CAPSTONE TURBINE CORP
Form 10-Q
February 09, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2006

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 number: 001-15957

Capstone Turbine Corporation

(Exact name of Registrant as specified in its charter)

Delaware	**95-4180883**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

21211 Nordhoff Street, Chatsworth, California 91311

(Address of principal executive offices and zip code)

818-734-5300

(Registrant s telephone number, including area code)

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

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

The number of outstanding shares of the registrant s common stock as of January 31, 2007 was 144,751,391.

CAPSTONE TURBINE CORPORATION

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PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

CAPSTONE TURBINE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)
(Unaudited)

	December 31, 2006	March 31, 2006
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 25,498	$ 58,051
Accounts receivable, net of allowance for doubtful accounts and sales returns of $800 at December 31, 2006 and $858 at March 31, 2006	4,456	5,869
Inventories	20,188	12,545
Prepaid expenses and other current assets	1,232	1,050
Total current assets	51,374	77,515
Property, plant and equipment, net	6,736	7,816
Non-current portion of inventories	3,009	3,113
Intangible asset, net and other long-term assets	1,072	1,273
Total	$ 62,191	$ 89,717
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable and accrued expenses	$ 5,976	$ 8,144
Accrued salaries and wages	1,041	1,623
Accrued warranty reserve	6,408	6,998
Deferred revenue	993	632
Current portion of notes payable	19	19
Total current liabilities	14,437	17,416
Long-term portion of notes payable	32	47
Other long-term liabilities	580	626
Stockholders Equity:		
Preferred stock, $.001 par value; 10,000,000 shares authorized; none issued		
Common stock, $.001 par value; 415,000,000 shares authorized; 105,302,599 shares issued and 104,751,391 shares outstanding at December 31, 2006; 103,521,829 shares issued and 102,970,621 shares outstanding at March 31, 2006	104	104
Additional paid-in capital	576,297	572,787
Accumulated deficit	(528,746)	(500,542)
Deferred stock compensation		(208)
Treasury stock, at cost; 551,208 shares	(513)	(513)
Total stockholders equity	47,142	71,628
Total	$ 62,191	$ 89,717

See accompanying notes to condensed consolidated financial statements.

CAPSTONE TURBINE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended December 31, 2006	2005	Nine Months Ended December 31, 2006	2005
Revenue	$ 5,715	$ 7,040	$ 15,227	$ 16,552
Cost of goods sold (includes stock-based compensation of $29, $0, $80 and $0, for the periods presented, respectively)	6,191	9,793	19,275	23,785
Gross loss	(476)	(2,753)	(4,048)	(7,233)
Operating expenses:				
Research and development (includes stock-based compensation of $63, $0, $175 and $0, for the periods presented, respectively)	2,021	3,093	7,419	7,926
Selling, general and administrative (includes stock-based compensation of $513, $176, $1,779 and $753, for the periods presented, respectively)	6,366	9,045	18,342	21,570
Total operating expenses	8,387	12,138	25,761	29,496
Loss from operations	(8,863)	(14,891)	(29,809)	(36,729)
Interest income	410	708	1,608	1,481
Interest expense		(1)	(2)	(22)
Other income		3	1	27
Loss before income taxes	(8,453)	(14,181)	(28,202)	(35,243)
Provision for income taxes			2	2
Net loss	$ (8,453)	$ (14,181)	$ (28,204)	$ (35,245)
Net loss per share of common stock Basic and Diluted	$ (0.08)	$ (0.14)	$ (0.27)	$ (0.39)
Weighted average shares used to calculate Basic and Diluted net loss per share	103,968	102,341	103,731	90,624

See accompanying notes to condensed consolidated financial statements.

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CAPSTONE TURBINE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended December 31, 2006	2005
Cash Flows from Operating Activities:		
Net loss	$ (28,204)	$ (35,245)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,353	3,231
Provision for(Benefit from) allowance for doubtful accounts and sales returns	(58)	244
Inventory write-downs	1,186	1,526
Provision for warranty expenses	1,323	1,243
Loss(Gain) on disposal of equipment	171	(21)
Stock-based compensation	2,034	753
Changes in operating assets and liabilities:		
Accounts receivable	1,471	(3,043)
Inventories	(8,725)	(3,904)
Prepaid expenses and other assets	(182)	53
Accounts payable and accrued expenses	(2,100)	976
Accrued salaries and wages and long-term liabilities	(629)	(645)
Accrued warranty reserve	(1,913)	(1,926)
Deferred revenue	361	(103)
Net cash used in operating activities	(32,912)	(36,861)
Cash Flows from Investing Activities:		
Acquisition of and deposits on equipment and leasehold improvements	(1,360)	(966)
Proceeds from disposal of equipment	49	30
Net cash used in investing activities	(1,311)	(936)
Cash Flows from Financing Activities:		
Net proceeds from sale of common stock		39,089
Repayment of notes payable and capital lease obligations	(15)	(14)
Exercise of stock options and employee stock purchases	1,685	1,319
Net cash provided by financing activities	1,670	40,394
Net Increase(Decrease) in Cash and Cash Equivalents	(32,553)	2,597
Cash and Cash Equivalents, Beginning of Period	58,051	63,593
Cash and Cash Equivalents, End of Period	$ 25,498	$ 66,190
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ 2	$ 22
Income taxes	$ 2	$ 2
Supplemental Disclosures of Non-Cash Information:		

During the nine months ended December 31, 2006 and 2005, the Company purchased on account $39 and $88 of fixed assets, respectively.

See accompanying notes to condensed consolidated financial statements.

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CAPSTONE TURBINE CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Business and Organization

Capstone Turbine Corporation (the Company) develops, manufactures, markets and services microturbine technology solutions for use in stationary distributed power generation applications, including cogeneration (combined heat and power (CHP) and combined cooling, heat and power (CCHP)), resource recovery and secure power. In addition, the Company s microturbines can be used as generators for hybrid electric vehicle applications. The Company was organized in 1988 and has been commercially producing its microturbine generators since 1998.

The Company has incurred significant operating losses since its inception. Management anticipates incurring additional losses until the Company can produce sufficient revenue to cover its operating costs. To date, the Company has funded its activities primarily through private and public equity offerings.

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (generally accepted accounting principles) for interim financial information and with the instructions to Form 10-Q and Regulation S-X promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). They do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The condensed consolidated balance sheet at March 31, 2006 was derived from audited financial statements included in the Company s annual report on Form 10-K for the year ended March 31, 2006. In the opinion of management, the interim condensed consolidated financial statements include all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial condition, results of operations and cash flows for such periods. Results of operations for any interim period are not necessarily indicative of results for any other interim period or for the full year. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s annual report on Form 10-K for the year ended March 31, 2006. This quarterly report on Form 10-Q refers to the Company s fiscal years ending March 31st as its Fiscal year.

The condensed consolidated financial statements include the accounts of the Company and Capstone Turbine International, Inc., its wholly owned subsidiary that was formed in June 2004, after elimination of inter-company transactions.

Stock-Based Compensation

On April 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all stock options issued to employees and directors based on estimated fair values. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method. The Company s condensed consolidated financial statements as of and for the three months and nine months ended December 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense for the three months and nine months ended December 31, 2006 was $0.6 million and $2.0 million, respectively. If not for the adoption of SFAS 123(R) in the first quarter of Fiscal 2007, stock-based compensation expense under existing guidance would have been approximately $65,000 and $0.3 million for the three months and nine months ended December 31, 2006. The impact of the adoption of SFAS 123(R) on basic and diluted net loss per common share was $(0.08) and $(0.25) for the three months and nine months ended December 31, 2006.

As noted above, prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25. The Company also accounted for equity instruments issued to non-employees using the fair value at the date of grant as prescribed by SFAS No. 123, Accounting for Stock-Based Compensation and Emerging Issues Task Force No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Service. The following table illustrates the effect on stock-based compensation expense and net loss per common share if the Company had applied the fair value recognition provisions of SFAS 123 to its employee and director stock option grants, stock purchases, restricted stock and stock awards during the three months and nine months ended December 31, 2005 (in thousands, except per share data):

	Three Months Ended December 31, 2005	**Nine Months Ended December 31, 2005**
Net loss, as reported	$ (14,181)	$ (35,245)
Add: Stock-based employee and director compensation included in reported net loss	62	214
Deduct: Total stock-based employee and director compensation expense determined under fair value based method	(857)	(2,441)
Pro forma net loss	$ (14,976)	$ (37,472)
Net loss per share Basic and Diluted:		
As reported	$ (0.14)	$ (0.39)
Pro forma	$ (0.15)	$ (0.41)

The Company calculated the estimated fair value of each stock option on the date of grant using the Black-Scholes option-pricing model and the following weighted-average assumptions:

	Three Months Ended December 31, 2005	**Nine Months Ended December 31, 2005**
Risk-free interest rates	4.1%	4.0%
Expected lives (in years)	5.3 - 5.4	5.3 - 5.4
Dividend yield	%	%
Expected volatility	105.0 - 105.9%	103.9 106.2%
Weighted average volatility	105.2%	104.7%

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. SFAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee share-based compensation, and to determine the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of employee share-based compensation awards that are outstanding upon adoption of SFAS 123(R). We are currently in the process of evaluating whether to adopt the provisions of SFAS 123(R)-3.

Prior to the adoption of SFAS 123(R), the Company would have presented all tax benefits resulting from the exercise of stock options as operating cash inflows in the consolidated statements of cash flows, in accordance with the provisions of the Emerging Issues Task Force Issue No 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option. However, the Company has not recorded tax benefits associated with the exercise of stock options based on the losses incurred to date. SFAS 123(R) requires the benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis.

3. Customer Concentrations and Accounts Receivable

Individually, three customers accounted for 18%, 16% and 15% of revenue, respectively, for the three months ended December 31, 2006, totaling approximately 49% of revenue. For the three months ended December 31, 2005, three customers accounted for 26%, 17% and 12% of revenue, respectively. For the three months ended December 31, 2006 and 2005, United Technologies Corporation (UTC) accounted for approximately 15% and 26% of revenue, respectively (see Note 10).

Individually, one customer accounted for 15% of revenue for the nine months ended December 31, 2006. For the same period last year, individually, one customer accounted for 23% of revenue. UTC accounted for approximately 8% and 23% of revenue for the nine months ended December 31, 2006 and 2005, respectively.

Accounts receivable included $0.8 million and $1.6 million for unpaid billings to the U.S. government under cost-sharing programs at December 31 and March 31, 2006, respectively. Individually, three additional customers accounted for 24%, 17% and 11% of net accounts receivable, respectively, as of December 31, 2006, totaling approximately 52% of net accounts receivable and one customer accounted for 27% of net accounts receivable as of March 31, 2006.

While the Company has individual customers who, in any given period, may represent a significant portion of the Company s business, overall, the Company is not dependent on any single customer or particular group of customers.

4. Inventories

Inventories are stated at the lower of standard cost (which approximates actual cost on the first-in, first-out method) or market and consisted of the following:

	December 31, 2006	**March 31, 2006**
	(In thousands)	
Raw materials	$ 17,026	$ 13,237
Work in process	1,509	705
Finished goods	4,662	1,716
Total	23,197	15,658
Less non-current portion	3,009	3,113
Current portion	$ 20,188	$ 12,545

The non-current portion of inventories represents that portion of the inventories in excess of amounts expected to be sold or used in the next twelve months.

5. Property, Plant and Equipment

Property, plant and equipment consisted of the following:

	December 31, 2006	**March 31, 2006**
	(In thousands)	
Machinery, equipment and furniture	$ 18,200	$ 18,493
Leasehold improvements	8,730	8,656
Molds and tooling	3,741	3,538
	30,671	30,687
Less, accumulated depreciation and amortization	(23,935)	(22,871)
Total property, plant and equipment, net	$ 6,736	$ 7,816

6. Intangible Asset

The Company s sole intangible asset is a manufacturing license. The gross carrying amount is $3.7 million. The balance of the intangible asset was $1.0 million and $1.2 million as of December 31 and March 31, 2006, respectively. The intangible asset is being amortized over its estimated useful life of ten years. The Company recorded $67,000 and $0.2 million of amortization expense for each of the three months and nine months ended December 31, 2006 and 2005, respectively. The manufacturing license is scheduled to be fully amortized by Fiscal 2011 with corresponding amortization estimated to be $66,000 for the remainder of Fiscal 2007, $0.3 million for each of Fiscal 2008, 2009 and 2010, and $92,000 for Fiscal 2011.

The manufacturing license provides the Company with the ability to manufacture recuperator cores previously purchased from the supplier. The Company is required to pay a per-unit royalty fee over a seventeen-year period for cores manufactured and sold by the Company using the technology. Royalties of $10,000 and $15,000 were earned by the supplier for the three months ended December 31, 2006 and 2005, respectively. Royalties of $23,000 and $38,000 were earned by the supplier for the nine months ended December 31, 2006 and 2005, respectively. As of December 31, 2006, a total of $99,000 was earned under the terms of the agreement. Earned royalties of $10,000 were unpaid as of December 31, 2006.

7. Stock-Based Compensation

1993 Incentive Stock Plan and 2000 Stock Incentive Plan

In 1993, the Board of Directors adopted and the stockholders approved the 1993 Incentive Stock Plan (1993 Plan). A total of 7,800,000 shares of common stock were initially reserved for issuance under the 1993 Plan. In June 2000, the Company adopted the 2000 Equity Incentive Plan (2000 Plan) as a successor plan to the 1993 Plan. A total of 3,300,000 shares of common stock were initially reserved for issuance under the 2000 Plan. The 2000 Plan was amended in May 2002 to add 400,000 shares of common stock to the total available for issuance, amended in January 2004 to update certain administrative provisions, amended in September 2004 to add 2,380,000 shares of common stock to the total available for issuance under awards, and amended again on January 31, 2005 and March 17, 2005 to coordinate the provisions for change in control with the Company s change in control agreements and programs. The 2000 Plan provides for awards of up to 6,080,000 shares of common stock, plus 7,800,000 shares previously authorized under the 1993 Plan; provided, however, that the maximum aggregate number of shares which may be issued upon exercise of incentive stock options is 13,880,000 shares. The 2000 Plan is administered by the Compensation Committee as designated by the Board of Directors. The Compensation Committee s authority includes determining the number of options granted and vesting provisions. As of December 31, 2006, 2,663,395 shares were available for future grant.

As of December 31, 2006, the Company had outstanding 6,045,000 non-qualified common stock options issued outside of the 2000 Plan. These stock options were originally granted at exercise prices equal to the fair market value of its common stock on the grant date, as inducement grants to new executive officers and employees of the Company. Included in the 6,045,000 options were 2,000,000 options to the Company s President and Chief Executive Officer, 1,500,000 options to the Company s former President and Chief Executive Officer, 1,000,000 options to the Company s Executive Vice President and Chief Financial Officer, 800,000 options to the Company s then Senior Vice President of Sales and Service, 500,000 options to the Company s Vice President of Operations and an aggregate of 245,000 options to two employees. Although the options were not granted under the 2000 Plan, they were governed by terms and conditions identical to those under the 2000 Plan. All options granted are subject to the following vesting provision: one-fourth vests one year after the issuance date and 1/48th vests on the first day of each full month thereafter, so that all shall be vested on the first day of the 48th month after the issuance date. All outstanding options have a contractual term of ten years.

Valuation and Expense Information under SFAS 123(R)

In the three months ended December 31, 2006 and 2005, the Company recognized stock-based compensation expense of $0.6 million and $0.2 million, respectively. In the nine months ended December 31, 2006 and 2005, the Company recognized stock-based compensation expense of $2.0 million and $0.8 million, respectively. The fair value of options vested during the three months ended December 31, 2006 and 2005 was $0.4 million and $0.6 million, respectively. The fair value of options vested during the nine months ended December 31, 2006 and 2005 was $1.7 million and $2.0 million, respectively. The Company has not capitalized as an asset any stock-based compensation costs.

The Company calculated the estimated fair value of each stock option on the date of grant using the Black-Scholes option-pricing model and the following weighted-average assumptions:

	Three Months Ended December 31, 2006	Nine Months Ended December 31, 2006
Risk-free interest rates	4.5%	4.5 5.1%
Expected lives (in years)	6.1	6.1
Dividend yield	%	%
Expected volatility	100.9%	100.9 103.5%
Weighted average volatility	100.9%	101.7%

The Company s computation of expected volatility for the three months and nine months ended December 31, 2006 and 2005 was based on historical volatility. The Company estimated the expected life of each stock option granted in the three months and nine months ended December 31, 2006 using the short-cut method permissible under SAB 107, which utilizes the weighted average expected life of each tranche of the stock option, determined based on the sum of each tranche s vesting period plus one-half of the period from the vesting date of each tranche to the stock option s expiration. This method is available for options granted prior to December 31, 2007. The risk-free interest rate is based on the implied yield available on U.S. Treasury securities with an equivalent remaining term. Included in the calculation is the Company s estimated forfeiture rate. SFAS 123(R) requires that equity-based compensation expense be based on awards that are ultimately expected to vest and accordingly, equity-based compensation recognized in the three months and nine months ended December 31, 2006, has been reduced by estimated forfeitures. Our estimate of forfeitures is based on historical option forfeiture behavior.

A summary of employee and non-employee stock option activity for the nine months ended December 31, 2006 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Options outstanding at March 31, 2006	10,372,018	$ 2.58		
Granted	2,981,600	1.68		
Exercised	(1,029,805)	1.58		
Forfeited	(1,788,939)	1.80		
Expired	(947,807)	7.06		
Options outstanding at December 31, 2006	9,587,067	$ 2.11	8.17	$ 130,236
Options exercisable at December 31, 2006	4,091,208	$ 2.16	6.85	$ 129,223
Options fully vested at December 31, 2006 and those expected to vest beyond December 31, 2006	8,263,243	$ 2.13	7.98	$ 130,045

The weighted average per share grant date fair value of options granted during the three months ended December 31, 2006 and 2005 was $1.03 and $2.18, respectively. The weighted average per share grant date fair value of options granted during the nine months ended December 31, 2006 and 2005 was $1.38 and $1.94, respectively. The total intrinsic value of options exercised by the Company from option exercises during the three months ended December 31, 2006 and 2005, was approximately $3,000 and $0.4 million, respectively. The total intrinsic value of options exercised by the Company from option exercises during the nine months ended December 31, 2006 and 2005, was approximately $1.4 million and $1.5 million, respectively. As of December 31, 2006, there was approximately $7.5 million of

unrecognized compensation cost related to stock option awards that is expected to be recognized as expense over a weighted average period of 1.59 years.

Effective July 31, 2006, 500,000 stock options were forfeited in accordance with the consulting agreement between the Company and its former Chief Executive Officer.

A summary of restricted stock activity for the nine months ended December 31, 2006 is as follows:

	Shares	Weighted Average Grant Date Fair Value
Nonvested restricted stock outstanding at March 31, 2006	177,083	$ 1.23
Granted	847,147	1.54
Vested	(79,354)	1.50
Forfeited	(136,300)	1.29
Nonvested restricted stock outstanding at December 31, 2006	808,576	$ 1.52

The restricted stock awards vest in equal installments over a period of two to four years. The restricted stock awards were valued based on the closing price of the Company s common stock on the date of grant, and compensation cost is recorded on a straight-line basis over the share vesting period. The Company recorded expense of approximately $72,000 and $0.2 million associated with its restricted stock awards in the three and nine months ended December 31, 2006, respectively, and approximately $37,000 and $111,000 associated with its restricted stock awards in the three and nine months ended December 31, 2005, respectively. As of December 31, 2006, there was approximately $0.9 million of unrecognized compensation cost related to restricted stock awards that would be recognized as expense over a weighted average period of 2.03 years.

On December 18, 2006 the Company issued a restricted stock grant for 500,000 shares of the Company s common stock to the Company s President and Chief Executive Officer that will become 25% vested each year of service over four years.

Effective July 31, 2006, 125,000 unvested shares of restricted stock were repurchased and retired for $125 by the Company in accordance with the consulting agreement between the Company and its former Chief Executive Officer.

8. Accrued Warranty Reserve

The Company provides for the estimated costs of warranties at the time revenue is recognized. The specific terms and conditions of those warranties vary depending upon the product sold, geography of sale and the length of extended warranties sold. The Company s product warranties generally start from the delivery date and continue for up to eighteen months. Factors that affect the Company s warranty obligation include product failure rates, anticipated hours of product operations and costs of repair or replacement in correcting product failures. These factors are estimates that change based on new information that becomes available each period. Similarly, the Company also accrues the estimated costs to address reliability repairs on products no longer in warranty when, in the Company s judgment, and in accordance with a specific plan developed by the Company, it is prudent to provide such repairs. The Company assesses the adequacy of recorded warranty liabilities quarterly and makes adjustments to the liability as necessary. When the Company has statistically valid evidence that product changes are altering the historical failure occurrence rates, the impact of such changes is then taken into account in estimating future warranty liabilities.

Changes in accrued warranty reserve during the nine months ended December 31, 2006 are as follows:

	(In thousands)
Balance, March 31, 2006	$ 6,998
Warranty provision relating to products shipped during the period	368
Deduction for performance on warranty claims	(1,913)
Changes for accruals related to preexisting warranties or reliability repairs programs	955
Balance, December 31, 2006	$ 6,408

9. Commitments and Contingencies

As of December 31, 2006, the Company had firm commitments to purchase inventories of approximately $6.8 million.

The Company leases offices and manufacturing facilities under various non-cancelable operating leases expiring at various times through the year ending March 31, 2011. All of the leases require the Company to pay maintenance, insurance and property taxes. The material lease agreements provide for rent escalation over the lease term and renewal options for five year periods. Rent expense is recognized on a straight-line basis over the term of the lease. The difference between rent expense recorded and the amount paid is credited or charged to deferred rent which is included in Other Long-Term Liabilities in the accompanying condensed consolidated balance sheets. Deferred rent amounted to $0.6 million as of both December 31, 2006 and March 31, 2006.

In December 2001, a purported shareholder class action lawsuit was filed in the United States District Court for the Southern District of New York (the District Court) against the Company, two of its then officers, and the underwriters of the Company s initial public offering. The suit purports to be a class action filed on behalf of purchasers of the Company s common stock during the period from June 28, 2000 to December 6, 2000. An amended complaint was filed on April 19, 2002. Plaintiffs allege that the underwriter defendants agreed to allocate stock in the Company s June 28, 2000 initial public offering and November 16, 2000 secondary offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices. Plaintiffs allege that the prospectuses for these two public offerings were false and misleading in violation of the securities laws because they did not disclose these arrangements. In June 2004, a committee of our Board of Directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. The settlement would include, among other things, a release of the Company and of the individual defendants for liability associated with the conduct alleged in the action to be wrongful in the amended complaint. The Company would agree to undertake other responsibilities under the proposed settlement, including agreeing to assign away, not assert, or release certain potential claims the Company may have against our underwriters.

The District Court requested that any objections to preliminary approval of the settlement be submitted by July 14, 2004. The District Court granted the preliminary approval motion on February 15, 2005, subject to certain modifications. On August 31, 2005, the District Court issued a preliminary order further approving the modifications to the settlement and certifying the settlement classes. The District Court also appointed the Notice Administrator for the settlement and ordered that notice of the settlement be distributed to all settlement class members beginning on November 15, 2005. The settlement fairness hearing was held on April 24, 2006, and the District Court reserved decision. On December 5, 2006, the United States Court of Appeals for the Second Circuit (the Second Circuit) issued an opinion vacating the District Court s certification of a litigation class in that portion of the case between the Plaintiffs and the underwriter defendants. Because the Second Circuit s opinion was directed to the class certified by the District Court for the Plaintiffs litigation against the underwriter defendants, the opinion s effect on the class certified by the District Court for the Company s settlement is unclear. On January 5, 2007, Plaintiffs filed a petition for rehearing en banc by the Second Circuit.

The proposed settlement is pending final approval by the District Court. There can be no assurance that the settlement will be approved and, because of the inherent uncertainties of litigation, the Company cannot accurately predict the ultimate outcome of the case if it is not. However, any direct financial impact of the proposed settlement is expected to be borne by the Company s insurers.

From time to time, the Company may become subject to additional legal proceedings, claims and litigation arising in the ordinary course of business. Other than the matters discussed above, the Company is not a party to any other material legal proceedings, nor is the Company aware of any other pending or threatened litigation that would have a material

adverse effect on the Company s business, operating results, cash flows or financial condition should such litigation be resolved unfavorably.

10. Related Party Transactions

In October 2002, the Company entered into a strategic alliance with UTC, a stockholder, through its UTC power division. In March 2005, the Company and UTC replaced the strategic alliance agreement with an original equipment manufacturer agreement (the OEM Agreement) between the Company and UTC Power LLC (UTCP). The OEM Agreement involves the integration, marketing, sales and service of CCHP solutions worldwide. Sales to UTC s affiliated c