PERMA FIX ENVIRONMENTAL SERVICES INC
Form 10-Q
November 10, 2008

**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 September 30, 2008**

**Or**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the transition period from _______________ to ___________________**

Commission File No. 111596

**PERMA-FIX ENVIRONMENTAL SERVICES, INC.**
*(Exact name of registrant as specified in its charter)*

| | |
|---|---|
| **Delaware** | **58-1954497** |
| *(State or other jurisdiction of incorporation or organization)* | *(IRS Employer Identification Number)* |
| **8302 Dunwoody Place, Suite 250, Atlanta, GA** | **30350** |
| *(Address of principal executive offices)* | *(Zip Code)* |

**(770) 587-9898**
*(Registrant's telephone number)*

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 T 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 definition of "large accelerated filer," “accelerated filer" and “smaller reporting

company” in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer £ Accelerated Filer T Non-accelerated Filer £ Smaller reporting company £

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

Indicate the number of shares outstanding of each of the issuer's classes of Common Stock, as of the close of the latest practical date.

| Class | Outstanding at November 3, 2008 |
|---|---|
| Common Stock, $.001 Par Value | 53,908,700 shares of registrant’s Common Stock |

**PERMA-FIX ENVIRONMENTAL SERVICES, INC.**

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**PART I - FINANCIAL INFORMATION**
**ITEM 1. - FINANCIAL STATEMENTS**

**PERMA-FIX ENVIRONMENTAL SERVICES, INC.**
**CONSOLIDATED BALANCE SHEETS**

| (Amount in Thousands, Except for Share Amounts) | September 30, 2008 (Unaudited) | December 31, 2007 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash | $ 91 | $ 118 |
| Restricted cash | 55 | 55 |
| Accounts receivable, net of allowance for doubtful accounts of $184 and $203, respectively | 8,541 | 14,961 |
| Unbilled receivables - current | 11,286 | 10,433 |
| Inventories | 321 | 332 |
| Prepaid and other assets | 3,318 | 3,206 |
| Current assets related to discontinued operations | 177 | 3,505 |
| Total current assets | 23,789 | 32,610 |
| | | |
| Property and equipment: | | |
| Buildings and land | 23,238 | 23,929 |
| Equipment | 31,397 | 32,240 |
| Vehicles | 993 | 1,302 |
| Leasehold improvements | 11,462 | 11,462 |
| Office furniture and equipment | 1,899 | 2,349 |
| Construction-in-progress | 2,812 | 1,673 |
| | 71,801 | 72,955 |
| Less accumulated depreciation and amortization | (22,979) | (23,161) |
| Net property and equipment | 48,822 | 49,794 |
| | | |
| Net property and equipment held for sale | 349 | 349 |
| | | |
| Property and equipment related to discontinued operations | 666 | 3,942 |
| | | |
| Intangibles and other long term assets: | | |
| Permits | 16,991 | 16,826 |
| Goodwill | 10,822 | 9,046 |
| Unbilled receivables - non-current | 3,661 | 3,772 |
| Finite Risk Sinking Fund | 10,739 | 6,034 |
| Other assets | 2,320 | 2,496 |
| Intangible and other assets related to discontinued operations | — | 1,179 |
| Total assets | $ 118,159 | $ 126,048 |

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

**PERMA-FIX ENVIRONMENTAL SERVICES, INC.**
**CONSOLIDATED BALANCE SHEETS, CONTINUED**

| (Amount in Thousands, Except for Share Amounts) | September 30, 2008 (Unaudited) | December 31, 2007 |
|---|---|---|
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $ 6,606 | $ 5,907 |
| Current environmental accrual | 228 | 475 |
| Accrued expenses | 10,514 | 9,982 |
| Disposal/transportation accrual | 6,818 | 6,850 |
| Unearned revenue | 1,933 | 4,978 |
| Current liabilities related to discontinued operations | 1,356 | 6,220 |
| Current portion of long-term debt | 3,875 | 15,352 |
| Total current liabilities | 31,330 | 49,764 |
| | | |
| Environmental accruals | 653 | 705 |
| Accrued closure costs | 10,679 | 8,901 |
| Other long-term liabilities | 441 | 968 |
| Long-term liabilities related to discontinued operations | 1,877 | 2,817 |
| Long-term debt, less current portion | 11,234 | 2,880 |
| Total long-term liabilities | 24,884 | 16,271 |
| | | |
| Total liabilities | 56,214 | 66,035 |
| | | |
| Commitments and Contingencies | | |
| | | |
| Preferred Stock of subsidiary, $1.00 par value; 1,467,396 shares authorized, 1,284,730 shares issued and outstanding, liquidation value $1.00 per share | 1,285 | 1,285 |
| | | |
| Stockholders' equity: | | |
| Preferred Stock, $.001 par value; 2,000,000 shares authorized, no shares issued and outstanding | ¾ | ¾ |
| Common Stock, $.001 par value; 75,000,000 shares authorized, 53,908,700 and 53,704,516 shares issued and outstanding, respectively | 54 | 54 |
| Additional paid-in capital | 97,129 | 96,409 |
| Stock subscription receivable | ¾ | (25) |
| Accumulated deficit | (36,523) | (37,710) |
| | | |
| Total stockholders' equity | 60,660 | 58,728 |
| | | |
| Total liabilities and stockholders' equity | $ 118,159 | $ 126,048 |

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

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**PERMA-FIX ENVIRONMENTAL SERVICES, INC.**
**CONSOLIDATED STATEMENTS OF OPERATIONS**
**(Unaudited)**

| (Amounts in Thousands, Except for Per Share Amounts) | Three Months Ended September 30, 2008 | Three Months Ended September 30, 2007 | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 |
|---|---|---|---|---|
| Net revenues | $ 15,989 | $ 16,306 | $ 51,961 | $ 48,452 |
| Cost of goods sold | 11,884 | 11,693 | 37,536 | 33,564 |
| Gross profit | 4,105 | 4,613 | 14,425 | 14,888 |
| | | | | |
| Selling, general and administrative expenses | 4,711 | 4,691 | 13,818 | 13,493 |
| Asset impairment recovery | (507) | ¾ | (507) | ¾ |
| (Gain) loss on disposal of property and equipment | (2) | (13) | 139 | 99 |
| (Loss) income from operations | (97) | (65) | 975 | 1,296 |
| | | | | |
| Other income (expense): | | | | |
| Interest income | 52 | 71 | 170 | 238 |
| Interest expense | (231) | (482) | (917) | (964) |
| Interest expense-financing fees | (14) | (48) | (124) | (143) |
| Other | ¾ | (40) | (5) | (55) |
| (Loss) income from continuing operations before taxes | (290) | (564) | 99 | 372 |
| Income tax (benefit) expense | (14) | (161) | 3 | 23 |
| (Loss) income from continuing operations | (276) | (403) | 96 | 349 |
| | | | | |
| Loss from discontinued operations, net of taxes | (159) | (1,549) | (1,218) | (2,163) |
| Gain on disposal of discontinued operations, net of taxes | 94 | ¾ | 2,309 | ¾ |
| Net (loss) income applicable to Common Stockholders | $ (341) | $ (1,952) | $ 1,187 | $ (1,814) |
| | | | | |
| Net (loss) income per common share - basic | | | | |
| Continuing operations | $ (.01) | $ (.01) | $ ¾ | $ .01 |
| Discontinued operations | ¾ | (.03) | (.02) | (.04) |
| Disposal of discontinued operations | ¾ | ¾ | .04 | ¾ |
| Net (loss) income per common share | $ (.01) | $ (.04) | $ .02 | $ (.03) |
| | | | | |
| Net (loss) income per common share - diluted | | | | |
| Continuing operations | $ (.01) | $ (.01) | ¾ | $ .01 |
| Discontinued operations | ¾ | (.03) | (.02) | (.04) |
| Disposal of discontinued operations | ¾ | ¾ | .04 | ¾ |

| | | | | |
|---|---|---|---|---|
| Net (loss) income per common share | $ (.01) | $ (.04) | $ .02 | $ (.03) |
| | | | | |
| Number of common shares used in computing net income (loss) per share: | | | | |
| Basic | 53,844 | 52,843 | 53,760 | 52,349 |
| Diluted | 53,844 | 52,843 | 54,149 | 53,673 |

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

**PERMA-FIX ENVIRONMENTAL SERVICES, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Unaudited)**

| | September 30, | |
|---|---|---|
| (Amounts in Thousands) | 2008 | 2007 |
| Cash flows from operating activities: | | |
| Net income (loss) | $ 1,187 | $ (1,814) |
| Less: Income (loss) on discontinued operations (Note 9) | 1,091 | (2,163) |
| | | |
| Income from continuing operations | 96 | 349 |
| Adjustments to reconcile net income (loss) to cash provided by operations: | | |
| Depreciation and amortization | 3,817 | 2,970 |
| Asset impairment recovery | (507) | |
| Provision for bad debt and other reserves | 33 | 76 |
| Loss on disposal of property and equipment | 139 | 99 |
| Issuance of common stock for services | 201 | 165 |
| Share based compensation | 335 | 288 |
| Changes in operating assets and liabilities of continuing operations, net of effect from business acquisitions: | | |
| Accounts receivable | 6,387 | 2,710 |
| Unbilled receivables | (742) | 465 |
| Prepaid expenses, inventories, and other assets | 2,367 | 2,260 |
| Accounts payable, accrued expenses, and unearned revenue | (7,515) | (2,958) |
| Cash provided by continuing operations | 4,611 | 6,424 |
| Gain on disposal of discontinued operations (Note 9) | (2,309) | |
| Cash used in discontinued operations | (997) | (98) |
| Cash provided by operating activities | 1,305 | 6,326 |
| | | |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (810) | (2,295) |
| Proceeds from sale of plant, property and equipment | 31 | 69 |
| Change in finite risk sinking fund | (4,031) | (1,443) |
| Cash used for acquisition consideration, net of cash acquired | (14) | (2,685) |
| Cash used in investing activities of continuing operations | (4,824) | (6,354) |
| Proceeds from sale of discontinued operations (Note 9) | 6,620 | |
| Cash provided by (used in) discontinued operations | 42 | (202) |
| Net cash provided by (used in) investing activities | 1,838 | (6,556) |
| | | |
| Cash flows from financing activities: | | |
| Net (repayments) borrowing of revolving credit | (3,483) | 5,202 |
| Principal repayments of long term debt | (6,658) | (7,319) |
| Proceeds from issuance of long-term debt | 7,000 | |
| Proceeds from issuance of stock | 184 | 399 |
| Repayment of stock subscription receivable | 25 | 40 |
| Cash used in financing activities of continuing operations | (2,932) | (1,678) |
| Principal repayment of long-term debt for discontinued operations | (238) | (216) |
| Cash used in financing activities | (3,170) | (1,894) |

| | | | | |
|---|---|---|---|---|
| Decrease in cash | | (27) | | (2,124) |
| Cash at beginning of period | | 118 | | 2,221 |
| Cash at end of period | $ | 91 | $ | 97 |
| | | | | |
| Supplemental disclosure: | | | | |
| Interest paid | $ | 915 | $ | 697 |
| Income taxes paid | | 29 | | 311 |
| Non-cash investing and financing activities: | | | | |
| Long-term debt incurred for purchase of property and equipment | | 20 | | 613 |
| Sinking fund financed | | 674 | | |

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

**PERMA-FIX ENVIRONMENTAL SERVICES, INC.**
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**
**(Unaudited, for the nine months ended September 30, 2008)**

| (Amounts in thousands, except for share amounts) | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Stock Subscription Receivable | Accumulated Deficit | Total Stockholders' Equity |
|---|---|---|---|---|---|---|
| **Balance at December 31, 2007** | 53,704,516 | $ 54 | $ 96,409 | $ (25) | $ (37,710) | $ 58,728 |
| Net income | ¾ | ¾ | ¾ | ¾ | 1,187 | 1,187 |
| Issuance of Common Stock for services | 93,005 | ¾ | 201 | ¾ | ¾ | 201 |
| Issuance of Common Stock upon exercise of Options | 111,179 | ¾ | 184 | ¾ | ¾ | 184 |
| Share based compensation | ¾ | ¾ | 335 | ¾ | ¾ | 335 |
| Repayment of stock subscription receivable | ¾ | ¾ | ¾ | 25 | ¾ | 25 |
| **Balance at September 30, 2008** | 53,908,700 | $ 54 | $ 97,129 | $ ¾ | $ (36,523) | $ 60,660 |

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

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**PERMA-FIX ENVIRONMENTAL SERVICES, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2008**
**(Unaudited)**

Reference is made herein to the notes to consolidated financial statements included in our Annual Report on Form 10-K and Form 10-K/A for the year ended December 31, 2007.

## 1. Basis of Presentation

The consolidated financial statements included herein have been prepared by the Company (which may be referred to as we, us or our), without an audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and note disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (“GAAP”) in the United States of America have been condensed or omitted pursuant to such rules and regulations, although the Company believes the disclosures which are made are adequate to make the information presented not misleading. Further, the consolidated financial statements reflect, in the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position and results of operations as of and for the periods indicated. The results of operations for the nine months ended September 30, 2008, are not necessarily indicative of results to be expected for the fiscal year ending December 31, 2008.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K and Form 10-K/A for the year ended December 31, 2007.

As previously disclosed, on May 18, 2007, our Board of Directors authorized divestiture of our Industrial Segment, which provides treatment, storage, processing, and disposal of hazardous and non-hazardous waste, wastewater management services, and environmental services, which includes emergency response, vacuum services, marine environmental, and other remediation services. As previously disclosed, we completed the sale of the following facilities/operations within our Industrial Segment as follows: on January 8, 2008, we completed sale of substantially all of the assets of Perma-Fix Maryland, Inc. (“PFMD”) for $3,825,000 in cash, subject to a working capital adjustment during 2008, and assumption by the buyer of certain liabilities of PFMD. As of the date of this report, we estimate receiving approximately $141,000 in working capital adjustment from the buyer in the fourth quarter of 2008, subject to finalization; on March 14, 2008, we completed the sale of substantially all of the assets of Perma-Fix of Dayton, Inc. (“PFD”) for approximately $2,143,000 in cash, plus assumption by the buyer of certain of PFD’s liabilities and obligations. In June 2008, we paid the buyer approximately $209,000 due to certain working capital adjustment. We do not anticipate making any further working capital adjustments on the sale of PFD; and on May 30, 2008, we completed the sale of substantially all of the assets of Perma-Fix Treatment Services, Inc. (“PFTS”) for approximately $1,503,000, and assumption by the buyer of certain liabilities of PFTS. In July 2008, we paid the buyer approximately $135,000 in final working capital adjustments (See “- Discontinued Operations and Divestiture” in this section for accounting treatment of divestitures and working capital adjustments).

In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets”, certain assets and liabilities of the Industrial Segment were reclassified as discontinued operations in May 2007 in the Consolidated Balance Sheets, and we ceased depreciation for the long-lived assets classified as held for sale. In accordance with SFAS No. 144, the long-lived assets were written down to fair value less anticipated selling costs and we recorded $6,367,000 in impairment charges (including $507,000 for PFO and $1,329,000 for PFSG recorded in the fourth quarter of 2007), which were included in “loss from discontinued operations, net of taxes” on our Consolidated Statement of Operations for the year ended December 31, 2007.

On September 26, 2008, our Board of Directors approved retaining our Industrial Segment facilities/operations at Perma-Fix of Fort Lauderdale, Inc. (“PFFL”), Perma-Fix of South Georgia (“PFSG”), and Perma-Fix of Orlando, Inc. (“PFO”). The decision to retain operations at PFFL, PFSG, and PFO is based on our belief that these operations are self-sufficient, which should allow senior management the freedom to focus on growing our nuclear operations, while benefiting from the cash flow and growth prospects of these three facilities and the fact that we were unable in the current economic climate to obtain the values for these companies that we believe they are worth. The accompanying condensed consolidated financial statements have been restated for all periods presented to reflect the reclassification of these three facilities/operations back into our continuing operations. During the third quarter of 2008, we classified one of the two properties at PFO as “net property and equipment held for sale” within our continued operations in the Consolidated Balance Sheets in accordance to SFAS No. 144. The Company plans to continue to market this property for sale. PFO has transferred its operating permit to the property not held for sale. We do not expect any impact or reduction to PFO’s operating capability from the sale of the property at PFO. We evaluated the fair value of PFO’s assets and as a result, recorded a credit of $507,000 related to the recovery of previous impairment charges for PFO, which is included in “Asset Impairment Recovery” on the Condensed Consolidated Statements of Operations for the quarter ended September 30, 2008.

As the long-lived assets for PFFL, PFSG, and PFO facilities, (excluding the property subject to sale at our PFO facility as described above), no longer meets the held for sale criteria under SFAS No. 144, the long-lived assets for these facilities are reported individually at the lower of their respective carrying amount before they were initially classified as held for sale, adjusted for any depreciation expense that would have been recognized had these assets been continuously classified as held and used or the fair value at the date of the subsequent decision not to sell (See “Changes to Plan of Sale and Asset Impairment Charges (Recovery)” in “Notes to Consolidated Financial Statements” for impact on our consolidated financial statements).

## 2. Summary of Significant Accounting Policies

Our accounting policies are as set forth in the notes to consolidated financial statements referred to above.

**Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS 157, “Fair Value Measurements”, which simplifies and codifies guidance on fair value measurements under generally accepted accounting principles. This standard defines fair value, establishes a framework for measuring fair value, and prescribes expanded disclosures about fair value measurements. In February 2008, the FASB issued FASB Staff Position No. 157-2, “Effective Date of FASB Statement No. 157” (“FSP FAS 157-2”), which delays the effective date of SFAS 157 for certain non-financial assets and non-financial liabilities. SFAS 157 is effective for financial assets and liabilities in fiscal years beginning after November 15, 2007 and for non-financial assets and liabilities in fiscal years beginning after March 15, 2008. We have evaluated the impact of the provisions applicable to our financial assets and liabilities and have determined that there is no current impact on our financial condition, results of operations, and cash flow. The aspects that have been deferred by FSP FAS 157-2 pertaining to non-financial assets and non-financial liabilities will be effective for us beginning January 1, 2009. We are currently evaluating the impact of SFAS 157 for non-financial assets and liabilities on the Company’s financial position and results of operations.

On October 10, 2008, the FASB issued FSP FAS No. 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active”, which clarifies the application of SFAS No. 157 in an inactive market and provides an example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP FAS 157-3 was effective upon issuance, including prior periods for which financial statements have not been issued. The adoption of this FSP had no impact on our financial statements.

In September 2006, the FASB issued SFAS No. 158, "Employer's Accounting for Defined Benefit Pension and Other Postretirement Plan - an amendment of FASB Statement No. 87, 88, 106, and 132", requiring employers to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and recognize changes in the funded status in the year in which the changes occur. SFAS 158 is effective for fiscal years ending December 15, 2006. SFAS 158 did not have a material effect on our financial condition, result of operations, and cash flows.

In February 2007, the FASB issued SFAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities", permitting entities to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS 159 is expected to expand use of fair value measurement, consistent with the Board's long-term measurement objectives for accounting for financial instruments. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. If the fair value option is elected, the effect of the first re-measurement to fair value is reported as a cumulative effect adjustment to the opening balance of retained earnings. We have not elected the fair value option for any of our assets or liabilities.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations*. SFAS No. 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. Accordingly, any business combinations the Company engages in will be recorded and disclosed following existing GAAP until December 31, 2008. The Company expects SFAS No. 141R will have an impact on its consolidated financial statements when effective, but the nature and magnitude of the specific effects will depend upon the nature, terms, and size of acquisitions it consummates after the effective date.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51*. SFAS No. 160 changes the accounting and reporting for minority interest. Minority interest will be recharacterized as noncontrolling interest and will be reported as a component of equity separate from the parent's equity, and purchases or sales of equity interest that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim period within those fiscal years, except for the presentation and disclosure requirements, which will apply retrospectively. This standard is not expected to materially impact the Company's future consolidated financial statements.

In December 2007, the SEC issued SAB No. 110, which expressed the views of the staff regarding the use of a "simplified" method, as discussed in SAB No. 107, in developing an estimate of expected term of "plain vanilla" share options in accordance with SFAS No. 123R, *Share-Based Payment.* In particular, the staff indicated in SAB No. 107 that it will accept a company's election to use the simplified method, regardless of whether the Company has sufficient information to make more refined estimates of expected term. At the time SAB No. 107 was issued, the staff believed that more detailed external information about employee exercise behavior would, over time, become readily available to companies. Therefore, the SEC staff stated in SAB No. 107 that it would not expect a company to use the simplified method for share option grants after December 31, 2007. The staff understands that such detailed information about employee exercise behavior may not be widely available by December 31, 2007. Accordingly, SAB No. 110 states that the staff will continue to accept, under certain circumstances, the use of the simplified method beyond December 31, 2007. The Company does not expect SAB No. 110 to materially impact its operations or financial position.

In March 2008, the FASB issued SFAS 161, "Disclosures about Derivative Instruments and Hedging Activities". SFAS 161 amends and expands the disclosure requirements of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities", and requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company does not expect this standard to materially impact the Company's future consolidated statements.

In April 2008, the FASB issued FSP No. 142-3, *Determination of the Useful Life of Intangible Assets* ("FSP FAS 142-3"), which amends the factors to be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"). The intent of FSP FAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R) and other U.S. generally accepted accounting principles. FSP FAS 142-3 requires an entity to disclose information for a recognized intangible asset that enables users of the financial statements to assess the extent to which the expected future cash flows associated with the asset are affected by the entity's intent and/or ability to renew or extend the arrangement. FSP FAS 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The Company does not expect the adoption of FSP FAS 142-3 to materially impact the Company's financial position or results of operations.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles". SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements. SFAS No. 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles". The implementation of this standard will not have a material impact on our consolidated financial position and results of operations.

In June 2008, the FASB ratified EITF (Emerging Issues Task Force) Issue No. 08-3, "Accounting for Lessees for Maintenance Deposits Under Lease Arrangement" (EITF 08-3), to provide guidance on the accounting of nonrefundable maintenance deposits. It also provides revenue recognition accounting guidance for the lessor. EITF 08-3 is effective for fiscal years beginning after December 15, 2008. The Company is currently assessing the impact of EITF 08-3 on its consolidated financial position and results of operations.

In June 2008, the FASB ratified EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock" (EITF 07-5). EITF 07-5 provides that an entity should use a two step approach to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock, including the instrument's contingent exercise and settlement provisions. It also clarifies on the impact of foreign currency denominated strike prices and market-based employee stock option valuation instruments on the evaluation. EITF 07-5 is effective for fiscal year beginning and after December 15, 2008. The Company does not expect EITF 07-5 to materially impact the Company's future consolidated financial statements.

In September 2008, the FASB issued FSP FAS 133-1 and FIN 45-4, "Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statements No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161" ("FSP FAS 133-1 and FIN 45-4"). The FSP amends the disclosure requirements of FAS 133, "Accounting for Derivative Instruments and Hedging Activities", requiring that the seller of a credit derivative, or writer of the contract, to disclose various items for each balance sheet presented including the nature of the credit derivative, the maximum amount of potential future payments the seller could be required to make, the fair value of the derivative at the balance sheet date, and the nature of any recorded provisions available to the seller to recover from third parties any of the amounts paid under the credit derivative. The FSP also amends FASB Interpretation No. 45 ("FIN 45") "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" to require disclosure of the current status of the payment performance risk of the guarantee. The additional disclosure requirements above will be effective for reporting periods ending after November 15, 2008. It is not expected that the FSP will materially impact the Company's current disclosure process. The FSP also clarifies that the effective date of FAS 161 will be for any period, annual or interim, beginning after November 15, 2008.

**Reclassifications**
Certain prior period amounts have been reclassified to conform with the current period presentation.

## 3. Stock Based Compensation

We follow the provisions of Financial Accounting Standards Board ("FASB") Statement No. 123 (revised) ("SFAS 123R"), *Share-Based Payment*, a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, superseding APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and its related implementation guidance. This Statement establishes accounting standards for entity exchanges of equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values.

The Company has certain stock option plans under which it awards incentive and non-qualified stock options to employees, officer, and outside directors. Stock options granted to employees have either a ten year contractual term with 1/5 yearly vesting over a five year period or a six year contractual term with 1/3 yearly vesting over a three year period. Stock options granted to outside directors have a ten year contractual term with vesting period of six months. On August 5, 2008, our Board of Directors authorized the grant of 918,000 Incentive Stock Options ("ISO") to certain officers and employees of the Company which allows for the purchase of Common Stock from the Company's 2004 Stock Option Plan. The options granted were for a contractual term of six years with vesting period over three year period at 1/3 increment per year. The exercise price of the options granted was $2.28 per share which was based on our closing stock price on the date of grant. We also granted 84,000 options from the Company's 2003 Outside Directors Stock Plan to our seven outside directors as a result of the reelection our Board of Directors at our Annual Meeting of Stockholders on August 5, 2008. The options granted were for a contractual term of ten years with vesting period of six months. The exercise price of the options was $2.34 per share which was equal to our closing stock price the day preceding the grant date, pursuant to the 2003 Outside Directors Stock Plan.

As of September 30, 2008, we had 2,754,846 employee stock options outstanding, of which 1,577,013 are vested. The weighted average exercise price of the 1,577,013 outstanding and fully vested employee stock option is $1.85 with a remaining weighted contractual life of 3.29 years. Additionally, we had 645,000 director stock options outstanding, of which 561,000 are vested. The weighted average exercise price of the 561,000 outstanding and fully vested director stock option is $2.16 with a weighted remaining contractual life of 5.92 years.

The Company estimates fair value of stock options using the Black-Scholes valuation model. Assumptions used to estimate the fair value of stock options granted include the exercise price of the award, the expected term, the expected volatility of the Company's stock over the option's expected term, the risk-free interest rate over the option's expected term, and the expected annual dividend yield. The fair value of the employee and director stock options granted above and the related assumptions used in the Black-Scholes option pricing model used to value the options granted as of September 30, 2008 and September 30, 2007, were as follows:

| | Employee Stock Options Granted | |
|---|---|---|
| | September 30, 2008 | September 30, 2007 (4) |
| Weighted-average fair value per share | $ 1.17 | $ — |
| Risk -free interest rate (1) | 3.28% | — |
| Expected volatility of stock (2) | 55.54% | — |
| Dividend yield | None | — |
| Expected option life (3) | 5.1 years | — |

| | Outside Director Stock Options Granted | |
|---|---|---|
| | September 30, 2008 | September 30, 2007 |
| Weighted-average fair value per share | $ 1.79 | $ 2.30 |
| Risk -free interest rate (1) | 4.04% | 4.77% |
| Expected volatility of stock (2) | 66.53% | 67.60% |
| Dividend yield | None | None |
| Expected option life (3) | 10.0 years | 10.0 years |

(1) The risk-free interest rate is based on the U.S. Treasury yield in effect at the grant date over the expected term of the option.

(2) The expected volatility is based on historical volatility from our traded Common Stock over the expected term of the option.

(3) The expected option life is based on historical exercises and post-vesting data.

(4) No employee option grants were made in 2007.

The following table summarizes stock-based compensation recognized for the three and nine months ended September 30, 2008 and September 30, 2007 for our employee and director stock options.

| Stock Options | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Employee Stock Options | $ 106,000 | $ 52,000 | $ 247,000 | $ 190,000 |
| Director Stock Options | 45,000 | 75,000 | 88,000 | 98,000 |
| Total | $ 151,000 | $ 127,000 | $ 335,000 | $ 288,000 |

We recognized share based compensation expense using a straight-line amortization method over the requisite period, which is the vesting period of the stock option grant. As SFAS 123R requires that stock based compensation expense be based on options that are ultimately expected to vest, we have reduced our stock based compensation for the August 5, 2008 employee and director stock option grants at an estimated forfeiture rate of 5.0% and 0.0%, respectively, for the first year of vesting. Our estimated forfeiture rate is based on historical trends of actual forfeitures. Forfeiture rates are evaluated, and revised as necessary. As of September 30, 2008, we have approximately $1,113,000 of total unrecognized compensation cost related to unvested options, of which $207,000 is expected to be recognized in remaining 2008, $380,000 in 2009, $303,000 in 2010, and $223,000 in 2011.

## 4. Capital Stock And Employee Stock Plan

During the nine months ended September 30, 2008, we issued 111,179 shares of our Common Stock upon exercise of 106,179 employee stock options, at exercise prices ranging from $1.25 to $1.86 and 5,000 director stock options, at an exercise price of $1.75. Total proceeds received during the nine months ended September 30, 2008 related to option exercises totaled approximately $184,000. In addition, we received the remaining $25,000 from repayment of stock subscription resulting from exercise of warrants to purchase 60,000 shares of our Common Stock on a loan by the Company at an arms length basis in 2006 in the first six months of 2008.

On July 28, 2006, our Board of Directors has authorized a common stock repurchase program to purchase up to $2,000,000 of our Common Stock, through open market and privately negotiated transactions, with the timing, the amount of repurchase transactions and the prices paid under the program as deemed appropriate by management and dependent on market conditions and corporate and regulatory considerations. As of the date of this report, we have not repurchased any of our Common Stock under the program as we continue to evaluate this repurchase program within our internal cash flow and/or borrowings under our line of credit.

The summary of the Company's total Plans as of September 30, 2008 as compared to September 30, 2007 and changes during the period then ended are presented as follows:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Options outstanding Janury 1, 2008 | 2,590,026 | $ 1.91 | | |
| Granted | 1,002,000 | 2.29 | | |
| Exercised | (111,179) | 1.66 | | $ 95,103 |
| Forfeited | (81,001) | 1.80 | | |
| Options outstanding End of Period (1) | 3,399,846 | 2.03 | 4.6 | $ 572,397 |
| Options Exercisable at September 30, 2008 (1) | 2,138,013 | | | |