

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

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from _____ to _____

Commission File Number: 001-34112

Energy Recovery, Inc.

(Exact Name of Registrant as Specified in its Charter)

Delaware 01-0616867

(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

1717 Doolittle Drive, San Leandro, CA 94577

(Address of Principal Executive Offices) (Zip Code)

(510) 483-7370

(Registrant's Telephone Number, including Area Code)

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

(Do not check if a smaller reporting company)

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

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

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

ENERGY RECOVERY, INC.
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PART I — FINANCIAL INFORMATION

Item 1 — Financial Statements (unaudited)

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

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

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

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ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

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

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

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

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

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

See Accompanying Notes to Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Description of Business and Significant Accounting Policies

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

Basis of Presentation

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

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

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

Use of Estimates

The preparation of the Condensed Consolidated Financial Statements in conformity with GAAP requires the Company’s management to make judgments, assumptions, and estimates that affect the amounts reported in the Condensed Consolidated Financial Statements and accompanying Notes to Condensed Consolidated Financial Statements. The accounting policies that reflect the Company’s more significant estimates and judgments and that the Company believes are the most critical to aid in fully understanding and evaluating the Company’s reported financial results are revenue recognition; capitalization of research and development assets; allowance for doubtful accounts; valuation of right of use asset; and lease liability; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill and acquired intangible assets; useful lives for depreciation and amortization; valuation adjustments for excess and obsolete inventory; deferred taxes and valuation allowances on deferred tax

assets; and evaluation and measurement of contingencies. Those estimates could change, and as a result, actual results could differ materially from those estimates.

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Recent Accounting Pronouncements

Recently Adopted Accounting Pronouncements

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

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

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

The Company adopted “ASU 2014-09”, “ASU 2016-08” and “ASU 2016-10” (the combination is also known as “ASC 606” 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 Schlumberger Technology Corporation (the “VorTeq Licensee”) under ASC 605 was recognized on a straight-line basis over the fifteen-year term of the license, while the two subsequent milestone payments of \$25.0 million each that could be earned under the VorTeq License

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

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

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

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

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

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

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

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

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

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

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

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

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

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

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

In May 2017, the FASB issued ASU No. 2017-09, Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting. ASU 2017-09 provides guidance about which changes to the terms or conditions of a

share-based payment awards 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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ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Impact of Recently Adopted Accounting Pronouncements

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

	December 31, 2017			
	As	Adoption	Adoption	As
	Previously	of New	of New	Adjusted
	Reported	Revenue	Lease	
		Standard	Standard	
	(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

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

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

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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

Recently issued accounting pronouncement not yet adopted

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

In February 2018, the FASB issued ASU No. 2018-02 (“ASU 2018-02”), Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. ASU 2018-02 was issued to address the income tax accounting treatment of the stranded tax effects within other comprehensive income due to the prohibition of backward tracing due to an income tax rate change that was initially recorded in other comprehensive income. This issue came about from the enactment of the U.S. Tax Cuts and Jobs Act of 2017 (the “Tax Act”) that changed the Company’s income tax rate from 35% to 21%. ASU 2018-02 changed current accounting whereby an entity may elect to reclassify the stranded tax effect from accumulated other comprehensive income to retained earnings. The ASU 2018-02 is effective for periods beginning after December 15,

2018 although early adoption is permitted. The Company does not expect the adoption of ASU 2018-02 to have a material impact on its financial position or results of operations.

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED 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 \$1.7 million and \$2.7 million for the three and six months ended June 30, 2017, respectively.

Revenue Recognition

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

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

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

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

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

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

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

Arrangements with Multiple Performance Obligations and Termination for Convenience

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

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

Practical Expedients and Exemptions

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

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

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

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Contract Balances

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

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

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

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

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

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

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

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED 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.

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

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

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

Contract Costs

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

Product and Service Revenue Recognition - Water Segment

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

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

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

The transfer of control for the Company's products follows transfer of title which typically occurs upon shipment of the equipment in accordance with International Commercial Terms (commonly referred to as "Incoterms"). The specified product performance criteria for the Company's products pertain to the ability of the Company's product to

meet its published performance specifications and warranty provisions, which the Company's products have demonstrated on a consistent basis. This factor, combined with historical performance metrics, provides the Company's management with a reasonable basis to conclude that the products will perform satisfactorily upon commissioning of the plant. Installation is relatively simple, requires no customization, and is performed by the customer under the supervision of the Company's 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.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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.

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 and the contractual pricing of products and commissioning of services in bundled arrangements.

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 is expected to be completed and shipped in the second half of 2018. 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.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

	December 31, 2017			
	June 30, As 2018	As Adjusted	Adoption of New Revenue Standard	As Previously Reported
	(In thousands)			
Estimated earnings to date	\$6,155	\$5,867	\$ (133)	\$ 6,000
Estimated costs to date	(4,947)	(4,525)	—	(4,525)
Subtotal	1,208	1,342	(133)	1,475
Net billings to date	1,826	2,718	—	2,718
Total	\$3,034	\$4,060	\$ (133)	\$ 4,193
Included in accompanying balance sheets:				
Unbilled project costs	\$3,478	\$4,865	\$ (133)	\$ 4,998
Cost and estimated earnings in excess of billings	(444)	(805)	—	(805)
Total	\$3,034	\$4,060	\$ (133)	\$ 4,193

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, and Lease 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 fifteen-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 14, "VorTeq Partnership and License Agreement."

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.

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED 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 restricted stock units (“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 shares of common stock, using the treasury stock method, and the shares of common stock underlying each outstanding RSU were issued. Diluted earnings per share for the three and six months ended June 30, 2018 and 2017, includes the dilutive effects of stock options and RSUs. Certain shares of common stock issuable under stock options and RSUs have been omitted from the three and six months ended June 30, 2018 and 2017 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. Prior year amounts have been adjusted for the adoption of ASC 606 in the first quarter of 2018. See Note 2, Recent Accounting Pronouncements, for reconciliation of prior year “As Previously Reported” and “As Adjusted” amounts.

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2017	
	2018	2017	2018	2017
	(In thousands, except per share amounts)			
Numerator:				
Net income	\$15,743	\$ 929	\$15,017	\$1,351
Denominator:				
Basic weighted average common shares outstanding	53,747	53,748	53,747	53,786
Weighted average effect of dilutive stock awards	1,659	1,817	1,690	2,018
Diluted weighted average common shares outstanding	55,406	55,565	55,437	55,804
Net income per share:				
Basic	\$0.29	\$ 0.02	\$0.28	\$0.03
Diluted	\$0.28	\$ 0.02	\$0.27	\$0.02

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.

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2017	
	2018	2017	2018	2017
	(In thousands)			
Anti-dilutive shares excluded from net income per share calculation	1,990	1,962	2,015	1,920

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 5 — Other Financial Information

Cash, Cash Equivalents and Restricted Cash

The Company's Condensed Consolidated Statement of Cash Flows explains the change in the total of cash, cash equivalents, and restricted cash. The following table provides a reconciliation of cash and cash equivalents, and restricted cash reported within the Condensed Consolidated Balance Sheets that sum to the total of such amounts in the Condensed Consolidated Statements of Cash Flows.

	June 30, December 31,	
	2018	2017
	(In thousands)	
Cash and cash equivalents	\$ 16,378	\$ 27,780
Restricted cash	894	2,846
Total cash, cash equivalents, and restricted cash	\$ 17,272	\$ 30,626

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," for additional discussion related to the Company's stand-by letters of credit and restricted cash requirements.

Accounts Receivable, net

	June 30, December 31,	
	2018	2017
	(In thousands)	
Accounts receivable	\$ 11,724	\$ 12,568
Less: Allowance for doubtful accounts	(420)	(103)
Accounts receivable, net	\$ 11,304	\$ 12,465

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.

	June 30, December 31,	
	2018	2017
	(In thousands)	
Raw materials	\$ 2,339	\$ 1,899
Work in process	2,594	2,191
Finished goods	1,442	1,424
Inventories, net	\$ 6,375	\$ 5,514

Valuation adjustments for excess and obsolete inventory, reflected as a reduction of inventory at June 30, 2018 and December 31, 2017 was \$0.6 million and \$0.7 million, respectively.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Prepaid and Other Current Assets

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

	June 30, December 31,	
	2018	2017
	(In thousands)	
Insurance	\$263	\$ 256
Interest receivable	472	439
Supplier advances	142	124
Software license	210	193
Other prepaid expenses and current assets	633	330
Total prepaid and other current assets	\$1,720	\$ 1,342

Property and Equipment

	June 30, December 31,	
	2018	2017
	(In thousands)	
Property and equipment	\$38,452	\$ 37,535
Less: Accumulated depreciation and amortization	(25,464)	(24,142)
Property and equipment, net	\$12,988	\$ 13,393

Accrued Expenses and Other Current Liabilities

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

	June 30, December 31,	
	2018	2017
	(In thousands)	
Payroll and commissions payable	\$3,402	\$ 6,071
Other accrued expenses and current liabilities	1,755	1,877
Total accrued expenses and other current liabilities	\$5,157	\$ 7,948

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Lease Liabilities

Lease liabilities are presented in the following table.

	June 30, 2018	December 31, 2017
	(In thousands)	
Lease liabilities	\$336	\$ 1,603
Lease liabilities, non-current	13,033	1,698
Total lease liabilities	\$13,369	\$ 3,301

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss by component are presented in the following table.

	Foreign Currency Translation Adjustments	Unrealized Losses on Investments	Total Accumulated Other Comprehensive Loss
	(In thousands)		
Balance, December 31, 2017	\$(33)	\$ (92)	\$ (125)
Other comprehensive loss, net	(12)	(57)	(69)
Balance, June 30, 2018	\$(45)	\$ (149)	\$ (194)

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.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 6 — Investments and Fair Value Measurements

The Company's cash, cash equivalents and short-term investments are presented in the following table.

	June 30, December 31,	
	2018	2017
	(In thousands)	
Cash and cash equivalents	\$16,378	\$ 27,780
Short-term investments	72,207	70,020
Total cash, cash equivalents and marketable securities	\$88,585	\$ 97,800

As of June 30, 2018, there were no available-for-sale investments reported in Cash and cash equivalents on the Condensed Consolidated Balance Sheets. As of December 31, 2017, available-for-sale investments of \$0.3 million were reported in Cash and cash equivalents on the Condensed Consolidated Balance Sheets.

Available-for-Sale Investments

The Company's investments are all classified as available-for-sale. As of June 30, 2018 and December 31, 2017, all available-for-sale investments were classified as short-term, with maturities less than 12 months. There were no sales of available-for-sale investments during the three and six months ended June 30, 2018 and 2017.

Available-for-sale investments as of June 30, 2018 and December 31, 2017 are presented in the following tables.

	June 30, 2018			
	Gross		Gross	
	Amortized	Unrealized	Unrealized	Fair
	Cost	Holding	Holding	Value
		Gains	Losses	
	(In thousands)			
U.S. Treasury securities	\$11,639	\$ —	\$ (8)	\$11,631
Corporate notes and bonds	60,429	272	(374)	60,327
Municipal notes and bonds	249	—	—	249
Total available-for-sale investments	\$72,317	\$ 272	\$ (382)	\$72,207

	December 31, 2017			
	Gross		Gross	
	Amortized	Unrealized	Unrealized	Fair
	Cost	Holding	Holding	Value
		Gains	Losses	
	(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

The Company monitors investments for other-than-temporary impairment. It was determined that unrealized gains and losses at June 30, 2018 and December 31, 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. 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 CONDENSED 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 are shown by contractual maturity in the following table.

	June 30, 2018	
	Amortized Cost	Fair Value
	(In thousands)	
Due in one year or less	\$72,317	\$72,207

Fair Value of Financial Instruments

Financial assets and liabilities that are remeasured and reported at fair value at each reporting period are classified and disclosed in one of the following three levels:

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.

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.

Financial Assets and Liabilities Measured at Fair Value on a Recurring Basis

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

	June 30, 2018			
	Total	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
	(In thousands)			
Assets:				
Cash equivalents				
Money market securities	\$8,191	\$	-\$8,191	\$
Total cash equivalents	8,191	—	8,191	—
Short-term investments				
U.S. Treasury securities	\$11,631	\$	-\$11,631	\$
Corporate notes and bonds	60,327	—	60,327	—
Municipal notes and bonds	249	—	249	—
Total short-term investments	72,207	—	72,207	—
Total assets	\$80,398	\$	-\$80,398	\$

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	December 31, 2017			
	Total	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
	(In thousands)			
Assets:				
Cash equivalents				
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 three and six months ended June 30, 2018, 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 June 30, 2018 and December 31, 2017 are summarized in the following table. All of the Company's available-for-sale investments were short-term with maturities less than 12 months. Available-for-sale investments that were in an unrealized gain position have been excluded from the following table.

	June 30, 2018		December 31, 2017	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(In thousands)			
U.S. Treasury securities	\$11,631	\$ (8)	\$10,162	\$ (14)
Corporate notes and bonds	60,327	(374)	53,222	(77)
Municipal notes and bonds	249	—	247	—
Total available-for-sale investments	\$72,207	\$ (382)	\$63,631	\$ (91)

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 7 — Goodwill and Intangible Assets

Goodwill

The net carrying amount of goodwill as of June 30, 2018 and December 31, 2017 was \$12.8 million. As of June 30, 2018 and December 31, 2017, no impairment of goodwill was recorded in the accompanying Condensed 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.

	June 30, December 31,	
	2018	2017
	(In thousands)	
Finite-lived intangible assets	\$6,643	\$ 6,643
Accumulated amortization	(5,689)	(5,374)
Intangible assets, net	\$954	\$ 1,269

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 8 — Long-term Debt and Lines of Credit

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 30, 2018 to extend the termination date of the Loan and Pledge Agreement from March 31, 2018 to March 31, 2020, of which the Company paid closing fees of \$16 thousand. No other provisions of the Loan and Pledge Agreement was amended. As of June 30, 2018, no amount under the Loan and Pledge Agreement was outstanding.

Stand-by Letters of Credit

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

	June 30, December 31,	
	2018	2017
	(In thousands)	
Financial Institution 1	\$ 770	\$ 1,687
Financial Institution 2	8,496	7,745
Financial Institution 3	—	990
Total	\$ 9,266	\$ 10,422

The Company’s total restricted cash balances by financial institution are presented in the following table. Financial Institution 2 requires pledged U.S. investments in lieu of restricted cash balances.

	June 30, December 31,	
	2018	2017
	(In thousands)	
Financial Institution 1	\$ 808	\$ 1,771
Financial Institution 3	—	990
Financial Institution 4	86	85
Total	\$ 894	\$ 2,846

ENERGY RECOVERY, INC.

NOTES TO CONDENSED 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 Doolittle Lease 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.

The components of lease expense are presented in the following table.

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Operating lease cost	\$471	\$ 851

(In thousands)

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

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Cash payments	\$ 176	\$ 611

(In thousands)

The weighted average remaining lease term and discount rate as of June 30, 2018 related to the operating leases are presented in the following table.

Weighted average remaining lease term	10.3	years
Weighted average discount rate	6.94	%

Maturities of lease liabilities as of June 30, 2018 are presented in the following table.

Year:	Lease Amounts (In thousands)
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2018 (remaining six months)	\$ 353
2019	1,823
2020	1,855
2021	1,653
2022	1,812
Thereafter	11,756
Total	19,252
Less imputed lease interest	(5,883)
Total lease liabilities	\$ 13,369

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Warranty

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

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2017	
	2018	2017	2018	2017
	(In thousands)			
Balance, beginning of period	\$359	\$398	\$366	\$406
Warranty costs charged to cost of revenue	87	36	135	91
Utilization charges against reserve	(23)	(2)	(28)	(38)
Release of accrual related to expired warranties	(34)	(58)	(84)	(85)
Balance, end of period	\$389	\$374	\$389	\$374

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 June 30, 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 June 30, 2018, the Company had approximately \$6.3 million of open cancellable purchase order arrangements related primarily to materials and parts.

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 June 30, 2018 and December 31, 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 in general for periods of 24 to 36 months, and in some cases up to 68 months. All stand-by letters of credit at June 30, 2018 and December 31, 2017, were in the aggregate for amounts of \$9.3 million and \$10.4 million, respectively. See Note 8, "Long-term Debt and Lines of Credit," for additional information about the Company's stand-by letters of credit arrangements.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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 the Company's 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.

On February 18, 2016 and July 27, 2016, two derivative action complaints were filed in connection with the Company's previously reported stockholder class action lawsuit in the Superior Court for the State of California, County of Alameda where the Company was named as a nominal defendant under the captions, Goldberg v. Rooney, et al., HG 16804359, and Gerald McManiman v. Gay, et al., RG 16824960. The complaints have been consolidated under the caption, In Re Energy Recovery, Inc. Derivative Litigation, HG16804359. The consolidated complaint is styled as a derivative action being brought on behalf of the Company and generally alleges breach of fiduciary duty, waste of corporate assets, and unjust enrichment causes of action against the individually named defendants. In

March 2018, the Company and the attorneys representing the plaintiffs reached an agreement in principle to settle all outstanding claims in the case. As part of the settlement agreement, the Company has agreed to certain changes to the Company's corporate governance policies and procedures, and to pay the attorneys representing the plaintiffs legal fees, which will be paid entirely by the Company's insurer. The settlement agreement was granted preliminary approval by the Superior Court for the State of California, County of Alameda and a final approval hearing has been scheduled for October 2018.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 10 — Income Taxes

For the six months ended June 30, 2018, the Company recognized an income tax benefit of \$11.5 million, which included a \$12.5 million discrete tax benefit. This discrete tax benefit includes a \$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. This resulted in a deferred tax asset related to tax expense recorded on earnings and profits under the US Tax Cut and Jobs Act ("Tax Act") on deferred revenue not yet recognized under US GAAP. The \$11.5 million tax benefit for the six months ended June 30, 2018 also included a \$534 thousand discrete tax benefit related to tax deductions from stock-based compensation. For the six months ended June 30, 2017, the Company recognized income tax expense of approximately \$236 thousand, which included a \$63 thousand discrete tax benefit related to tax deductions from stock-based compensation.

The effective tax rate for the six months ended June 30, 2018 and 2017 was (324.4)% and 14.9%, respectively.

Excluding the discrete tax income tax items, the effective tax rate for the six months ended June 30, 2018 and 2017 was 27.8% and 19.3%, respectively.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 11 — Stockholder's Equity

Stock Repurchase Program

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 June 30, 2018, the Company repurchased 1,193,102 shares at an aggregate cost of \$10.0 million. The Company accounts for stock repurchases using the cost method. The aggregate cost includes fees charged in connection with acquiring the outstanding common stock.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 12 — Stock-based Compensation

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.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In thousands)			
Stock-based compensation expense by financial line:				
Cost of revenue	\$16	\$27	\$40	\$76
General and administrative ⁽¹⁾	455	551	2,131	1,118
Sales and marketing	157	200	419	437
Research and development	313	229	594	489
Total stock-based compensation expense	\$941	\$1,007	\$3,184	\$2,120
Stock-based compensation expense by type of award:				
Options ⁽¹⁾	\$680	\$827	\$2,344	\$1,716
RSUs ⁽¹⁾	261	180	840	404
Total stock-based compensation expense	\$941	\$1,007	\$3,184	\$2,120

⁽¹⁾ First six months of 2018 amounts include modifications of equity awards.

The Company estimates forfeitures at the time of grant and revise 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 record 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.

Modifications of Equity Awards

In the first quarter of 2018, the Company recorded additional stock-based compensation expense of \$0.9 million due to an equity award modification charge chiefly related to the modification of certain equity awards held by the Company's former President and Chief Executive Officer, who resigned on February 24, 2018, in consideration for his entering into a Settlement Agreement and Release.

Unamortized Stock-based Compensation Costs

Stock-based compensation cost related to unvested stock options and RSUs will generally be amortized on a straight-line basis over the remaining average service period of each award. The following table presents the unamortized compensation cost and weighted average service period of all unvested outstanding awards as of June 30,

2018.

	Unamortized Compensation Costs (In thousands)	Weighted Average Service Period (In years)
Stock options	\$ 6,422	2.62
RSUs	3,066	2.6
Total	\$ 9,488	

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
	(In thousands)			
Stock options	\$ 1,256	\$ 1,217	\$ 2,517	\$ 2,389
RSUs	116	96	625	532
Total grant date fair value of stock options and RSUs vested during the period	\$ 1,372	\$ 1,313	\$ 3,142	\$ 2,921

Stock Option Activities

The following table summarizes the stock option activities under the Company's 2016 Incentive Plan ("2016 Plan") and Amended and Restated 2008 Equity Incentive 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, 2017	5,092	\$ 5.43	6.6	\$ 17,735
Granted	989	7.67		
Exercised	(731)	3.32		3,760
Forfeited	(104)	7.55		
Balance, June 30, 2018	5,246	\$ 6.10	6.7	\$ 11,913
Vested and exercisable as of June 30, 2018	3,338	\$ 5.33	5.6	\$ 9,843
Vested and exercisable as of June 30, 2018 and expected to vest thereafter	4,991	\$ 6.02	6.6	\$ 11,741

⁽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 June 30, 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 June 30, 2018 or the last trading day prior to June 30, 2018. The aggregate intrinsic value at December 31, 2017 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 December 31, 2017 or the last trading day prior to

December 31, 2017.

Restricted Stock Unit Activities

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

	Shares	Weighted Average Grant-Date Fair Value (In thousands, except for weighted average grant-date fair value)
Balance, December 31, 2017	274	\$ 9.54
Awarded	280	7.74
Vested	(65)	9.58
Forfeited	—	—
Balance, June 30, 2018	489	8.50

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ENERGY RECOVERY, INC.

NOTES TO CONDENSED 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 energy recovery devices (“ERDs”) and pumps as well as related products and services. The Company’s chief operating decision-maker (“CODM”) is the chief executive officer.

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 (loss) for each segment excludes other income and expenses and certain corporate expenses managed outside the operating segment, 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.

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
	(In thousands)					
Product revenue	\$17,116	\$290	\$17,406	\$28,164	\$300	\$28,464
Product cost of revenue	5,640	336	5,976	8,868	422	9,290
Product gross profit	11,476	(46)	11,430	19,296	(122)	19,174
License and development revenue	—	3,358	3,358	—	6,107	6,107
Operating expenses:						
General and administrative	666	371	1,037	971	1,022	1,993
Sales and marketing	1,363	318	1,681	2,808	662	3,470
Research and development	230	3,375	3,605	474	7,040	7,514
Amortization of intangibles	158	—	158	316	—	316
Operating expenses	2,417	4,064	6,481	4,569	8,724	13,293
Operating income (loss)	\$9,059	\$(752)	8,307	\$14,727	\$(2,739)	11,988
Less: Corporate operating expenses			4,067			9,079
Consolidated operating income			4,240			2,909
Non-operating income			381			629
Income before income taxes			\$4,621			\$3,538

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Prior year amounts in the following table have been adjusted for the adoption of ASC 606 in the first quarter of 2018. See Note 2, Recent Accounting Pronouncements, for reconciliation of prior year “As Previously Reported” and “As Reported” amounts.

	Three Months Ended June 30, 2017			Six Months Ended June 30, 2017		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
	(In thousands)					
Product revenue	\$9,764	\$1,100	\$10,864	\$20,480	\$2,629	\$23,109
Product cost of revenue	2,705	867	3,572	6,229	1,955	8,184
Product gross profit	7,059	233	7,292	14,251	674	14,925
License and development revenue	—	3,050	3,050	—	5,298	5,298
Operating expenses:						
General and administrative	313	375	688	631	724	1,355
Sales and marketing	1,244	563	1,807	2,743	1,204	3,947
Research and development	232	2,819	3,051	494	5,065	5,559
Amortization of intangibles	158	—	158	316	—	316
Operating expenses	1,947	3,757	5,704	4,184	6,993	11,177
Operating income (loss)	\$5,112	\$(474)	4,638	\$10,067	\$(1,021)	9,046
Less: Corporate operating expenses			3,632			7,687
Consolidated operating income			1,006			1,359
Non-operating income			111			228
Income before income taxes			\$1,117			\$1,587

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 14 — 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 twenty 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 well. 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," for further discussion of revenue recognition.

Item 2 — Management’s Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q for the three and six months ended June 30, 2018, including “Part I, Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations” (the “MD&A”) and certain information incorporated by reference, contain forward-looking statements within the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions, or strategies regarding the future.

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

Words such as “expects,” “anticipates,” “aims,” “projects,” “intends,” “plans,” “believes,” “estimates,” “seeks,” variations of such words, and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are directed to risks and uncertainties identified under “Part II, Item 1A – Risk Factors” and elsewhere in this report for factors that may cause actual results to be different from those expressed in these forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

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

- our belief that levels of gross profit margin are sustainable to the extent that volume grows, we experience a favorable product mix, pricing remains stable, and we continue to realize cost savings through production efficiencies and enhanced yields;
- our plan to improve our existing energy recovery devices and to develop and manufacture new and enhanced versions of these devices;
- our belief that our PX[®] energy recovery devices are the most cost-effective energy recovery devices over time and will result in low life-cycle costs;
- our belief that our turbocharger devices have long operating lives;
- our objective of finding new applications for our technology and developing new products for use outside of desalination, including oil & gas applications;
- our expectation that our expenses for research and development and sales and marketing may increase as a result of diversification into markets outside of desalination;
- our expectation that we will continue to rely on sales of our energy recovery devices in the desalination market for a substantial portion of our revenue and that new desalination markets, including the United States (“U.S.”), will provide revenue opportunities to us;
- our ability to meet projected new product development dates, anticipated cost reduction targets, or revenue growth objectives for new products;
 - our belief that we can commercialize the VorTeq[™] hydraulic fracturing system;
- our belief that the VorTeq enables oilfield services (“OFS”) companies to migrate to more efficient pumping technology;
- our belief that we will be able to enter into a long-term licensing agreement to bring the MTeq[™] solution to market;
- our belief that customers will accept and adopt our new products;
- our belief that our current facilities will be adequate for the foreseeable future;
- our expectation that sales outside of the U.S. will remain a significant portion of our revenue;

the timing of our receipt of payment for products or services from our customers;
our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated liquidity needs for the foreseeable future, with the exception of a decision to enter into an acquisition and/or fund investments in our latest technology arising from rapid market adoption that could require us to seek additional equity or debt financing;
our expectation that, as we expand our international sales, a portion of our revenue could be denominated in foreign currencies and the impact of changes in exchange rates on our cash and cash equivalents and operating results;

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- our expectations of the impact of the U.S. Tax Cuts and Jobs Act (“Tax Act”);
- our belief that new markets will grow in the water desalination market;
- our expectation that we will be able to enforce our intellectual property rights;
- our expectation that the adoption of new accounting standards will not have a material impact on our financial position or results of operations;
- the outcome of proceedings, lawsuits, disputes, and claim;
- the impact of losses due to indemnification obligations; and
- the impact of changes in internal control over financial reporting.

You should not place undue reliance on these forward-looking statements, which reflect management’s opinions only as of the date of the filing of this Quarterly Report on Form 10-Q. All forward-looking statements included in this document are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected in the forward-looking statements, as disclosed from time to time in our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as in our Annual Reports to Stockholders and, if necessary, updated in “Part II, Item 1A – Risk Factors.” In preparing the MD&A below, we presume the readers have access to and have read the MD&A in our Annual Report on Form 10-K, pursuant to Instruction 2 to paragraph (b) of Item 303 of Regulation S-K. We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements.

We provide our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statements, Forms 3, 4 and 5 filed by or on behalf of directors, executive officers and certain large shareholders, and any amendments to those documents filed or furnished pursuant to the Securities Exchange Act of 1934, free of charge on the Investor Relations section of our website, www.energyrecovery.com. These filings will become available as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. From time to time, we may use our website as a channel of distribution of material company information.

We also make available in the Investor Relations section of our website our corporate governance documents, including our code of business conduct and ethics and the charters of the audit, compensation, and nominating and governance committees. These documents, as well as the information on the website, are not intended to be part of this Quarterly Report on Form 10-Q. We use the Investor Relations section of our website as a means of complying with our disclosure obligations under Regulation FD. Accordingly, you should monitor the Investor Relations section of our website in addition to following our press releases, SEC filings, and public conference calls and webcasts.

Overview

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

Our reportable operating segments consist of the Water and the Oil & Gas segments. These segments are based on the industries in which the technology solutions are sold, the type of energy recovery device or other technology sold, and the related solution and service.

Certain prior year amounts in Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” have been reclassified to conform to the current year presentation due to the adoptions of Accounting Standards Update (“ASU”) No. 2014-09 (“ASU 2014-09”), Revenue from Contracts with Customers (Topic 606), 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, also referred to as “ASC 606” or “New Revenue Standard,” the adoption of ASU No. 2016-02 (“ASU 2016-02”), Leases (Topic 842), also referred to as “ASC 842” or “New Lease Standard,” and the adoption of ASU 2016-18 (“ASU 2016-18”), Statement of Cash Flows (Topic 230): Restricted Cash, also referred to as “New Cash Flow Presentation Standard.” See Notes 2, “Recent Accounting Pronouncements,” and 3, “Revenues,” of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, “Financial Statements (unaudited),” of this Quarterly Report on Form 10-Q for further discussion on the adoption of ASC 606 and a reconciliation between prior year “As Previously Reported” and “As Adjusted” amounts.

Water Segment

Our Water segment consists of revenues and expenses associated with solutions sold for use in seawater, brackish, and wastewater reverse osmosis desalination. Our Water segment revenue is principally derived from the sale of energy recovery devices (“ERDs”); however, we also derive revenue from the sale of our high-pressure and circulation pumps, which we manufacture and sell in connection with our ERDs for use in desalination plants. Additionally, we receive revenue from the sale of spare parts and services, including start-up and commissioning services that we provide for our customers.

Oil & Gas Segment

Our Oil & Gas segment consists of revenues and expenses associated with solutions sold or licensed for use in hydraulic fracturing, gas processing, and chemical processing. In the past several years, we have invested significant research and development, and sales and marketing costs to expand our business into pressurized fluid flow industries within the oil & gas industry.

Results of Operations

Total Revenue

On January 1, 2018, we adopted ASC 606. Adoption of ASC 606 did not have a material impact on the timing of revenue and expense recognition for product revenue for either the Water segment or the cost-to-total cost (“CTC”) revenue contract in the Oil & Gas segment.

The implementation of ASC 606 for license and development revenue resulted in a material difference in the timing of revenue recognition under the new standard, with an overall acceleration of the recognition of deferred revenue for VorTeq license agreement (the “VorTeq License Agreement”) that the company entered into with the Vorteq licensee. The amounts below have been adjusted for adoption of ASC 606. See Notes 2, “Recent Accounting Pronouncements,” and 3, “Revenues,” of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, “Financial Statements (unaudited),” of this Quarterly Report on Form 10-Q for further discussion on the adoption of ASC 606 and a reconciliation between prior year “As Previously Reported” and “As Adjusted” amounts.

Since the full retrospective method was adopted, the Company has fully comparable period to period results.

	Three Months Ended June 30,				Six Months Ended June 30,				Change			
	2018	2017		Change	2018	2017		Change				
	\$	% of Total Revenue	\$	% of Total Revenue	\$	%	\$	% of Total Revenue	\$	% of Total Revenue		
	(In thousands, except for percentages)											
Product revenue	\$17,406	84 %	\$10,864	78 %	\$6,542	60%	\$28,464	82 %	\$23,109	81 %	\$5,355	23%
License and development revenue	3,358	16 %	3,050	22 %	308	10%	6,107	18 %	5,298	19 %	809	15%
Total revenue	\$20,764	100 %	\$13,914	100 %	\$6,850	49%	\$34,571	100 %	\$28,407	100 %	\$6,164	22%

Product Revenue by Segment

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	Change		2018	2017	Change	
	\$	\$	\$	%	\$	\$	\$	%
	(In thousands, except for percentages)							
Water	\$17,116	\$9,764	\$7,352	75 %	\$28,164	\$20,480	\$7,684	38 %
Oil & Gas	290	1,100	(810)	(74%)	300	2,629	(2,329)	(89%)
Total product revenue	\$17,406	\$10,864	\$6,542	60 %	\$28,464	\$23,109	\$5,355	23 %

During the three months ended June 30, 2018, compared to the three months ended June 30, 2017, Water segment product revenue increased \$7.4 million, or 75%, due primarily to an increase of \$6.4 million of MPD shipments, and an increase of \$1.0 million of AM shipments. For the six months ended June 30, 2018, compared to the six months ended June 30, 2017, water segment product revenue increased \$7.7 million, or 38%, due primarily to an increase of \$4.8 million of MPD shipments, an increase of \$1.9 million of AM shipments, and an increase of \$1.0 million of OEM.

During the three months ended June 30, 2018, compared to the three months ended June 30, 2017, Oil & Gas segment product revenue decreased \$0.8 million, or (74%), due primarily to lower CTC revenue recognition associated with the sale of multiple IsoBoost systems. For the six months ended June 30, 2018, compared to the six months ended June 30, 2017, Oil & Gas segment product revenue decreased \$2.3 million, or (89%), due primarily to lower CTC

revenue recognition associated with the sale of multiple IsoBoost systems.

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A limited number of our customers account for a substantial portion of our product revenue in the Water and Oil & Gas segments. Revenue from our top 10 customers represented 70%, 65%, 66% and 66% of our product revenues in the three and six months ended June 30, 2018 and 2017, respectively. Customers representing 10% or more of product revenue varies from period to period and are presented in the following table.

Segment	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Customer A Water	12%	20%	21%	13%
Customer B Oil & Gas	—%	10%	—%	11%
Customer C Water	31%	—%	19%	—%
Customer D Water	—%	—%	—%	18%

Product revenue attributable to domestic and international sales as a percentage of total product revenue is presented in the following table.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Domestic revenue	4 %	6 %	4 %	4 %
International revenue	96 %	94 %	96 %	96 %
Total product revenue	100%	100%	100%	100%

License and Development Revenue

	Three Months Ended June 30,			Six Months Ended June 30,		
	2018	2017	Change \$ %	2018	2017	Change \$ %
Oil & Gas	\$3,358	\$3,050	\$308 10%	\$6,107	\$5,298	\$809 15%

(In thousands, except for percentages)

In October 2015, through our subsidiary ERI Energy Recovery Ireland Ltd., we entered into the VorTeq License Agreement. License and development revenue increased \$0.3 million, or 10%, and \$0.8 million, or 15%, in the three and six months ended June 30, 2018, compared to the three and six months ended June 30, 2017, due primarily to higher costs incurred according to input measured based revenue recognition methodology under ASC 606.

See Note 2, "Recent Accounting Pronouncements," of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, "Financial Statements (unaudited)," of this Quarterly Report on Form 10-Q for further discussion on our license and development revenue recognition policy under ASC 606 and Note 14, "VorTeq Partnership and License Agreement," of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, "Financial Statements (unaudited)," of this Quarterly Report on Form 10-Q for additional discussion on the VorTeq License agreement.

Product Gross Profit and Margin

	Three Months Ended June 30, 2018			Three Months Ended June 30, 2017		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
	(In thousands, except for percentages)					
Product gross profit	\$11,476	\$(46)	\$11,430	\$7,059	\$233	\$7,292
Product gross margin	67.0%	(15.9%)	65.7%	72.3%	21.2%	67.1%

	Six Months Ended June 30, 2018			Six Months Ended June 30, 2017		
	Water	Oil & Gas	Total	Water	Oil & Gas	Total
	(In thousands, except for percentages)					
Product gross profit	\$19,296	\$(122)	\$19,174	\$14,251	\$674	\$14,925
Product gross margin	68.5%	(40.7%)	67.4%	69.6%	25.6%	64.6%

Product gross profit represents our product revenue less our product cost of revenue. Our product cost of revenue consists primarily of raw materials, personnel costs (including stock-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components.

In the three months ended June 30, 2018, compared to the three months ended June 30, 2017, product gross profit increased \$4.1 million, or 57%, due primarily to higher MPD volume of \$5.2 million, AM volume of \$0.7 million offset by unfavorable price and mix of \$1.9 million. In the six months ended June 30, 2018, compared to the six months ended June 30, 2017, product gross profit increased \$4.2 million, or 28%, due primarily to higher MPD volume of \$3.5 million, higher OEM volume of \$0.7 million, higher AM volume of \$1.3 million, offset by lower O&G volume of \$0.6 million and unfavorable price and product mix of \$0.8 million.

Product gross margin decreased by 1.4 percentage points to 65.7% in the three months ended June 30, 2018, compared to the three months ended June 30, 2017, due primarily to unfavorable price and product mix. Product gross margin increased by 2.8 percentage points to 67.4% in the six months ended June 30, 2018, compared to the six months ended June 30, 2017, due primarily to increased Water sales volume, partially offset by unfavorable price and product mix.

Operating Expenses

	Three Months Ended June 30,				Six Months Ended June 30,							
	2018	2017		Change		2018	2017		Change			
	\$	% of Total Revenue	\$	% of Total Revenue	\$	%	\$	% of Total Revenue	\$	%		
(In thousands, except for percentages)												
Total revenue	\$20,764	100 %	\$13,914	100 %	\$6,850	49 %	\$34,571	100 %	\$28,407	100 %	\$6,164	22 %
Operating expenses:												
General and administrative	\$4,927	24 %	\$3,927	28 %	\$1,000	25 %	\$10,764	31 %	\$8,335	29 %	\$2,429	29 %
Sales and marketing	1,858	9 %	2,174	16 %	(316)	(15%)	3,770	11 %	4,627	16 %	(857)	(19%)
Research and development	3,605	17 %	3,077	22 %	528	17 %	7,522	22 %	5,586	20 %	1,936	35 %
Amortization of intangible assets	158	1 %	158	1 %	—	— %	316	1 %	316	1 %	—	— %
Total operating expenses	\$10,548	51 %	\$9,336	67 %	\$1,212	13 %	\$22,372	65 %	\$18,864	66 %	\$3,508	19 %

General and Administrative

General and administrative expense increased \$1.0 million, or 25%, in the three months ended June 30, 2018, compared to the three months ended June 30, 2017, due primarily to higher bad debt expense of \$0.4 million, employee-related compensation and benefits of \$0.2 million and higher professional services of \$0.3 million.

General and administrative expense increased \$2.4 million, or 29%, in the six months ended June 30, 2018, compared to the six months ended June 30, 2017, mainly due to higher employee-related compensation and benefits expenses of \$1.7 million and higher facility cost and bad debt of \$0.5 million. Employee-related compensation and benefits included an increase in salary and wages of \$0.6 million, and a stock-based compensation increase of \$1.0 million, due primarily to a \$0.9 million equity award modification charge chiefly related to the modification of certain equity awards held by the Company's former President and Chief Executive Officer, who resigned on February 24, 2018, in consideration for his entering into a Settlement Agreement and Release.

Sales and Marketing

For the three months ended June 30, 2018, compared to the three months ended June 30, 2017, sales and marketing expense decreased \$0.3 million, or (15%), and for the six months ended June 30, 2018, compared to the six months ended June 30, 2017, sales and marketing expense decreased \$0.9 million, or 19%. In both periods, the decrease was due primarily to lower employee-related compensation and benefits.

Research and Development

For the three months ended June 30, 2018, compared to the three months ended June 30, 2017, research and development expense increased \$0.5 million, or 17%, due primarily to higher depreciation costs of \$0.2 million and

higher occupancy costs of \$0.2 million.

Research and development expense increased \$1.9 million, or 35%, in the six months ended June 30, 2018, compared to the six months ended June 30, 2017, due primarily to increased R&D supplies of \$0.6 million, higher depreciation of \$0.5 million, and testing equipment rental of \$0.4 million, and occupancy of \$0.2 million.

Amortization of Intangible Assets

Amortization of intangible assets is related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. There was no material change in our amortization amounts in the three and six months ended June 30, 2018, compared to the three and six months ended June 30, 2017.

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Other Income (Expense), net

	Three Months Ended June 30,				Six Months Ended June 30,							
	2018	2017		Change		2018	2017		Change			
	\$	% of Total Revenue	\$	% of Total Revenue	\$	%	\$	% of Total Revenue	\$	% of Total Revenue		
(In thousands, except for percentages)												
Total revenue	\$20,764	100%	\$13,914	100%	\$6,850	49%	\$34,571	100%	\$28,407	100%	\$6,164	22%
Other income (expense):												
Interest income	\$373	2%	\$198	1%	\$175	88%	\$674	2%	\$369	1%	\$305	83%
Interest expense	(1)	—%	—	—%	(1)	—%	(1)	—%	(1)	—%	—	—%
Other non-operating income, net	9	—%	(87)	(1)%	96	(110)%	(44)	—%	(140)	—%	96	(69)%
Total other income, net	\$381	2%	\$111	1%	\$270	243%	\$629	2%	\$228	1%	\$401	176%

Total other income (expense), net increased in the three months ended June 30, 2018, compared to the three months ended June 30, 2017, and in the six months ended June 30, 2018, compared to the six months ended June 30, 2017, due to primarily to interest income on higher investment balances.

Income Taxes

For the six months ended June 30, 2018, the Company recognized an income tax benefit of \$11.5 million, which included a \$12.5 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. This resulted in a deferred tax asset related to tax expense recorded on earnings and profits under the Tax Act on deferred revenue not yet recognized under US GAAP. This election resulted in the recognition of U.S. federal and state deferred tax assets related to existing Irish company book-tax temporary differences as a tax benefit in Q2 2018. The \$11.5 million tax benefit for the six months ended June 30, 2018 also included a \$534 thousand discrete tax benefit related to tax deductions from stock-based compensation. For the six months ended June 30, 2017, the Company recognized income tax expense of approximately \$236 thousand, which included a \$63 thousand discrete tax benefit related to tax deductions from stock-based compensation.

The effective tax rate for the six months ended June 30, 2018 and 2017 was (324.4)% and 14.9%, respectively. Excluding the discrete tax income tax items, the effective tax rate for the six months ended June 30, 2018 and 2017 was 27.8% and 19.3%, respectively.

Liquidity and Capital Resources

Overview

Our primary source of cash to fund our operations and capital expenditures has been proceeds from customer payments for our products and services and the issuance of common stock.

As of June 30, 2018, our principal sources of liquidity consisted of unrestricted cash and cash equivalents of \$16.4 million that are primarily invested in money market funds, short-term investments of \$72.2 million that are primarily invested in marketable debt instruments, such as corporate notes and bonds, municipal notes and bonds and U.S. Treasury securities, and accounts receivable, net of allowances of \$11.3 million. We invest cash not needed for current operations predominantly in high-quality, investment-grade, marketable debt instruments with the intent to make such funds available for operating purposes as needed.

As of June 30, 2018, our unrestricted cash, cash equivalents and short-term investments held outside the U.S. was \$38.9 million. Our intent has been to reinvest the earnings of foreign subsidiaries indefinitely outside the U.S. to fund both organic growth and acquisitions. On December 22, 2017, the "Tax Act" was enacted into law. In light of the new tax regulations, we are reviewing our prior position on the reinvestment of the earnings of our foreign subsidiaries outside of the U.S.

At both June 30, 2018 and 2017, we had \$6.0 million and \$6.3 million, respectively, of short-term contract assets which represents unbilled receivables. In the Water segment, we have contract assets pertaining to customer contractual holdback provisions, whereby we will invoice the final retention payment(s) due under certain sales contracts in the next 12 months. The customer holdbacks represent amounts intended to provide a form of security for the customer; accordingly, these contract assets have not been discounted to present value. In the Oil & Gas segment, we had unbilled receivables, net of unbilled project costs, of \$3.0 million at June 30, 2018. See Note 3, "Revenues," of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, "Financial Statements (unaudited)," of this Quarterly Report on Form 10-Q for additional information about our cost and estimated earnings on uncompleted contracts.

Loan Agreements

On January 27, 2017, we entered into a loan and pledge agreement (the "Loan and Pledge Agreement") with a financial institution. The Loan and Pledge Agreement provides for a committed revolving credit line of \$16.0 million and an uncommitted revolving credit line of \$4.0 million. Under the Loan and Pledge Agreement, we are allowed to borrow and request letters of credit against the eligible assets held from time to time in the pledged account maintained with the financial institution. Revolving loans incur interest per annum at a base rate equal to the London Interbank Offered Rate (also referred to as "LIBOR") plus 1.5%. Any default bears the aforementioned interest rate plus an additional 2%. The unused portion of the credit line is subject to a fee equal to the product of 0.2% per annum multiplied by the difference, if positive, between \$16.0 million and the average daily balance of all advances under the committed facility plus aggregate average daily undrawn amounts of all letters of credit issued under the committed facility during the immediately preceding month or portion thereof. We are subject to certain financial and administrative covenants under the Loan and Pledge Agreement. The Loan and Pledge Agreement was amended on March 30, 2018 to extend the termination date of the Loan and Pledge Agreement from March 31, 2018 to March 31, 2020, of which the Company paid closing fees of \$16 thousand. No other provisions of Loan and Pledge Agreement were amended. As of June 30, 2018, we were in compliance with these covenants. See Note 8, "Long-term Debt and Lines of Credit," of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, "Financial Statements (unaudited)," of this Quarterly Report on Form 10-Q for additional information about our loan agreement.

Stand-by Letters of Credit

At June 30, 2018, we have stand-by letters of credit with various financial institutions totaling \$9.3 million whereby we are required to maintain a restricted cash balance of \$0.8 million and a U.S. investment balance of \$8.5 million. Stand-by letters of credit are subject to fees based on the amount of the letter of credit that are payable quarterly and are non-refundable. See Note 8, "Long-term Debt and Lines of Credit," of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, "Financial Statements (unaudited)," of this Quarterly Report on Form 10-Q for additional information about our stand-by letters of credit arrangements.

Share Repurchase Programs

Our Board of Directors has authorized various share repurchase programs since 2012. On March 7, 2018, our Board of Directors authorized a share repurchase program (the “March 2018 Authorization”) under which the Company, at the discretion of management, may repurchase up to \$10.0 million in aggregate cost of our outstanding common stock through September 30, 2018. As of June 30, 2018, we have repurchased 1,193,102 shares for \$10.0 million under the March 2018 Authorization. Since the initial authorization of the share repurchase programs, we have spent an aggregate \$30.3 million, excluding commissions, to repurchase 5.5 million shares.

Cash Flows

Our cash flows are presented in the following table.

	Six Months Ended	
	June 30,	
	2018	2017
	(In thousands)	
Net cash used in operating activities	\$(1,670)	\$(5,984)
Net cash used in investing activities	(4,015)	(22,418)
Net cash used in financing activities	(7,691)	(794)
Effect of exchange rate differences on cash and cash equivalents	22	(15)
Net change in cash, cash equivalents and restricted cash	\$(13,354)	\$(29,211)

Cash Flows from Operating Activities

Cash used in operating activities is generated by net income adjusted for certain non-cash items and changes in assets and liabilities.

Cash used in operating activities was lower in the six months ended June 30, 2018, compared to the cash used in six months ended June 30, 2017, by \$4.3 million, due to higher cash generated from current year-to-date net income adjusted for non-cash items as compared to prior year-to-date net income adjusted for non-cash items. The current year-to-date net income included higher stock-based compensation expense, primarily due to a one-time equity award modification adjustment of \$0.9 million related to the modification of certain equity awards held by the Company’s former President and Chief Executive Officer, who resigned on February 24, 2018, in consideration for his entering into a Settlement Agreement and Release.

Cash Flows from Investing Activities

Cash flows from investing activities primarily relate to maturities and purchases of marketable securities to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk, capital expenditures to support our growth, and changes in our restricted cash used to collateralize our stand-by letters of credit and other contingent considerations.

Cash used in investing activities of \$4.0 million during the six months ended June 30, 2018 was primarily due to \$40.6 million in maturities of marketable security investments, partially offset by \$43.1 million used to purchase investments and \$1.5 million for capital expenditures.

Cash used in investing activities of \$22.4 million during the six months ended June 30, 2017 was primarily due to \$31.1 million used to purchase investments and \$3.8 million for capital expenditures, partially offset by \$12.5 million

in maturities of marketable security investments.

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Cash Flows from Financing Activities

Cash used in financing activities of \$7.7 million during the six months ended June 30, 2018 was primarily due to \$10.0 million to repurchase our common stock related to a repurchase program, partially offset by \$2.4 million received from the purchase of common stock through stock option exercises.

Cash used in financing activities of \$0.8 million during the six months ended June 30, 2017 was primarily due to \$4.3 million used to repurchase our common stock related to a repurchase program and \$0.2 million used for taxes paid related to net share settlement of RSUs, partially offset by \$3.7 million received from the purchase of common stock through stock option exercises.

Liquidity and Capital Resource Requirements

We believe that our existing resources and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months. However, we may need to raise additional capital or incur additional indebtedness to continue to fund our operations or to support acquisitions in the future and/or fund investments in our latest technology arising from rapid market adoption that could require us to seek additional equity or debt financing. Our future capital requirements will depend on many factors, including the continuing market acceptance of our products, our rate of revenue growth, the timing of new product introductions, the expansion of our research and development, manufacturing, and sales and marketing activities, the timing and extent of our expansion into new geographic territories, and the amount and timing of cash used for stock repurchases. In addition, we may enter into potential material investments in, or acquisitions of, complementary businesses, services, or technologies in the future, which could also require us to seek additional equity or debt financing. Should we need additional liquidity or capital funds, these funds may not be available to us on favorable terms, or at all.

Contractual Obligations

We lease facilities and equipment under fixed non-cancellable operating leases that expire on various dates through 2028. Additionally, in the course of our normal operations, we have entered into cancellable purchase commitments with our suppliers for various key raw materials and component parts. The purchase commitments covered by these arrangements are subject to change based on our sales forecasts for future deliveries.

The following is a summary of our contractual obligations as of June 30, 2018.

	Payments Due by Period				Total
	1 Year (6 months)	2-3 Years (2019 - 2020)	4-5 Years (2021 - 2022)	5+ Years (2023+)	
	(In thousands)				
Operating leases	\$353	\$3,678	\$3,465	\$11,756	\$19,252
Loan payable	6	16	—	—	22
Purchase obligations ⁽¹⁾	6,278	2	—	—	6,280
	\$6,637	\$3,696	\$3,465	\$11,756	\$25,554

(1) Purchase obligations are related to open purchase orders for materials and supplies

This table excludes agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of June 30, 2018, we believe that our exposure related to these guarantees and indemnities as of June 30, 2018 was not material.

Off-Balance Sheet Arrangements

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

Recent Accounting Pronouncements

See Note 2, "Recent Accounting Pronouncements," of the Notes to Condensed Consolidated Financial Statements in Part I, Item 1, "Financial Statements (unaudited)," of this Quarterly Report on Form 10-Q regarding the impact of certain recent accounting pronouncements on our Condensed Consolidated Financial Statements.

Item 3 — Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Risk

The majority of our revenue contracts have been denominated in U.S. Dollars (“USD”). The amount of revenue recognized in foreign currencies during the three and six months ended June 30, 2018 and year ended December 31, 2017 were not material.

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

Interest Rate Risk and Credit Risk

We have an investment portfolio of fixed-income marketable debt securities, including amounts classified as cash equivalents and short-term investments. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. We invest primarily in investment-grade short-term debt instruments of high-quality corporate issuers, and U.S. government and its agencies. These investments are subject to counter party credit risk. To minimize this risk, we invest pursuant to a Board-approved investment policy. The policy mandates high credit rating requirements and restricts our exposure to any single corporate issuer by imposing concentration limits.

Our investment portfolio includes fixed income marketable debt securities, including amounts classified as cash equivalents and short-term investments. At June 30, 2018, all of our investments were classified as short-term, with maturity dates less than 12 months, and totaled approximately \$72.2 million. These investments were presented in Short-term investments on our Condensed Consolidated Balance Sheets as of June 30, 2018. These investments are subject to interest rate fluctuations and will decrease in market value if interest rates increase. To minimize the exposure due to adverse shifts in interest rates, we maintain investments with an average maturity of less than seven months. A hypothetical 1% increase in interest rates would have resulted in an approximately \$0.3 million decrease in the fair value of our fixed-income debt securities as of June 30, 2018.

Item 4. — Controls and Procedures

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

Based on that evaluation, our President, Chief Executive Officer and Chief Financial Officer has concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective.

(b) Changes in internal controls. There were no changes in our internal control over financial reporting during the period covered by this report that, have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II — OTHER INFORMATION

Item 1. — Legal Proceedings

Note 16, “Litigation,” of our Annual Report on Form 10-K filed with the SEC on March 8, 2018, provides information on certain litigation in which we are involved.

For an update on the litigation matters previously disclosed in our Form 10-K, see the discussion in Note 9, “Commitments and Contingencies – Litigation,” of the Notes to Condensed Consolidated Financial Statements of this quarterly report on Form 10-Q, which discussion is incorporated by reference into this Item 1.

Item 1A. — Risk Factors

There has been no material changes in our risk factors from those disclosed in Part I, Item 1A, in our Annual Report on Form 10-K filed on March 8, 2018.

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

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

The following table summarizes the stock repurchase activity during the three months ended June 30, 2018:

Period	Total Number of Shares Purchased	Average Price Paid per Share ⁽¹⁾	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Number of Shares or Approximate Dollar Value That May Yet be Purchased Under the Program (In thousands)
April 1 – April 30, 2018	628,852	\$8.3098	1,038,702	\$ 1,261
May 1 – May 31, 2018	154,400	8.1354	1,193,102	—
June 1 – June 30, 2018	—	—	1,193,102	—

⁽¹⁾ Excluding commissions

Pursuant to the March 2018 Authorization, the Company, at the discretion of management, could repurchase up to \$10.0 million in aggregate cost of our outstanding common stock. As of June 30, 2018, 1,193,102 shares at an aggregate cost of \$10.0 million had been repurchased under the March 2018 Authorization. The aggregate cost includes fees charged in connection with acquiring the outstanding common stock.

Item 3. — Default Upon Senior Securities

None.

Item 4. — Mine Safety Disclosures

Not applicable.

Item 5. — Other Information

None.

Item 6. — Exhibits

See the Exhibit Index following the Signature page to this Quarterly Report on Form 10-Q for a list of exhibits filed or furnished with this report, which Exhibit Index is incorporated herein by reference.

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SIGNATURES

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

ENERGY RECOVERY, INC.

Dated: August 2, 2018 By: /s/ CHRIS GANNON
Chris Gannon
President and Chief Executive Officer, and
Chief Financial Officer

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EXHIBIT LIST

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	File No.	Exhibit	
10.1	<u>Offer of Promotion of President and Chief Executive Officer. Energy Recovery, Inc.</u>	8-K	001-34112	10.1	5/8/2018 X
31.1	<u>Certification of Principal Executive Officer and 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.</u>				X
32.1	<u>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.</u>				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				