ORION ENERGY SYSTEMS, INC.
Form 10-Q
August 09, 2013
Table of Contents

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

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2013

OR

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

Commission file number 001-33887

Orion Energy Systems, Inc.
(Exact name of Registrant as specified in its charter)

Wisconsin	39-1847269
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification number)
2210 Woodland Drive, Manitowoc, Wisconsin	54220
(Address of principal executive offices)	(Zip code)

Registrant's telephone number, including area code: (920) 892-9340

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

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

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

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

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

There were 21,081,680 shares of the Registrant's common stock outstanding on August 5, 2013.

Table of Contents

Orion Energy Systems, Inc.
Quarterly Report On Form 10-Q
For The Quarter Ended June 30, 2013
Table Of Contents

Table of Contents

PART I – FINANCIAL INFORMATION
Item 1: Financial Statements
ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	March 31, 2013	June 30, 2013
Assets		
Cash and cash equivalents	$14,376	$15,464
Short-term investments	1,021	1,022
Accounts receivable, net of allowances of $900 and $610	18,397	23,695
Inventories, net	15,230	15,376
Deferred contract costs	2,118	3,011
Prepaid expenses and other current assets	2,465	2,032
Total current assets	53,607	60,600
Property and equipment, net	27,947	27,012
Long-term inventory	11,491	9,887
Patents and licenses, net	1,709	1,695
Long-term accounts receivable	5,069	4,078
Other long-term assets	2,274	2,261
Total assets	$102,097	$105,533
Liabilities and Shareholders' Equity		
Accounts payable	$7,773	$10,643
Accrued expenses and other	5,457	5,963
Deferred revenue, current	2,946	4,022
Current maturities of long-term debt	2,597	2,451
Total current liabilities	18,773	23,079
Long-term debt, less current maturities	4,109	3,405
Deferred revenue, long-term	1,258	1,372
Other long-term liabilities	188	250
Total liabilities	24,328	28,106
Commitments and contingencies (See Note F)		
Shareholders' equity:		
Common stock, no par value: Shares authorized: 200,000,000 at March 31, 2013 and June 30, 2013; shares issued: 30,498,900 and 30,543,863 at March 31, 2013 and June 30, 2013; shares outstanding: 20,162,397 and 20,208,351 at March 31, 2013 and June 30, 2013	—	—
Additional paid-in capital	128,104	128,540
Treasury stock: 10,336,503 and 10,335,512 common shares at March 31, 2013 and June 30, 2013	(38,378)	(38,376)
Shareholder notes receivable	(265)	(264)
Retained deficit	(11,692)	(12,473)
Total shareholders' equity	77,769	77,427
Total liabilities and shareholders' equity	$102,097	$105,533

The accompanying notes are an integral part of these condensed consolidated statements.

3

Table of Contents

ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except share and per share amounts)

	Three Months Ended June 30,	
	2012	2013
Product revenue	$13,580	$17,523
Service revenue	1,730	3,329
Total revenue	15,310	20,852
Cost of product revenue	9,597	12,884
Cost of service revenue	1,340	2,245
Total cost of revenue	10,937	15,129
Gross profit	4,373	5,723
Operating expenses:		
General and administrative	3,302	2,759
Sales and marketing	3,952	3,303
Research and development	697	490
Total operating expenses	7,951	6,552
Loss from operations	(3,578)	(829)
Other income (expense):		
Interest expense	(161)	(113)
Interest income	225	174
Total other income	64	61
Loss before income tax	(3,514)	(768)
Income tax (benefit) expense	(1,574)	13
Net loss	$(1,940)	$(781)
Basic net loss per share attributable to common shareholders	$(0.09)	$(0.04)
Weighted-average common shares outstanding	22,561,135	20,173,743
Diluted net loss per share	$(0.09)	$(0.04)
Weighted-average common shares and share equivalents outstanding	22,561,135	20,173,743

The accompanying notes are an integral part of these condensed consolidated statements.

Table of Contents

ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Three Months Ended June 30,			
	2012		2013	
Operating activities				
Net loss	$(1,940	)	$(781	)
Adjustments to reconcile net loss to net cash provided by operating activities:				
Depreciation and amortization	1,097		1,054	
Stock-based compensation expense	366		370	
Deferred income tax benefit	(1,446	)	—	
Loss on sale of property and equipment	10		21	
Provision for bad debts	5		80	
Other	34		33	
Changes in operating assets and liabilities:				
Accounts receivable, current and long-term	3,245		(4,387	)
Inventories, current and long-term	1,307		1,458	
Deferred contract costs	(553	)	(893	)
Prepaid expenses and other assets	24		439	
Accounts payable	(2,497	)	2,870	
Accrued expenses	221		568	
Deferred revenue	134		1,190	
Net cash provided by operating activities	7		2,022	
Investing activities				
Purchase of property and equipment	(978	)	(130	)
Purchase of short-term investments	(1	)	(1	)
Additions to patents and licenses	(25	)	(19	)
Proceeds from sales of property, plant and equipment	8		30	
Net cash used in investing activities	(996	)	(120	)
Financing activities				
Payment of long-term debt	(685	)	(850	)
Proceeds from repayment of shareholder notes	2		1	
Repurchase of common stock into treasury	(2,463	)	—	
Excess tax benefits from stock-based compensation	27		—	
Proceeds from issuance of common stock	48		35	
Net cash used in financing activities	(3,071	)	(814	)
Net (decrease) increase in cash and cash equivalents	(4,060	)	1,088	
Cash and cash equivalents at beginning of period	23,011		14,376	
Cash and cash equivalents at end of period	$18,951		$15,464	
Supplemental cash flow information:				
Cash paid for interest	$146		$109	
Cash paid for income taxes	$30		$4	
Supplemental disclosure of non-cash investing and financing activities:				
Shares issued from treasury for shareholder note receivable	$17		$—	

The accompanying notes are an integral part of these condensed consolidated statements.

5

ORION ENERGY SYSTEMS, INC. AND SUBSIDIARIES
UNAUDITED NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE A — DESCRIPTION OF BUSINESS

Organization

The Company includes Orion Energy Systems, Inc., a Wisconsin corporation, and all consolidated subsidiaries. The Company is a developer, manufacturer and seller of lighting and energy management systems and a seller and integrator of renewable energy technologies to commercial and industrial businesses, predominantly in North America.

See Note I “Segment Reporting” of these financial statements for further discussion of the Company's reportable segments.

The Company’s corporate offices and manufacturing operations are located in Manitowoc, Wisconsin and an operations facility is located in Plymouth, Wisconsin. The Company leases office space for sales offices located in New Jersey, Chicago and Texas.

NOTE B — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

Reclassifications

Where appropriate, certain reclassifications have been made to prior years’ financial statements to conform to the current year presentation.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included. Interim results are not necessarily indicative of results that may be expected for the year ending March 31, 2014 or other interim periods.

The condensed consolidated balance sheet at March 31, 2013 has been derived from the audited and adjusted consolidated financial statements at that date but does not include all of the information required by GAAP for complete financial statements.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended March 31, 2013 filed with the Securities and Exchange Commission on June 14, 2013.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during that reporting period. Areas that require the use of significant management estimates include revenue recognition, inventory obsolescence and bad debt reserves, accruals for warranty expenses, income taxes and certain equity transactions. Accordingly, actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid, short-term investments with original maturities of three months or less to be cash equivalents.

6

Table of Contents

Short-Term Investments

The amortized cost and fair value of short-term investments, with gross unrealized gains and losses, as of March 31, 2013 and June 30, 2013 were as follows (in thousands):

March 31, 2013

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short-Term Investments
Money market funds	$487	$—	$—	$487	$ 487	$—
Bank certificate of deposit	1,021	—	—	1,021	—	1,021
Total	$1,508	$—	$—	$1,508	$ 487	$1,021

June 30, 2013

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short-Term Investments
Money market funds	$487	$—	$—	$487	$ 487	$—
Bank certificate of deposit	1,022	—	—	1,022	—	1,022
Total	$1,509	$—	$—	$1,509	$ 487	$1,022

As of March 31, 2013 and June 30, 2013, the Company's financial assets described in the table above were measured at cost which approximates fair value due to the short-term nature of the investment (level 1 inputs).

Fair Value of Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, short-term investments, accounts receivable, accounts payable, accrued liabilities and long-term debt. The carrying amounts of the Company's financial instruments approximate their respective fair values due to the relatively short-term nature of these instruments, or in the case of long-term, because of the interest rates currently available to the Company for similar obligations.

Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. GAAP describes a fair value hierarchy based on the following three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value:

Level 1 — Valuations are based on unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 — Valuations are based on quoted prices for similar assets or liabilities in active markets, or quoted prices in markets that are not active for which significant inputs are observable, either directly or indirectly.

Level 3 — Valuations are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. Inputs reflect management's best estimate of what market participants would use in valuing the asset or liability at the measurement date.

Accounts Receivable

The majority of the Company's accounts receivable are due from companies in the commercial, industrial and agricultural industries, as well as wholesalers. Credit is extended based on an evaluation of a customer's financial condition. Generally, collateral is not required for end users; however, the payment of certain trade accounts receivable from wholesalers is secured by irrevocable standby letters of credit and/or guarantees. Accounts receivable are generally due within 30-60 days. Accounts receivable are stated at the amount the Company expects to collect from outstanding balances. The Company provides for probable uncollectible amounts through a charge to earnings and a credit to an allowance for doubtful accounts based on its assessment of the current status of individual accounts. Balances that are still outstanding after the Company has used reasonable collection efforts are written off through a charge to the allowance for doubtful accounts and a credit to accounts receivable.

Financing Receivables

The Company considers its lease balances included in consolidated current and long-term accounts receivable from its Orion Throughput Agreement, or OTA, sales-type leases to be financing receivables. Additional disclosures on the credit quality of the Company's financing receivables are as follows:

7

Table of Contents

Aging Analysis as of June 30, 2013 (in thousands):

	Not Past Due	1-90 days past due	Greater than 90 days past due	Total past due	Total sales-type leases
Lease balances included in consolidated accounts receivable—current	$2,761	$119	$165	$284	$3,045
Lease balances included in consolidated accounts receivable—long-term	3,231	—	—	—	3,231
Total gross sales-type leases	5,992	119	165	284	6,276
Allowance	—	—	(87)	(87)	(87)
Total net sales-type leases	$5,992	$119	$78	$197	$6,189

Allowance for Credit Losses on Financing Receivables

The Company's allowance for credit losses is based on management's assessment of the collectability of customer accounts. A considerable amount of judgment is required in order to make this assessment, including a detailed analysis of the aging of the lease receivables and the current credit worthiness of the Company's customers and an analysis of historical bad debts and other adjustments. If there is a deterioration of a major customer's credit worthiness or if actual defaults are higher than historical experience, the estimate of the recoverability of amounts due could be adversely affected. The Company reviews in detail the allowance for doubtful accounts on a quarterly basis and adjusts the allowance estimate to reflect actual portfolio performance and any changes in future portfolio performance expectations. The Company believes that there is currently no impairment of the receivables for the sales-type leases. The Company incurred $0 of write-offs or credit losses against its OTA sales-type lease receivable balances in fiscal 2013 and for the three months ended June 30, 2013, respectively.

Inventories

Inventories consist of raw materials and components, such as ballasts, metal sheet and coil stock and molded parts; work in process inventories, such as frames and reflectors; and finished goods, including completed fixtures and systems, and wireless energy management systems and accessories, such as lamps, meters and power supplies. All inventories are stated at the lower of cost or market value with cost determined using the first-in, first-out (FIFO) method. The Company reduces the carrying value of its inventories for differences between the cost and estimated net realizable value, taking into consideration usage in the preceding 12 months, expected demand, and other information indicating obsolescence. The Company records as a charge to cost of product revenue the amount required to reduce the carrying value of inventory to net realizable value. As of March 31, 2013 and June 30, 2013, the Company had inventory obsolescence reserves of $2.3 million and $2.3 million, respectively.

Costs associated with the procurement and warehousing of inventories, such as inbound freight charges and purchasing and receiving costs, are also included in cost of product revenue.

Inventories were comprised of the following (in thousands):

	March 31, 2013	June 30, 2013
Raw materials and components	$8,207	$7,216
Work in process	846	999
Finished goods	6,177	7,161
	$15,230	$15,376

Deferred Contract Costs

Deferred contract costs consist primarily of the costs of products delivered, and services performed, that are subject to additional performance obligations or customer acceptance. These deferred contract costs are expensed at the time the related revenue is recognized. Deferred contract costs amounted to $2.1 million and $3.0 million as of March 31, 2013 and June 30, 2013, respectively.

Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist primarily of prepaid insurance premiums, prepaid license fees, purchase deposits, advance payments to contractors, unbilled revenue, prepaid taxes and miscellaneous receivables.

Table of Contents

Property and Equipment

Property and equipment were comprised of the following (in thousands):

	March 31, 2013	June 30, 2013
Land and land improvements	$1,562	$1,562
Buildings	15,918	15,918
Furniture, fixtures and office equipment	11,995	11,969
Leasehold improvements	58	58
Equipment leased to customers under Power Purchase Agreements	4,997	4,997
Plant equipment	10,620	10,597
Construction in progress	91	138
	45,241	45,239
Less: accumulated depreciation and amortization	(17,294)	(18,227)
Net property and equipment	$27,947	$27,012

Depreciation is provided over the estimated useful lives of the respective assets, using the straight-line method.

Depreciable lives by asset category are as follows:

Land improvements	10-15 years
Buildings and building improvements	3-39 years
Leasehold improvements	Shorter of asset life or life of lease
Furniture, fixtures and office equipment	2-10 years
Plant equipment	3-10 years

Patents and Licenses

Patents and licenses are amortized over their estimated useful life, ranging from 7 to 17 years, using the straight line method.

Long-Term Receivables

The Company records a long-term receivable for the non-current portion of its sales-type capital lease OTA contracts. The receivable is recorded at the net present value of the future cash flows from scheduled customer payments. The Company uses the implied cost of capital from each individual contract as the discount rate.

Also included in other long-term receivables are amounts due from a third party finance company to which the Company has sold, without recourse, the future cash flows from OTAs entered into with customers. Such receivables are recorded at the present value of the future cash flows discounted between 8.8% and 11%. As of June 30, 2013, the following amounts were due from the third party finance company in future periods (in thousands):

Fiscal 2014	$638
Fiscal 2015	955
Fiscal 2016	308
Fiscal 2017	9
Total gross long-term receivable	1,910
Less: amount representing interest	(235)
Net long-term receivable	$1,675

Long-Term Inventories

The Company records long-term inventory for the non-current portion of its wireless controls finished goods inventory. The inventories are stated at the lower of cost or market value with cost determined using the FIFO method.

Other Long-Term Assets

Table of Contents

Other long-term assets include long-term security deposits, prepaid licensing costs, a note receivable, deferred costs for a long-term contract, and deferred financing costs. Other long-term assets include $58,000 and $52,000 of deferred financing costs as of March 31, 2013 and June 30, 2013, respectively. Deferred financing costs related to debt issuances are amortized to interest expense over the life of the related debt issue (5 to 10 years).

Accrued Expenses and Other

Accrued expenses include warranty accruals, accrued wages and benefits, accrued vacation, accrued legal costs, accrued commissions, accrued project costs, sales tax payable and other various unpaid expenses. Accrued expenses include $1.3 million and $1.6 million of accrued reorganization and settlement costs as of March 31, 2013 and June 30, 2013.

The Company generally offers a limited warranty of one year on its products in addition to those standard warranties offered by major original equipment component manufacturers. The manufacturers' warranties cover lamps and ballasts, which are significant components in the Company's products.

Changes in the Company's warranty accrual were as follows (in thousands):

	Three Months Ended June 30,	
	2012	2013
Beginning of period	$84	$284
Provision to product cost of revenue	15	149
Charges	(9)	(146)
End of period	$90	$287

Revenue Recognition

Revenue is recognized on the sales of our lighting and related energy efficiency systems and products when the following four criteria are met:

- persuasive evidence of an arrangement exists;
- delivery has occurred and title has passed to the customer;
- the sales price is fixed and determinable and no further obligation exists; and
- collectability is reasonably assured.

These four criteria are met for the Company's product-only revenue upon delivery of the product and title passing to the customer. At that time, the Company provides for estimated costs that may be incurred for product warranties and sales returns. Revenues are presented net of sales tax and other sales related taxes.

For sales of the Company's lighting and energy management technologies, consisting of multiple elements of revenue, such as a combination of product sales and services, the Company determines revenue by allocating the total contract revenue to each element based on their relative selling prices in accordance with ASC 605-25, Revenue Recognition - Multiple Element Arrangements. In such circumstances, the Company uses a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (1) vendor-specific objective evidence (VSOE) of fair value, if available, (2) third-party evidence (TPE) of selling price if VSOE is not available, and (3) best estimate of the selling price if neither VSOE nor TPE is available (a description as to how the Company determined estimated selling price is provided below).

The nature of the Company's multiple element arrangements for the sale of its lighting and energy management technologies is similar to a construction project, with materials being delivered and contracting and project management activities occurring according to an installation schedule. The significant deliverables include the shipment of products and related transfer of title and the installation.

To determine the selling price in multiple-element arrangements, the Company established the selling price for its HIF lighting and energy management system products using management's best estimate of the selling price, as VSOE or TPE does not exist. Product revenue is recognized when products are shipped. For product revenue, management's best estimate of selling price is determined using a cost plus gross profit margin method. In addition, the Company records in service revenue the selling price for its installation and recycling services using management's best estimate of selling price, as VSOE or TPE does not exist. Service revenue is recognized when services are completed and customer acceptance has been received. Recycling services provided in connection with installation entail the disposal of the customer's legacy lighting fixtures. The Company's service revenues, other than for installation and recycling that are completed prior to delivery of the product, are included in product revenue using management’s best estimate of selling price, as VSOE or TPE does not exist. These services include comprehensive site assessment, site field verification, utility incentive and government subsidy management, engineering design, and project management. For these services, along with the Company's installation and recycling services, under a multiple-element arrangement, management’s best estimate of selling price is determined by considering several external and internal factors including, but not limited to, economic conditions and trends, customer demand, pricing practices, margin objectives, competition, geographies in which the Company offers its products and services and internal costs. The determination of estimated selling price is made through consultation with and approval by management, taking into account all of the preceding factors.

For sales of solar photovoltaic systems, which are governed by customer contracts that require the Company to deliver functioning solar power systems and are generally completed within three to 15 months from the start of construction, the Company recognizes revenue from fixed price construction contracts using the percentage-of-completion method in accordance with ASC 605-35, Construction-Type and Production-Type Contracts. Under this method, revenue arising from fixed price construction contracts is recognized as work is performed based upon the percentage of incurred costs to estimated total forecasted costs. The Company has determined that the appropriate method of measuring progress on these sales is measured by the percentage of costs incurred to date of the total estimated costs for each contract as materials are installed. The percentage-of-completion method requires revenue recognition from the delivery of products to be deferred and the cost of such products to be capitalized as a deferred cost and asset on the balance sheet. The Company performs periodic evaluations of the progress of the installation of the solar photovoltaic systems using actual costs incurred over total estimated costs to complete a project. Provisions for estimated losses on uncompleted contracts, if any, are recognized in the period in which the loss first becomes probable and reasonably estimable.

The Company offers a financing program, called an OTA, for a customer’s lease of the Company’s energy management systems. The OTA is structured as a sales-type lease and upon successful installation of the system and customer acknowledgment that the system is operating as specified, revenue is recognized at the Company’s net investment in the lease, which typically is the net present value of the future cash flows.

The Company offers a financing program, called a power purchase agreement, or PPA, for the Company’s renewable energy product offerings. A PPA is a supply side agreement for the generation of electricity and subsequent sale to the end user. Upon the customer’s acknowledgment that the system is operating as specified, product revenue is recognized on a monthly basis over the life of the PPA contract, which is typically in excess of 10 years.

Deferred revenue relates to advance customer billings, investment tax grants received related to PPAs and a separate obligation to provide maintenance on OTAs and is classified as a liability on the Consolidated Balance Sheet. The fair value of the maintenance is readily determinable based upon pricing from third-party vendors. Deferred revenue related to maintenance services is recognized when the services are delivered, which occurs in excess of a year after the original OTA contract is executed.

Income Taxes

The Company recognizes deferred tax assets and liabilities for the future tax consequences of temporary differences between financial reporting and income tax basis of assets and liabilities, measured using the enacted tax rates and laws expected to be in effect when the temporary differences reverse. Deferred income taxes also arise from the future tax benefits of operating loss and tax credit carryforwards. A valuation allowance is established when management determines that it is more likely than not that all or a portion of a deferred tax asset will not be realized. As of June 30, 2013, the Company has a valuation allowance of $7.5 million against its deferred tax assets.

ASC 740, Income Taxes, also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination. The Company has classified the amounts recorded for uncertain tax benefits in the balance sheet as other liabilities (non-current) to the extent that payment is not anticipated within one year. The Company recognizes penalties and interest related to uncertain tax liabilities in income tax expense. Penalties and interest are immaterial and are included in the unrecognized tax benefits.

Deferred tax benefits have not been recognized for income tax effects resulting from the exercise of non-qualified stock options. These benefits will be recognized in the period in which the benefits are realized as a reduction in taxes payable and an increase in additional paid-in capital. For the three months ended June 30, 2012 and 2013, realized tax benefits from the exercise of stock options were $27,000 and $0, respectively.

Stock Option Plans

Table of Contents

The fair value of each option grant for the three months ended June 30, 2012 and 2013 was determined using the assumptions in the following table:

	Three Months Ended June 30,	
	2012	2013
Weighted average expected term	5.5 years	4.1 years
Risk-free interest rate	0.8 %	0.8 %
Expected volatility	74.4 %	73.3 %
Expected forfeiture rate	15.1 %	21.4 %

Net (Loss) Income per Common Share

Basic net (loss) income per common share is computed by dividing net (loss) income attributable to common shareholders by the weighted-average number of common shares outstanding for the period and does not consider common stock equivalents.

Diluted net (loss) income per common share reflects the dilution that would occur if warrants and employee stock options were exercised. In the computation of diluted net (loss) income per common share, the Company uses the "treasury stock" method for outstanding options, warrants and restricted shares. Diluted net loss per common share is the same as basic net loss per common share for the three months ended June 30, 2012 and 2013, because the effects of potentially dilutive securities are anti-dilutive. The effect of net (loss) income per common share is calculated based upon the following shares (in thousands except share amounts):

	Three Months Ended June 30,	
	2012	2013
Numerator:		
Net loss (in thousands)	$(1,940)	$(781)
Denominator:		
Weighted-average common shares outstanding	22,561,135	20,173,743
Weighted-average effect of assumed conversion of stock options and warrants	—	—
Weighted-average common shares and common share equivalents outstanding	22,561,135	20,173,743
Net loss per common share:		
Basic	$(0.09)	$(0.04)
Diluted	$(0.09)	$(0.04)

The following table indicates the number of potentially dilutive securities outstanding as of the end of each period:

	June 30, 2012	June 30, 2013
Common stock options	4,272,747	3,459,091
Restricted shares	138,750	270,788
Common stock warrants	38,980	38,980
Total	4,450,477	3,768,859

Concentration of Credit Risk and Other Risks and Uncertainties

The Company purchases its solar panels from multiple suppliers. For the three months ended June 30, 2012, no panel supplier accounted for more than 10% of total cost of revenue. For the three months ended June 30, 2013, purchases from one supplier accounted for 13% of total cost of revenue.

For the three months ended June 30, 2012, no customer accounted for more than 10% of revenue. For the three months ended June 30, 2013, one customer accounted for 22% of revenue.

As of March 31, 2013, no customer accounted for more than 10% of accounts receivable. As of June 30, 2013, one customer accounted for 23% of accounts receivable.

Recent Accounting Pronouncements

Table of Contents

In December 2011, the FASB issued ASU No. 2011-11, “Balance Sheet: Disclosures about Offsetting Assets and Liabilities.” ASU 2011-11 requires entities to disclose information about offsetting and related arrangements of financial instruments and derivative instruments and will be applied retrospectively for all comparative periods presented. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of ASU 2011-11 did not have a significant impact on the Company’s consolidated financial statements.

In October 2012, the FASB issued ASU No. 2012-04, "Technical Corrections and Improvements", which amends a wide variety of Topics in the FASB Accounting Standards Codification ("Codification" or "ASC"). The amendments in ASU No. 2012-04 represent changes to clarify the Codification, correct unintended application of guidance, or make minor improvements to the Codification that are not expected to have a significant effect on current accounting practice. Additionally, the amendments make the Codification easier to understand and the fair value measurement guidance easier to apply by eliminating inconsistencies and providing needed clarifications. Amendments in ASU 2012-04 that do not provide transition guidance were effective upon issuance for public entities. Amendments that are subject to the transition guidance are effective for fiscal periods beginning after December 15, 2012. The adoption of ASU 2012-04 did not have a significant impact on the Company’s consolidated financial statements.

NOTE C — RELATED PARTY TRANSACTIONS

During the three months ended June 30, 2012 and 2013, the Company purchased goods and services from an entity in the amounts of $40,000 and $0, respectively, for which a director of the Company serves as a member of the board of directors.

NOTE D — LONG-TERM DEBT

Long-term debt as of March 31, 2013 and June 30, 2013 consisted of the following (in thousands):

	March 31, 2013	June 30, 2013
Term note	$263	$193
Customer equipment finance notes payable	4,408	3,724
First mortgage note payable	694	673
Debenture payable	721	710
Other long-term debt	620	556
Total long-term debt	6,706	5,856
Less current maturities	(2,597)	(2,451)
Long-term debt, less current maturities	$4,109	$3,405

Revolving Credit Agreement

The Company has a credit agreement (Credit Agreement) with JP Morgan Chase Bank, N.A. (JP Morgan). The Credit Agreement provides for a revolving credit facility (Credit Facility) that matures on August 30, 2013. Borrowings under the Credit Facility are limited to $15.0 million, subject to a borrowing base requirement when the outstanding principal balance of loans under the Credit Facility is greater than $5.0 million. Such commitment includes a $2.0 million sublimit for the issuance of letters of credit. As of June 30, 2013, the Company had outstanding letters of credit totaling $1.7 million, primarily for securing collateral requirements under equipment operating leases. There were no loans outstanding under the Credit Agreement as of March 31, 2013 or June 30, 2013. In February 2013, the Company completed an amendment to the Credit Agreement making certain changes to the financial covenants, which are described below. In June 2013, due to the timing of the closing of the Harris acquisition, the Company completed an amendment to extend the maturity date to August 30, 2013.

The Credit Agreement, as amended, requires the Company to maintain (i) a ratio of total liabilities to tangible net worth not to exceed 0.50 to 1.00 as of the last day of any fiscal quarter, (ii) average daily unencumbered liquidity of at least $20.0 million during each period of three consecutive business days and (iii) EBITDA of at least $1.0 million during each fiscal quarter. The Credit Agreement also contains certain restrictions on the ability of the Company to make capital or lease expenditures over prescribed limits, incur additional indebtedness, consolidate or merge, guarantee obligations of third parties, make loans or advances, declare or pay any dividend or distribution on its stock, redeem or repurchase shares of its stock or pledge assets. The Company was not in compliance with the EBITDA covenant in the Credit Agreement, as amended, as of June 30, 2013. The Company expects to receive a waiver to the EBITDA covenant noncompliance, and to establish a revised EBITDA requirement, as part of its renewal of the Credit Agreement, which is expected to be completed before the end of August 2013.

Table of Contents

The Credit Agreement is secured by a first priority security interest in the Company's accounts receivable, inventory and general intangibles, and a second priority security interest in the Company's equipment and fixtures. All OTAs, PPAs, leases, supply agreements and/or similar agreements relating to solar PV and wind turbine systems or facilities, as well as all accounts receivable and assets of the Company related to the foregoing, are excluded from these liens, except to the extent the Company elects to finance any such assets with JP Morgan.

Borrowings under the Credit Agreement bear interest based on LIBOR plus an applicable margin (the Applicable Margin), which ranges from 2.0% to 3.0% per annum based on the Company's debt service coverage ratio from time to time. The Company must pay a fee ranging between 0.25% and 0.50% per annum on the average daily unused amount of the Credit Facility (with the amount of such fee based on the Company's debt service coverage ratio from time to time) and a fee in the amount of the Applicable Margin on the daily average face amount of undrawn issued letters of credit. The fee on unused amounts is waived if the Company or its affiliates maintain funds on deposit with JP Morgan or its affiliates above a specified amount. The deposit threshold requirement was not met as of June 30, 2013.

OTA Credit Agreement

The Company has a credit agreement with JP Morgan that provided up to $5.0 million that was immediately available to fund completed customer contracts under its OTA finance program. The Company had one year from the date of the commitment to borrow under the credit agreement, which expired on September 30, 2012 for new borrowings. As of June 30, 2013, the Company had $1.6 million outstanding under the credit agreement. There were no new borrowings during fiscal 2013. The loan amount is collateralized by the OTA-related equipment and the expected future monthly payments under the supporting 37 individual OTA customer contracts. The current loan amount under the credit agreement bears interest at LIBOR plus 4% and matures in December 2016. In February 2013, the Company completed an amendment to the credit agreement making certain changes to the financial covenants requiring the Company to maintain (i) average daily unencumbered liquidity of at least $20.0 million during each period of three consecutive business days and (ii) EBITDA of at least $1.0 million during each fiscal quarter. The Company was not in compliance with the EBITDA covenant, as amended, in the credit agreement as of June 30, 2013. The Company expects to receive a waiver to the EBITDA covenant noncompliance, and to establish a revised EBITDA requirement, as part of its renewal of the Credit Agreement, which is expected to be completed before the end of August 2013.

NOTE E — INCOME TAXES

The income tax provision for the three months ended June 30, 2013 was determined by applying an estimated annual effective tax rate of (1.7)% to loss before taxes. The estimated effective income tax rate was determined by applying statutory tax rates to pretax loss adjusted for certain permanent book to tax differences and tax credits. As of June 30, 2013, the Company has recorded a valuation allowance of $7.5 million, equaling the net deferred tax asset due to the uncertainty of its realization value in the future. ASC 740, Income Taxes, requires that a deferred tax asset be reduced by a valuation allowance if there is less than a 50% chance that it will be realized. The determination of the realization of deferred tax assets requires considerable judgment. ASC 740 prescribes the consideration of both positive and negative evidence in evaluating the need for a valuation allowance. Negative evidence for the Company includes a cumulative three year operating loss and limited visibility into future earnings. While the Company has positive evidence with a strong backlog of orders, the Company has determined that the current negative evidence outweighs the current positive evidence and has concluded that the conservative approach is to record a valuation allowance. The estimated effective income tax rate was determined by applying statutory tax rates to pretax loss adjusted for certain permanent book to tax differences and tax credits.

Below is a reconciliation of the statutory federal income tax rate and the effective income tax rate:

	Three Months Ended June 30,			
	2012		2013	
Statutory federal tax rate	34.0	%	34.0	%
State taxes, net	5.2	%	1.9	%
Federal tax credit	—	%	12.5	%
State tax credit	—	%	4.1	%

Change in valuation reserve	—	%	(53.0	)%
Permanent items	5.5	%	0.1	%
Change in tax contingency reserve	0.1	%	(0.3	)%
Other, net	—	%	(1.0	)%
Effective income tax rate	44.8	%	(1.7	)%

The Company is eligible for tax benefits associated with the excess of the tax deduction available for exercises of non-qualified stock options, or NQSOs, over the amount recorded at grant. The amount of the benefit is based on the ultimate deduction reflected in the applicable income tax return. Benefits of $70,000 were recorded in fiscal 2013 as a reduction in taxes payable and a credit to additional paid in capital based on the amount that was utilized during the year. Benefits of $0 were recorded for the three months ended June 30, 2013.

As of June 30, 2013, the Company had federal net operating loss carryforwards of approximately $11.8 million, of which $3.0 million are associated with the exercise of NQSOs that have not yet been recognized by the Company. The Company also has state net operating loss carryforwards of approximately $11.2 million, of which $4.1 million are associated with the exercise of NQSOs. The Company also has federal tax credit carryforwards of approximately $1.5 million and state tax credits of $0.5 million. As of June 30, 2013, the Company has recorded a valuation allowance of $7.5 million, equaling the net deferred tax asset due to the uncertainty of its realization value in the future. The Company considers future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance. In the event that the Company determines that the deferred tax assets are able to be realized, an adjustment to the deferred tax asset would increase income in the period such determination is made.

Uncertain Tax Positions

As of June 30, 2013, the balance of gross unrecognized tax benefits was approximately $0.2 million, all of which would reduce the Company’s effective tax rate if recognized. The Company does not expect this amount to change during fiscal 2014 as none of the issues are currently under examination, the statutes of limitations do not expire within the period, and the Company is not aware of any pending litigation. Due to the existence of net operating loss and credit carryforwards, all years since 2002 are open to examination by tax authorities.

The Company has classified the amounts recorded for uncertain tax benefits in the balance sheet as other liabilities (non-current) to the extent that payment is not anticipated within one year. The Company recognizes penalties and interest related to uncertain tax liabilities in income tax expense. Penalties and interest are immaterial as of the date of adoption and are included in the unrecognized tax benefits. For the three months ended June 30, 2012 and 2013, the Company had the following unrecognized tax benefit activity (in thousands):

	Three Months Ended June 30,	
	2012	2013
Unrecognized tax benefits as of beginning of period	$406	$188
Additions based on tax positions related to the current period positions	—	2
Reduction due to lapse of statute of limitations	(5)	—
Unrecognized tax benefits as of end of period	$401	$190

NOTE F — COMMITMENTS AND CONTINGENCIES

Operating Leases and Purchase Commitments

The Company leases vehicles and equipment under operating leases expiring at various dates through 2021. Rent expense under operating leases was $0.5 million and $0.3 million for the three months ended June 30, 2012 and 2013, respectively. The Company enters into non-cancellable purchase commitments for certain inventory items in order to secure better pricing and ensure materials are on hand to meet anticipated order volume and customer expectations, as well as for capital expenditures. As of June 30, 2013, the Company had entered into $9.4 million of purchase commitments related to fiscal 2014, including $1.0 million for operating lease commitments and $5.7 million for inventory purchase commitments.

NOTE G — SHAREHOLDERS’ EQUITY

Shareholder Rights Plan

On January 7, 2009, the Company’s Board of Directors adopted a shareholder rights plan and declared a dividend distribution of one common share purchase right (a “Right”) for each outstanding share of the Company’s common stock. The issuance date for the distribution of the Rights was February 15, 2009 to shareholders of record on February 1, 2009. Each Right entitles the registered holder to purchase from the Company one share of the Company’s common stock at a price of $30.00 per share, subject to adjustment (the “Purchase Price”).

The Rights will not be exercisable (and will be transferable only with the Company's common stock) until a "Distribution Date" occurs (or the Rights are earlier redeemed or expire). A Distribution Date generally will occur on the earlier of a public announcement that a person or group of affiliated or associated persons (an "Acquiring Person") has acquired beneficial ownership of 20% or more of the Company's outstanding common stock (a "Shares Acquisition Date") or 10 business days after the commencement of, or the announcement of an intention to make, a tender offer or exchange offer that would result in any such person or group of persons acquiring such beneficial ownership.

If a person becomes an Acquiring Person, holders of Rights (except as otherwise provided in the shareholder rights plan) will have the right to receive that number of shares of the Company's common stock having a market value of two times the then-current Purchase Price, and all Rights beneficially owned by an Acquiring Person, or by certain related parties or transferees, will be null and void. If, after a Shares Acquisition Date, the Company is acquired in a merger or other business combination transaction or 50% or more of its consolidated assets or earning power are sold, proper provision will be made so that each holder of a Right (except as otherwise provided in the shareholder rights plan) will thereafter have the right to receive that number of shares of the acquiring company's common stock which at the time of such transaction will have a market value of two times the then-current Purchase Price.

Until a Right is exercised, the holder thereof, as such, will have no rights as a shareholder of the Company. At any time prior to a person becoming an Acquiring Person, the Board of Directors of the Company may redeem the Rights in whole, but not in part, at a price of $0.001 per Right. Unless they are extended or earlier redeemed or exchanged, the Rights will expire on January 7, 2019.

Employee Stock Purchase Plan

In August 2010, the Company's Board of Directors approved a non-compensatory employee stock purchase plan, or ESPP. The ESPP authorizes 2,500,000 shares to be issued from treasury or authorized shares to satisfy employee share purchases under the ESPP. All full-time employees of the Company are eligible to be granted a non-transferable purchase right each calendar quarter to purchase directly from the Company up to $20,000 of the Company's common stock at a purchase price equal to 100% of the closing sale price of the Company's common stock on the NYSE MKT exchange on the last trading day of each quarter. The ESPP allows for employee loans from the Company, except for Section 16 officers, limited to 20% of an individual's annual income and no more than $250,000 outstanding at any one time. Interest on the loans is charged at the 10-year loan IRS rate and is payable at the end of each calendar year or upon loan maturity. The loans are secured by a pledge of any and all the Company's shares purchased by the participant under the ESPP and the Company has full recourse against the employee, including offset against compensation payable. As of March 31, 2013, the Company had halted the loan program. The Company had the following shares issued from treasury for cash purchases as of March 31, 2013 and for the three months ended June 30, 2013:

	Shares Issued Under ESPP Plan	Closing Market Price	Shares Issued Under Loan Program	Dollar Value of Loans Issued	Repayment of Loans
Cumulative through March 31, 2013	150,408	$1.66-4.04	128,143	$361,550	$96,441
Quarter Ended June 30, 2013	990	$2.48	—	—	823
Total as of June 30, 2013	151,398	$1.66 - 4.04	128,143	$361,550	$97,264

Loans issued to employees are reflected on the Company's balance sheet as a contra-equity account.

Share Repurchase Program

In October 2011, the Company's Board of Directors approved a share repurchase program authorizing the Company to repurchase in aggregate up to a maximum of $1.0 million of the Company's outstanding common stock. In November 2011, the Company's Board of Directors approved an increase to the share repurchase program authorizing the Company to repurchase in aggregate up to a maximum of $2.5 million of the Company's outstanding common stock. In April 2012, the Company's Board approved another increase to the share repurchase program authorizing the Company to repurchase in aggregate up to a maximum of $7.5 million of the Company's outstanding common stock. As of June 30, 2013, the Company had repurchased 3,002,200 shares of common stock at a cost of $6,742,000 under the program. The Company does not intend to repurchase common stock under this program in the near-term.

NOTE H — STOCK OPTIONS, RESTRICTED SHARES AND WARRANTS

The Company grants stock options and restricted stock awards under its 2003 Stock Option and 2004 Stock and Incentive Awards Plans (the Plans). Under the terms of the Plans, the Company has reserved 13,500,000 shares for issuance to key employees, consultants and directors. The options generally vest and become exercisable ratably between 1 month and 5 years although longer vesting periods have been used in certain circumstances. Exercisability of the options granted to employees are generally contingent on the employees' continued employment and non-vested options are subject to forfeiture if employment

Table of Contents

terminates for any reason. Options under the Plans have a maximum life of 10 years. In the past, the Company has granted both ISOs and NQSOs, although in July 2008, the Company adopted a policy of thereafter only granting NQSOs. Certain non-employee directors have elected to receive stock awards in lieu of cash compensation pursuant to elections made under the Company's non-employee director compensation program. The Plans also provide to certain employees accelerated vesting in the event of certain changes of control of the Company as well as under other special circumstances.

In fiscal 2011, the Company converted all of its existing ISO awards to NQSO awards. No consideration was given to the employees for their voluntary conversion of ISO awards.

In June 2012, the Compensation Committee of the Board of Directors approved the issuance of restricted shares under the Plans to key employees to provide an opportunity for such employees to earn long-term equity incentive awards. The restricted shares are settled in Company stock when the restriction period ends. Compensation cost for restricted shares granted to employees is recognized ratably over the vesting term, which is between three to five years. Settlement of the shares is contingent on the employees' continued employment and non-vested shares are subject to forfeiture if employment terminates for any reason. For the three months ended June 30, 2013, an aggregate of 186,788 of restricted shares were granted valued at a price per share between $2.41 and $2.42, which was the closing market price as of each grant date.

For the three months ended June 30, 2012 and 2013, the Company issued 13,547 and 13,714 shares under the 2004 Stock and Incentive Awards Plan to certain non-employee directors who elected to receive stock awards in lieu of cash compensation. The shares were valued at $2.03 per share and $2.41 per share, respectively, the closing market prices as of the issuance dates. Additionally, during the three months ended June 30, 2012, the Company issued 3,000 shares to a consultant as part of a consulting compensation agreement. The shares were valued at $2.03 per share, the closing market price as of the issuance date.

The following amounts of stock-based compensation were recorded (in thousands):

	Three Months Ended June 30,	
	2012	2013
Cost of product revenue	$31	$20
General and administrative	150	221
Sales and marketing	177	126
Research and development	8	3
Total	$366	$370

As of June 30, 2013, compensation cost related to non-vested common stock-based compensation, excluding restricted share awards, amounted to $2.5 million over a remaining weighted average expected term of 6.5 years.

The following table summarizes information with respect to the Plans:

	Options Outstanding				
	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Balance at March 31, 2013	1,632,778	3,312,523	$3.42	6.54	
Granted stock options	(305,544)	305,544	2.41		
Granted shares	(13,714)	—	—		
Restricted shares	(186,788)	—	—		
Forfeited restricted shares	6,250	—	—		
Forfeited stock options	142,476	(142,476)	2.57		
Exercised	—	(16,500)	2.03		
Balance at June 30, 2013	1,275,458	3,459,091	$3.37	6.52	$556,937
Exercisable at June 30, 2013		1,475,356	$4.07	4.85	$181,506

The aggregate intrinsic value represents the total pre-tax intrinsic value, which is calculated as the difference between the exercise price of the underlying stock options and the fair value of the Company's closing common stock price of $2.48 as of June 28, 2013.

Table of Contents

A summary of the status of the Company’s outstanding non-vested stock options as of June 30, 2013 was as follows:

Non-vested at March 31, 2013	1,747,805
Granted	305,544
Vested	(226,521)
Forfeited	(142,476)
Non-vested at June 30, 2013	1,684,352

During the first three months of fiscal 2014, the Company granted restricted shares as follows (which are included in the above stock plan activity tables):

Balance at March 31, 2013	105,000
Shares issued	186,788
Shares vested	(14,750)
Shares forfeited	(6,250)
Shares outstanding at June 30, 2013	270,788
Per share price on grant date	$1.80-2.42
Compensation expense for three months ended June 30, 2013	$22,683

As of June 30, 2013, the amount of deferred stock-based compensation related to grants of restricted shares, to be recognized over a remaining period of 4.25 years, was approximately $0.6 million.

The Company has previously issued warrants in connection with various private placement stock offerings and services rendered. The warrants granted the holder the option to purchase common stock at specified prices for a specified period of time. No warrants were issued in fiscal 2013 or during the three months ended June 30, 2013.

A summary of outstanding warrants at June 30, 2013 follows:

	Number of Shares	Exercise Price	Expiration
Balance at March 31, 2013	38,980	$2.25	Fiscal 2015
Balance at June 30, 2013	38,980	$2.25	

March 31, 2006	2,150,083	$	12.90	2,150,083	$ 206,000,000
Total	3,470,183	$	12.72	3,470,183	

Item 6: Exhibits

Exhibit No.	Description of Exhibit
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a 14(a) or 15d 14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a 14(a) or 15d 14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURE

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.

Date: May 9, 2006

THE SERVICEMASTER COMPANY
(Registrant)

By: /s/ Ernest J. Mrozek

Ernest J. Mrozek
President and Chief Financial Officer

29