omitted because they are not applicable, not required, or because the required information is included in the Consolidated Financial Statements, the Notes thereto, or in the Exhibits listed under Item 15(a)(2).

Item 16 — Form 10-K Summary

None

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, in the City of San Leandro, State of California, on the 7th day of March 2019.

ENERGY RECOVERY, INC.

By: /s/ CHRIS GANNON
Chris Gannon
President and Chief Executive Officer

Pursuant to the requirements of the Securities and Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ CHRIS GANNON Chris Gannon	President and Chief Executive Officer (Principal Executive Officer)	March 7, 2019
/s/ JOSHUA BALLARD Joshua Ballard	Chief Financial Officer (Principal Financial and Accounting Officer)	March 7, 2019
/s/ HANS PETER MICHELET Hans Peter Michelet	Director and Chairman of the Board	March 7, 2019
/s/ ALEXANDER J. BUEHLER Alexander J. Buehler	Director	March 7, 2019
/s/ OLAV FJELL Olav Fjell	Director	March 7, 2019
/s/ SHERIF FODA Sherif Foda	Director	March 7, 2019
/s/ ARVE HANSTVEIT Arve Hanstveit	Director	March 7, 2019
/s/ OLE PETER LORENTZEN Ole Peter Lorentzen	Director	March 7, 2019
/s/ ROBERT YU LANG MAO Robert Yu Lang Mao	Director	March 7, 2019

EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File No.	Exhibit	Filing Date	
3.1	Amended and Restated Certificate of Incorporation, as filed with the Delaware Secretary of State on July 7, 2008.	10-K	001-34112	3.1	3/27/2009	
3.2	Amended and Restated Bylaws, effective as of July 8, 2008.	10-K	001-34112	3.2	3/27/2009	
10.1*	Form of Indemnification Agreement between the Company and its directors and officers.	S-1/A	333-150007	10.1	5/12/2008	
10.2*	2006 Stock Option/Stock Issuance Plan of the Company and forms of Stock Option and Stock Purchase Agreements thereunder.	S-1	333-150007	10.5	4/1/2008	
10.3*	Amendment to 2006 Stock Option/Stock Issuance Plan of the Company.	S-1	333-150007	10.5.1	4/1/2008	
10.4*	Second Amendment to 2006 Stock Option/Stock Issuance Plan of the Company.	S-1	333-150007	10.5.2	4/1/2008	
10.5*	2008 Equity Incentive Plan of the Company and form of Stock Option Agreement thereunder.	S-1/A	333-150007	10.6	5/12/2008	
10.6*	Energy Recovery Inc. Amended and Restated 2008 Equity Incentive Plan.	DEF14A	001-34112	Appendix A	4/27/2012	
10.7	Modified Industrial Gross Lease Agreement dated November 25, 2008, between the Company and Doolittle Williams, LLC.	10-K	001-34112	10.17	3/27/2009	
10.8	First Amendment to Modified Industrial Gross Lease dated May 28, 2009, between the Company and Doolittle Williams, LLC.	10-Q	001-34112	10.17.1	8/7/2009	
10.9	Second Amendment to Modified Industrial Gross Lease dated June 26, 2009, between the Company and Doolittle Williams, LLC.	10-Q	001-34112	10.17.2	8/7/2009	
10.10	Third Amendment to Modified Industrial Gross Lease dated November 10, 2010 between the Company and Doolittle Williams, LLC.	10-K	001-34112	10.14	3/12/2013	
10.11	Control Agreement dated July 7, 2011, between the Company, Citibank, N.A., Citigroup Global Markets Inc., and Morgan Stanley Smith Barney LLC.	10-Q	001-34112	10.43	8/8/2011	
10.12*	Energy Recovery, Inc. Change in Control Severance Plan dated March 5, 2012.	8-K	001-34112	10.1	3/9/2012	
10.13	Loan Agreement dated June 5, 2012 between Company and HSBC Bank, USA, National Association.	8-K	001-34112	10.1	6/11/2012	
10.14*	Energy Recovery, Inc. Annual Incentive Plan dated January 1, 2014.	8-K	001-34112	10.1	4/30/2014	
10.15*	Offer Letter dated June 26, 2014, to Mr. Joel Gay.	8-K/A	001-34112	99.2	7/8/2014	
10.16*	Draft Consulting Agreement with Thomas S. Rooney, Jr.	8-K	001-34112	10.2	1/13/2015	
10.17*	Energy Recovery, Inc. 2015 Annual Incentive Plan.	8-K	001-34112	10.1	4/29/2015	

10.18*	Offer Letter dated April 22, 2015 to Mr. Joel Gay.	8-K	001-34112	99.2	4/29/2015
10.19*	Promotion Letter dated April 30, 2015 to Ms. Sharon Smith-Lenox.	8-K	001-34112	99.1	5/1/2015
10.20*	Offer Letter dated May 5, 2015 to Mr. Eric Siebert.	10-K	001-34112	10.25	3/3/2016
10.21	Settlement and Mutual Release Agreement.	8-K	001-34112	99.1	5/13/2015
10.22*	Offer Letter dated May 13, 2015 to Mr. Chris Gannon.	8-K	001-34112	99.1	5/15/2015
10.23	Second Amendment to Loan Agreement with HSBC Bank USA, National Association.	10-Q	001-34112	10.7	8/6/2015
10.24*	Offer Letter dated September 17, 2015 to Ms. Emily Smith.	10-K	001-34112	10.30	3/3/2016
10.25**	License Agreement by and between ERI Energy Recovery Ireland, Ltd. and Schlumberger Technology Corporation.	10-K	001-34112	10.31	3/3/2016
10.26*	Energy Recovery, Inc. Annual Incentive Plan effective as of January 1, 2016.	8-K	001-34112	10.1	3/1/2016
10.27*	Transition and Separation Agreement dated March 15, 2016 by and between Energy Recovery, Inc. and Mr. Juan Otero.	8-K	001-34112	99.1	3/18/2016

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Exhibit Number	Exhibit Description	Incorporated by Reference Form	File No.	Exhibit	Filing Date	Filed Herewith
10.28*	Energy Recovery, Inc. 2016 Incentive Plan.	DEF14A	001-34112	Appendix A	4/27/2016	
10.29*	Offer Letter dated May 27, 2016 to Mr. William Yeung.	8-K	001-34112	99.1	6/22/2016	
10.30	Loan and Pledge Agreement between Energy Recovery, Inc. as Borrower, and Citibank, N.A. as Lender.	10-K	001-34112	10.34	3/10/2017	
10.31	First Amendment to Loan and Pledge Agreement by and between Energy Recovery, Inc. and Citibank, N.A.	10-Q	001-34112	10.1	5/4/2017	
10.32	1717 Doolittle Lease Agreement.	8-K	001-34112	10.1	4/18/2018	
10.33	Settlement Agreement and Release.	8-K	001-34112	10.1	4/24/2018	
10.34	First Amendment to Loan and Pledge Agreement by and between Energy Recovery, Inc and Citibank, N.A.	10-Q	333-15007	10.1	5/12/2018	
10.35	Offer of Promotion to President and Chief Executive Officer.	8-K	001-34112	10.1	5/08/2018	
10.36	Offer Letter to Mr. Joshua Ballard.	8-K	001-34112	10.1	08/15/2018	
10.37	Employment Agreement with Mr. Eric Siebert.	8-K	001-34112	10.1	8/27/2018	
10.38	Employment Agreement with Mr. Nocair Bensalah.	8-K	001-34112	10.1	8/27/2018	
10.39	Employment Agreement with Mr. Nocair Bensalah.	8-K	001-34112	10.2	8/27/2018	
10.39	Employment Agreement with Mr. Rodney Clemente.	8-K	001-34112	10.3	8/27/2018	
10.40	Third Amendment to Loan and Pledge Agreement by and between Energy Recovery, Inc. and Citibank N.A.	10-Q	333-15007	10.5	11/1/2018	
14.1	Code of Ethics of Energy Recovery, Inc. Additional Conduct and Ethics Policies for the Chief Executive Officer and Senior Financial Officers.	10-K	001-34112	14.1	3/27/2009	
18.1	BDO USA, LLP, Letter re Change in Method of Accounting for Inventory Valuation.	10-Q	001-34112	18.1	5/8/2014	
21.1	List of subsidiaries of the Company.					X
23.1	Consent of Deloitte & Touche LLP, Independent Registered Public Accounting Firm.					X
23.2	Consent of BDO USA, LLP, Independent Registered Public Accounting Firm.					X
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.					X
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.					X
32.1	Certification of Principal Executive Officer and Principal Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.					X

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.

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* Indicates management compensatory plan, contract or arrangement.

** Portions of this exhibit have been omitted based on a request for Confidential Treatment submitted to the Securities and Exchange Commission (the “SEC”). The omitted information has been filed separately with the SEC as a part of the confidential treatment request. In the event that the SEC should deny such request in whole or in part, the relevant, previously omitted portions of this exhibit shall be publicly filed.

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