ERESEARCHTECHNOLOGY INC /DE/
Form 10-Q
November 05, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

þ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2007

or

o **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the transitional period from__________to__________**

Commission file number 0-29100

eResearchTechnology, Inc.

(Exact name of registrant as specified in its charter)

Delaware	22-3264604
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
30 South 17th Street Philadelphia, PA	19103
(Address of principal executive offices)	(Zip code)

215-972-0420

(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 þ 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.

Large accelerated filer o Accelerated filer þ 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 þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

The number of shares of Common Stock, $.01 par value, outstanding as of October 26, 2007, was 50,615,672.

eResearchTechnology, Inc. and Subsidiaries

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Part 1. Financial Information
Item 1. Financial Statements

eResearchTechnology, Inc. and Subsidiaries
Consolidated Balance Sheets
(In thousands, except share and per share amounts)

	December 31, 2006	September 30, 2007 (unaudited)
Assets		
Current Assets:		
Cash and cash equivalents	$ 15,497	$ 27,198
Short-term investments	41,416	43,591
Accounts receivable, net	17,866	21,790
Prepaid income taxes	2,819	754
Prepaid expenses and other	2,761	3,613
Deferred income taxes	912	913
Total current assets	81,271	97,859
Property and equipment, net	31,129	33,127
Goodwill	1,212	1,212
Long-term investments	928	244
Other assets	524	311
Total assets	$ 115,064	$ 132,753
Liabilities and Stockholders Equity		
Current Liabilities:		
Accounts payable	$ 4,360	$ 2,505
Accrued expenses	3,445	4,968
Income taxes payable	781	966
Current portion of capital lease obligations	40	1,621
Deferred revenues	11,325	12,415
Total current liabilities	19,951	22,475
Capital lease obligations, excluding current portion		66
Deferred income taxes	1,491	2,203
Total liabilities	21,442	24,744
Commitments and contingencies		
Stockholders Equity:		
Preferred stock $10.00 par value, 500,000 shares authorized, none issued and outstanding		

Common stock $.01 par value, 175,000,000 shares authorized, 58,356,546 and 58,854,254 shares issued, respectively		584		589
Additional paid-in capital		83,493		87,331
Accumulated other comprehensive income		1,510		1,961
Retained earnings		70,225		80,318
Treasury stock, 8,247,119 shares at cost		(62,190)		(62,190)
Total stockholders equity		93,622		108,009
Total liabilities and stockholders equity	$	115,064	$	132,753

The accompanying notes are an integral part of these statements.

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eResearchTechnology, Inc. and Subsidiaries
Consolidated Statements of Operations
(In thousands, except per share amounts)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2007	2006	2007
Net revenues:				
Licenses	$ 602	$ 651	$ 2,336	$ 2,013
Services	14,493	16,453	42,040	47,982
Site support	7,131	6,867	22,067	19,794
Total net revenues	22,226	23,971	66,443	69,789
Costs of revenues:				
Cost of licenses	75	70	228	199
Cost of services	6,674	7,567	19,130	21,590
Cost of site support	4,548	4,831	14,492	13,143
Total costs of revenues	11,297	12,468	33,850	34,932
Gross margin	10,929	11,503	32,593	34,857
Operating expenses:				
Selling and marketing	2,471	2,487	8,687	8,079
General and administrative	3,945	2,527	11,758	8,915
Research and development	980	1,128	3,328	3,155
Total operating expenses	7,396	6,142	23,773	20,149
Operating income	3,533	5,361	8,820	14,708
Other income, net	339	584	1,067	1,703
Income before income taxes	3,872	5,945	9,887	16,411
Income tax provision	1,407	2,239	3,821	6,318
Net income	$ 2,465	$ 3,706	$ 6,066	$ 10,093
Basic net income per share	$ 0.05	$ 0.07	$ 0.12	$ 0.20
Diluted net income per share	$ 0.05	$ 0.07	$ 0.12	$ 0.20
Shares used to calculate basic net income per share	49,540	50,594	49,302	50,430
Shares used to calculate diluted net income per share	51,376	51,829	51,525	51,681

The accompanying notes are an integral part of these statements.

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eResearchTechnology, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(In thousands)
(unaudited)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2007
Operating activities:		
Net income	$ 6,066	$ 10,093
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,537	11,066
Cost of sales of equipment	3,483	1,004
Non-cash share-based compensation	2,319	1,576
Changes in operating assets and liabilities:		
Accounts receivable	44	(3,777)
Prepaid expenses and other	(452)	(595)
Accounts payable	1,966	(1,888)
Accrued expenses	(1,156)	1,500
Income taxes	(3,062)	2,749
Deferred revenues	(8,744)	995
Net cash provided by operating activities	9,001	22,723
Investing activities:		
Purchases of property and equipment	(12,269)	(10,066)
Purchases of investments	(24,516)	(50,108)
Proceeds from sales of investments	21,040	48,617
Net cash used in investing activities	(15,745)	(11,557)
Financing activities:		
Repayment of capital lease obligations	(114)	(1,962)
Proceeds from exercise of stock options	3,548	1,600
Stock option income tax benefit	3,702	628
Repurchase of common stock for treasury	(5,803)	
Net cash provided by financing activities	1,333	266
Effect of exchange rate changes on cash	244	269
Net (decrease) increase in cash and cash equivalents	(5,167)	11,701
Cash and cash equivalents, beginning of period	18,432	15,497

Cash and cash equivalents, end of period	$ 13,265	$ 27,198

The accompanying notes are an integral part of these statements.

eResearchTechnology, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
(unaudited)

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements, which include the accounts of eResearchTechnology, Inc. (the Company , eRT or we) and its wholly-owned subsidiaries, have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles 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. Operating results for the nine-month period ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. Further information on potential factors that could affect our financial results can be found in our Report on Form 10-K for the year ended December 31, 2006 filed with the Securities and Exchange Commission and in this Form 10-Q.

Note 2. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported revenues and expenses during the reporting period. Actual results could differ from those estimates.

Revenue Recognition

We recognize revenues primarily from three sources: license fees, services and site support. Our license revenues consist of license fees for perpetual license sales and monthly and annual term license sales. Our services revenues consist of Cardiac Safety services, technology consulting and training services and software maintenance services. Our site support revenues consist of cardiac safety equipment rentals and sales along with related supplies and freight.

We recognize software revenues in accordance with the Accounting Standards Executive Committee Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition , With Respect to Certain Transactions. Accordingly, we recognize up-front license fee revenues under the residual method when a formal agreement exists, delivery of the software and related documentation has occurred, collectability is probable and the license fee is fixed or determinable. We recognize monthly and annual term license fee revenues over the term of the arrangement. Hosting service fees are recognized evenly over the term of the service. Cardiac Safety services revenues consist of services that we provide on a fee for services basis and are recognized as the services are performed. Site support revenues are recognized at the time of sale or over the rental period. We recognize revenues from software maintenance contracts on a straight-line basis over the term of the maintenance contract, which is typically twelve months. We provide consulting and training services on a time and materials basis and recognize revenues as we perform the services.

At the time of the transaction, management assesses whether the fee associated with our revenue transactions is fixed or determinable and whether or not collection is reasonably assured. The assessment of whether the fee is fixed or determinable is based upon the payment terms of the transaction. If a significant portion of a fee is due after our normal payment terms or upon implementation or client acceptance, the fee is accounted for as not being fixed or determinable. In these cases, revenue is recognized as the fees become due or after implementation or client acceptance has occurred.

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Collectability is assessed based on a number of factors, including past transaction history with the client and the creditworthiness of the client. If it is determined that collection of a fee is not reasonably assured, the fee is deferred and revenue is recognized at the time collection becomes reasonably assured, which is generally upon receipt of cash. Under a typical contract for Cardiac Safety services, clients pay us a portion of our fee for these services upon contract execution as an upfront deposit, some of which is typically nonrefundable upon contract termination. Revenues are then recognized under Cardiac Safety service contracts as the services are performed.

For arrangements with multiple deliverables where the fair value of each element is known, the revenue is allocated to each component based on the relative fair values of each element. For arrangements with multiple deliverables where the fair value of one or more delivered elements is not known, revenue is allocated to each component of the arrangement using the residual method provided that the fair value of all undelivered elements is known. Fair values for undelivered elements are based primarily upon stated renewal rates for future products or services.

Property and Equipment

Pursuant to SOP 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, we capitalize costs associated with internally developed or purchased software systems for new products and enhancements to existing products that have reached the application development stage and meet recoverability tests. These costs are included in property and equipment. Capitalized costs include external direct costs of materials and services utilized in developing or obtaining internal-use software, and payroll and payroll-related expenses for employees who are directly associated with and devote time to the internal-use software project.

Amortization of capitalized software development costs is charged to cost of revenues. Amortization of capitalized software development costs was $0.2 million and $0.7 million for the three months ended September 30, 2006 and 2007, respectively, and $1.0 million and $2.2 million for the nine months ended September 30, 2006 and 2007, respectively. For the nine months ended September 30, 2006 and 2007, we capitalized $3.6 million and $1.4 million, respectively, of software development costs related to labor and consulting and $0 and $1.7 million, respectively, related to capitalized software. As of September 30, 2007, $3.1 million of capitalized costs have not yet been placed in service and are therefore not being amortized.

The largest component of property and equipment is cardiac safety equipment. Our clients use the cardiac safety equipment to perform the ECG and Holter recordings, and it also provides the means to send such recordings to eRT. We provide this equipment to clients primarily through rentals via cancellable agreements and, in some cases, through non-recourse equipment sales. The equipment rentals and sales are included in, or associated with, our Cardiac Safety services agreements with our clients and the decision to rent or buy equipment is made by our clients prior to the start of the cardiac safety study. The decision to buy rather than rent is usually predicated upon the economics to the client based upon the length of the study and the number of ECGs to be performed each month. The longer the study and the fewer the number of ECGs performed, the more likely it is that the client may request to purchase cardiac safety equipment rather than rent. Regardless of whether the client rents or buys the cardiac safety equipment, we consider the resulting cash flow to be part of our operations and reflect it as such in our consolidated statements of cash flows.

Our Cardiac Safety services agreements contain multiple elements. As a result, significant contract interpretation is sometimes required to determine the appropriate accounting. In doing so, we consider factors, such as whether the deliverables specified in a multiple element arrangement should be treated as separate units of accounting for revenue recognition purposes and, if so, how the contract value should be allocated among the deliverable elements and when to recognize revenue for each element. We recognize revenue for delivered elements only when the fair values of undelivered elements are known, uncertainties regarding client acceptance are resolved and there are no client-negotiated refund or return rights affecting the revenue recognized for delivered elements.

The gross cost for cardiac safety equipment was $29.2 million and $36.3 million at December 31, 2006 and September 30, 2007, respectively. The accumulated depreciation for cardiac safety equipment was $15.2 million and $20.1 million at December 31, 2006 and September 30, 2007, respectively.

Prior to 2007, a portion of our cardiac safety equipment was obtained under operating leases. During the first quarter of 2007, we entered into an agreement to purchase all of our leased cardiac safety equipment at an established price at the end of each lease schedule s term, rather than return the equipment at that time. As a result, in accordance

with Statement of Financial Accounting Standards (SFAS) No. 13, Accounting for Leases, we re-evaluated the classification of the leases and

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determined that the classification should be converted from operating leases to capital leases. As a result, we recorded a non-cash addition to property, plant and equipment of $3.6 million and $3.6 million of capital lease obligations.

Long-lived Assets

In accordance with the provisions of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, when events or circumstances so indicate, we assess the potential impairment of our long-lived assets based on anticipated undiscounted cash flows from the assets. Such events and circumstances include a sale of all or a significant part of the operations associated with the long-lived asset, or a significant decline in the operating performance of the asset. If an impairment is indicated, the amount of the impairment charge would be calculated by comparing the anticipated discounted future cash flows to the carrying value of the long-lived asset. No impairment was indicated during either of the nine-month periods ended September 30, 2006 or September 30, 2007.

Software Development Costs

Research and development expenditures are charged to operations as incurred. SFAS No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed, requires the capitalization of certain software development costs subsequent to the establishment of technological feasibility. Since software development costs have not been significant after the establishment of technological feasibility, all such costs have been charged to expense as incurred.

Stock-Based Compensation

Accounting for Stock-Based Compensation

On January 1, 2006, we adopted the provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R), which requires that the costs resulting from all share-based payment transactions be recognized in the financial statements at their fair values. We adopted SFAS No. 123R using the modified prospective application method under which the provisions of SFAS No. 123R apply to new awards and to awards modified, repurchased or cancelled after the adoption date. Additionally, compensation cost for the portion of the awards for which the requisite service had not been rendered that were outstanding as of January 1, 2006 is recognized in the Consolidated Statements of Operations over the remaining service period after such date based on the award s original estimate of fair value. The aggregate share-based compensation expense recorded in the Consolidated Statements of Operations for the three and nine months ended September 30, 2006 under SFAS No. 123R was $0.7 million and $2.3 million, respectively. The aggregate share-based compensation expense recorded in the Consolidated Statements of Operations for the three and nine months ended September 30, 2007 under SFAS No. 123R was $0.4 million and $1.6 million, respectively. For the three months ended September 30, 2006, this additional share-based compensation lowered pre-tax earnings by $0.7 million, lowered net income by $0.6 million and lowered basic and diluted earnings per share by $0.01. For the three months ended September 30, 2007, this additional share-based compensation lowered pre-tax earnings by $0.4 million, lowered net income by $0.4 million and lowered basic and diluted earnings per share by $0.01. For the nine months ended September 30, 2006, this additional share-based compensation lowered pre-tax earnings by $2.3 million, lowered net income by $1.9 million and lowered basic and diluted earnings per share by $0.04. For the nine months ended September 30, 2007, this additional share-based compensation lowered pre-tax earnings by $1.6 million, lowered net income by $1.3 million and lowered basic and diluted earnings per share by $0.03. SFAS No. 123R also amended SFAS No. 95, Statement of Cash Flows, to require that tax benefits be reported as financing cash inflows, rather than as a reduction of taxes paid, which is included within operating cash flows.

Valuation Assumptions for Options Granted

The fair value of each stock option granted during the nine months ended September 30, 2006 and 2007 was estimated at the date of grant using Black-Scholes, assuming no dividends and using the weighted-average valuation assumptions noted in the following table. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected life (estimated period of time outstanding) of the stock options granted was estimated using the historical exercise behavior of employees. Expected volatility was based on historical volatility for a period equal to the stock option s expected life, calculated on a daily basis.

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	2006	2007
Risk-free interest rate	4.82%	4.68%
Expected dividend yield	0.00%	0.00%
Expected life	3.5 years	3.5 years
Expected volatility	59.68%	55.89%

The above assumptions were used to determine the weighted-average per share fair value of $6.15 and $3.38 for stock options granted during the first nine months of 2006 and 2007, respectively.

Stock Option Plans

In 1996, we adopted a stock option plan (the 1996 Plan) that authorized the grant of both incentive and non-qualified options to acquire up to 3,375,000 shares of the Company s common stock. Our Board of Directors determined the exercise price of the options under the 1996 Plan. The exercise price of incentive stock options was not below the fair value of the common stock on the grant date. Incentive stock options under the 1996 Plan expire ten years from the grant date and are exercisable in accordance with vesting provisions set by the Board, which generally are over three to five years. In May 1999, the stockholders approved an amendment to the 1996 Plan that increased the number of shares which could be acquired through option grants under the 1996 Plan by 4,050,000 to 7,425,000 and provided for an annual option grant of 5,000 shares to each outside director. In April 2001, the stockholders approved an amendment to the 1996 Plan that increased the number of shares which could be acquired through option grants under the 1996 Plan by 2,025,000 to 9,450,000. No additional options have been granted under this plan, as amended, since December 31, 2003 and no additional options may be granted thereunder in accordance with the terms of the 1996 Plan.

In May 2003, the stockholders approved a new stock option plan (the 2003 Plan) that authorized the grant of both incentive and non-qualified options to acquire shares of our common stock and provided for an annual option grant of 10,000 shares to each outside director. The Compensation Committee of our Board of Directors determines the recipients of option grants, the exercise price and other terms of the options under the 2003 Plan. The exercise price of incentive stock options may not be set below the fair value of the common stock on the grant date. Incentive stock options under the 2003 Plan expire ten years from the grant date, or at the end of such shorter period as may be designated by the Compensation Committee, and are exercisable in accordance with vesting provisions set by the Compensation Committee, which generally are over four years. In April 2006, the stockholders approved an amendment to the 2003 Plan that increased the number of shares which could be acquired through option grants under the 2003 Plan by 3,500,000. In accordance with the terms of the 2003 Plan, there are a total of 7,318,625 shares reserved for issuance under the 2003 Plan. The Company normally issues new shares to satisfy option exercises under these plans. On February 15, 2007, the Board of Directors of the Company, based on the recommendation of the Compensation Committee, adopted, subject to stockholder approval at the Annual Meeting, the Company s Amended and Restated 2003 Equity Incentive Plan (the 2003 Equity Plan). On April 26, 2007, the stockholders approved the adoption of the Plan. The 2003 Equity Plan amended the Company s existing 2003 Plan in two material respects. First, it prohibits repricing of any stock options granted under the Plan unless the stockholders approve such repricing. Second, it permits awards of stock appreciation rights, restricted stock, long term performance awards and performance shares in addition to grants of stock options.

On February 7, 2006, we entered into a new employment agreement with our former President and Chief Executive Officer in connection with the announcement of his retirement from his position as President and Chief Executive Officer and Director of the Company. His employment terminated on September 11, 2006 and any options not then exercisable became exercisable in full. As a result of this modification to his option terms, we revalued his options as of February 7, 2006 and amortized the resulting expense through September 11, 2006. This change resulted in additional pre-tax compensation expense of $0.3 million in the first nine months of 2006.

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Information with respect to outstanding options under our plans is as follows:

	Shares	Weighted Average Exercise Price	Remaining Contractual Term	Intrinsic Value (in thousands)
Outstanding as of January 1, 2007	4,387,033	$ 8.56		
Granted	599,900	7.54		
Exercised	(498,708)	3.21		
Cancelled/forfeited	(344,652)	16.12		
Outstanding as of September 30, 2007	4,143,573	7.68	5.0	$ 19,937
Options exercisable or expected to vest at September 30, 2007	3,974,257	8.37	5.0	$ 19,564
Options exercisable at September 30, 2007	3,014,798	7.68	4.8	$ 17,447

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company s closing common stock price on the last trading day of the third quarter of 2007 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2007. This amount changes based on the fair market value of the Company s common stock. The total intrinsic value of options exercised for the nine months ended September 30, 2006 and 2007 was $10.6 million and $2.4 million, respectively.

As of September 30, 2007, there was $3.8 million of total unrecognized compensation cost related to non-vested stock options granted under the plans. That cost is expected to be recognized over a weighted-average period of 2.3 years.

Tax Effect Related to Stock-based Compensation Expense

SFAS No. 123R provides that income tax effects of share-based payments are recognized in the financial statements for those awards that will normally result in tax deductions under existing tax law. Under current U.S. federal tax law, we receive a compensation expense deduction related to non-qualified stock options only when those options are exercised. Accordingly, the financial statement recognition of compensation cost for non-qualified stock options creates a deductible temporary difference which results in a deferred tax asset and a corresponding deferred tax benefit in the statement of operations. We do not recognize a tax benefit for compensation expense related to incentive stock options (ISOs) unless the underlying shares are disposed of in a disqualifying disposition. Accordingly, compensation expense related to ISOs is treated as a permanent difference for income tax purposes. The tax benefit recognized in our Consolidated Statement of Operations in the nine months ended September 30, 2007 related to stock-based compensation expense was approximately $0.3 million. There was no tax benefit recognized in the nine months ended September 30, 2006.

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Note 3. Net Income per Common Share

Basic net income per share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period, adjusted for the dilutive effect of common stock equivalents, which consist of stock options. The dilutive effect of stock options is calculated using the treasury stock method.

The tables below set forth the reconciliation of the numerators and denominators of the basic and diluted net income per share computations (in thousands, except per share amounts):

Three Months Ended September 30,	Net Income	Shares	Per Share Amount
2006			
Basic net income	$ 2,465	49,540	$ 0.05
Effect of dilutive shares		1,836	
Diluted net income	$ 2,465	51,376	$ 0.05
2007			
Basic net income	$ 3,706	50,594	$ 0.07
Effect of dilutive shares		1,235	
Diluted net income	$ 3,706	51,829	$ 0.07

Nine Months Ended September 30,	Net Income	Shares	Per Share Amount
2006			
Basic net income	$ 6,066	49,302	$ 0.12
Effect of dilutive shares		2,223	
Diluted net income	$ 6,066	51,525	$ 0.12