HOME SOLUTIONS OF AMERICA INC
Form 10-Q
May 10, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q

(Mark One)

þ **Quarterly report Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2007

o **Transition report under Section 13 or 15(d) of the Exchange Act of 1934**
For the transition period from __________ to __________

Commission file number **001-31711**

HOME SOLUTIONS OF AMERICA, INC.

(Exact name of registrant as specified in its charter)

Delaware	99-0273889
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

1500 Dragon Street Suite B, Dallas, Texas 75207

(Address of principal executive offices)

(214) 623-8446

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 12b2 of the Exchange Act. (check one):
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

The number of shares outstanding of the registrant s common stock, $0.001 par value per share, as of May 10, 2007 was 47,327,683.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Home Solutions of America, Inc.
Consolidated Balance Sheets
(Dollars and shares in thousands, except per share data)

	March 31, 2007 (unaudited)	December 31, 2006 (audited)
Assets		
Current assets:		
Cash	$ 5,540	$ 8,713
Accounts receivable, net	67,544	58,106
Current portion of notes receivable	1,093	703
Inventories	3,408	4,000
Prepaid expenses and other current assets	6,126	4,654
Costs in excess of billings	14,981	6,292
Deferred tax asset	1,269	1,337
Total current assets	99,961	83,805
Property and equipment, net	6,284	6,129
Intangibles, net	12,742	8,732
Goodwill	118,026	122,500
Notes receivable, net of current portion		750
Other assets	778	809
	$ 237,791	$ 222,725
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 21,499	$ 15,608
Billings in excess of costs	3,713	688
Current portion of debt	26,824	26,816
Current portion of capital lease obligations	284	254
Total current liabilities	52,320	43,366
Long-term Liabilities:		
Debt, net of current portion	9,190	10,448
Line of credit	15,111	13,111
Amounts due to seller	8,736	9,855
Deferred tax liabilities	890	890
Capital lease obligations, net of current portion	1,023	929
Total liabilities	87,270	78,599
Minority interest	317	237
Commitments and contingencies		

Stockholders equity:		
Common stock, $0.001 par value, 100,000 shares authorized; 47,327 and 47,297 shares issued and outstanding, respectively	**47**	47
Additional paid-in capital	**141,104**	140,497
Retained earnings	**9,053**	3,345
Total stockholders equity	**150,204**	143,889
	$ 237,791	$ 222,725

See Notes to Consolidated Financial Statements.

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Home Solutions of America, Inc.
Consolidated Statements of Income
(Dollars and shares in thousands, except per share data)
(unaudited)

	For the Three Months Ended March 31,	
	2007	2006
Net sales	**$ 39,931**	$ 19,280
Costs and expenses:		
Cost of sales	**20,206**	9,332
Selling, general and administrative expenses	**9,185**	5,949
	29,391	15,281
Operating income	**10,540**	3,999
Other income (expense), net:		
Loss on sale of assets	**(7)**	(2)
Interest income	**63**	51
Interest expense	**(1,105)**	(60)
Other income, net	**24**	25
Total other (expense) income, net	**(1,025)**	14
Income from continuing operations before income taxes and minority interest	**9,515**	4,013
Income taxes	**(3,652)**	(1,413)
Minority interest	**(155)**	(258)
Income before discontinued operations	**5,708**	2,342
Gain on disposal, net of loss from discontinued operations, net of taxes		781
Net income	**$ 5,708**	$ 3,123
Net income available to common shareholders:		
Basic	**$ 5,708**	$ 3,123
Diluted	**$ 5,708**	$ 3,123

Basic earnings per share:				
Income from continuing operations	**$**	**0.12**	$	0.07
Gain from discontinued operations, net of taxes				0.02
	$	**0.12**	$	0.09
Diluted earnings per share:				
Income from continuing operations	**$**	**0.12**	$	0.06
Gain from discontinued operations, net of taxes				0.02
	$	**0.12**	$	0.08
Weighted average number of common shares outstanding:				
Basic		**47,322**		35,898
Diluted		**48,084**		40,702

See Notes to Consolidated Financial Statements.

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Home Solutions of America, Inc.
Consolidated Statements of Cash Flows
(Dollars in thousands)
(unaudited)

	For the Three Months Ended March 31,	
	2007	2006
Cash Flows from Operating Activities		
Net income	**$ 5,708**	$ 3,123
Adjustments-		
Depreciation and amortization	**681**	428
Minority interest in income of consolidated subsidiary	**155**	258
Provision for doubtful accounts		1,200
Loss on sale of assets	**12**	2
Stock-based compensation	**673**	154
Gain on sale of discontinued operations		(1,698)
Changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	**(9,438)**	(1,352)
Prepaid expenses and other current assets	**(1,575)**	301
Costs in excess of billings, net	**(5,664)**	
Inventories	**592**	(523)
Other assets	**31**	721
Deferred tax asset	**68**	
Accounts payable and accrued expenses	**5,965**	(2,191)
Net cash (used in) provided by operating activities	**(2,792)**	423
Cash Flows from Investing Activities		
Cash received under note receivable	**360**	650
Cash acquired in acquisition, net of cash paid		87
Purchases of property and equipment	**(230)**	(97)
Net cash provided by investing activities	**130**	640
Cash Flows from Financing Activities		
Principal payments on debt and capital leases	**(1,354)**	(2,083)
Proceeds on line of credit, net of repayments	**2,000**	
Excess tax benefit from options exercises		218
Proceeds from exercise of warrants and options	**37**	250
Payments on amounts due to seller	**(1,119)**	
Distributions to minority stockholder	**(75)**	(487)
Net cash used in financing activities	**(511)**	(2,102)
Net decrease in cash	**(3,173)**	(1,039)

Cash at beginning of period		**8,713**		8,225
Cash at end of period	**$**	**5,540**	$	7,186

See Notes to Consolidated Financial Statements.

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Home Solutions of America, Inc.
Consolidated Statements of Cash Flows
(Dollars in thousands)
(unaudited)

	For the Three Months Ended March 31,	
	2007	2006
Cash paid for:		
Interest	$ 654	$ 389
Income taxes	$ 106	$ 59
Supplemental schedule of non-cash investing and financing activities:		
Issuance of stock for conversion of debt and accrued interest	$	$ 902
Fixed assets acquired through debt and capital lease obligations	$ 228	$ 104
Deferred gain on discontinued operations	$	$ 1,433
Issuance of notes payable for acquisition	$	$ 725
Reclassification of goodwill to intangibles	$ 4,400	$
Goodwill adjustment	$ 74	$

See Notes to Consolidated Financial Statements.

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Home Solutions of America, Inc.
Notes to Consolidated Financial Statements
March 31, 2007
(Unless otherwise indicated, dollars and shares in thousands, except per share data)
(unaudited)

NOTE 1 BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Interim Unaudited Condensed Consolidated Financial Statements

The accompanying condensed consolidated financial statements have been prepared in accordance with the regulations for interim financial information of the Securities and Exchange Commission (the SEC). Accordingly, they do not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (which consist only of normal and recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the three month period ended March 31, 2007 are not necessarily indicative of the results that may be expected for the entire fiscal year.

Company Description and Nature of Operations

Home Solutions of America, Inc. (Home Solutions , or the Company), a Delaware corporation, is a provider of restoration, construction and interior services to commercial and residential areas that are (i) prone to flooding, hurricanes, tornados, fires or other naturally occurring and repetitive weather related emergencies, and/or (ii) experiencing robust commercial or residential development. With operations in the South, Gulf Coast regions and California, we believe that the Company is well positioned to capitalize on the growing demand for our suite of restoration, construction and interior services business segments. We seek to expand our core service offerings through the future acquisition of strategic, specialized, profitable and well-managed companies operating in our target markets and business segments with a proven history of internal growth.

The Company s business consists of two integrated service offerings: (i) restoration and construction services and (ii) interior services. See Note 7 Segment Reporting for additional segment information.

Restoration and Construction Services

Home Solutions is an emerging restoration and construction services company, offering diversified general contracting, restoration, construction management and design-build services to private clients and public agencies throughout the southern United States and California. We have established a strong reputation within our markets by executing significant projects on time and within budget while adhering to strict quality control measures. We offer general contracting, preconstruction planning and comprehensive project management services, including planning, scheduling and providing the manpower, equipment, materials and subcontractors required for a project. A portion of our work requires surety bonding and the Company has surety bonding agreements with various institutions to meet its bonding needs. We also serve as the subcontractor on several projects in the same markets.

The Company s restoration services include catastrophic storm response, clean up and removal of debris, initial set up services in an impacted area (including power, lodging, sustenance and training), water mitigation, drying, dehumidification and preparing affected areas for the next stage of restoration and rebuilding. We have trained employees who provide onsite first response to respond to fire, water and weather-related emergencies in our target markets to both commercial and residential clients. These services are primarily provided through our wholly-owned subsidiaries, Fireline Restoration, Inc. (Fireline), which we acquired effective July 1, 2006 pursuant to an acquisition closed on July 31, 2006, and Home Solutions Restoration of Louisiana, Inc. (HSR of Louisiana), which commenced operations in September 2005 in connection with the acquisition of substantially all the assets of Florida Environmental Remediation Services, Inc. (FERS). In October 2006, HSR of Louisiana purchased Associated Contractors, LLC (Associated) to expand its business development and general contracting capabilities. Our restoration services are currently provided in the areas of Florida, Louisiana, Mississippi, Alabama, Georgia, South Carolina, Texas and California.

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Our restoration services include servicing the next stage of the project after the initial clean up and catastrophic storm response. Restoration services include water, fire and wind restoration, mold remediation, contents restoration, air decontamination, asbestos and lead paint removal, cleaning, drying, and deodorization of carpet and furniture and moving and storage services. Fireline, which specializes in disaster recovery services and insurance estimates and repairs for commercial, industrial and residential properties, is certified in multiple aspects of the restoration industry, including smoke, fire, water and mold. Fireline and HSR of Louisiana are licensed as general contractors in Florida and Louisiana, respectively, and offer full interior and exterior restoration and reconstruction services in those states. Restoration business segment services are also provided through PW Stephens, Inc. (PWS) and Fiber Seal Systems, L.P. (FSS), two of our wholly-owned subsidiaries. PWS provides water and fire restoration services, air decontamination and removal of mold, asbestos and lead paint in California and, to a lesser extent, in Florida, and FSS provides cleaning, drying and deodorization of carpet and furniture as well as moving and storage services in 24 states and the District of Columbia.

We provide the following recovery and restoration services:

Recovery: Our recovery services include providing initial set up services in an impacted area (including power, lodging, and training) and then providing the drying, dehumidification, cleanup and removal of debris from commercial and residential areas to prepare the areas for the next stage of restoration. We provide these services on an hourly rate to our commercial and residential clients, both as a contractor and as a subcontractor to customers providing additional services in these markets.

Fire and Water Damage Restoration: We provide trained employees to respond to fire, water and weather-related emergencies, to inspect structural members and contents damaged by water, to determine the likelihood or extent of mold growth and to provide immediate cleaning, drying, moving, storage and deodorization, among other services.

Construction: The Company s construction services include providing services to a number of high growth companies and specialized building markets, including hospitality and gaming, insurance, education and healthcare markets. We believe our success in construction services results from our proven ability to manage and perform meaningful, complex projects while providing accurate budgeting and strict quality control. Although price is a key competitive factor, we believe our strong reputation, long-standing customer relationships and significant level of repeat and referral business have enabled us to achieve our leading position.

Indoor Air Contamination: Through PWS, we provide indoor air contamination services, including contamination from mold, asbestos and lead paint. With increased media attention regarding the health threat of mold, fewer insurance options and property transfers at risk, current market conditions have created significant demand for mold inspections, certifications and remediation services. These services consist of property and system inspections, surface and air testing, project design, microbial removal, light interior demolition, repair and specialized cleaning work. Customer opportunities are developed through a regional sales force as well as through referrals by real estate firms, insurance adjusters, mortgage companies, attorneys and nationally-branded retailers. The Company believes it can use its industry experience to give efficacy to its processes and provide homeowners with quality assurance.

Cleaning and Fabric Protection: Through FSS, we provide fabric protection services to protect furniture, carpet and draperies from stains and daily wear through both Company-owned locations and over forty licensed locations. This niche market is primarily targeted at above-average income homeowners. We also provide air duct cleaning services to remove particulate (organic and inorganic) material, which can cause allergic reactions and is often the breeding ground for many types of mold, from heating and air conditioning systems.

Interior Services

Through our wholly-owned subsidiaries, Southern Exposure Unlimited of Florida, Inc. (Southern Exposure) and Cornerstone Marble and Granite, Inc. (formerly known as Cornerstone Building and Remodeling, Inc. (Cornerstone), we offer cabinet and countertop installation services. Southern Exposure manufactures and installs a high-end product line of cabinets and countertops. Our position in this market was strengthened in March 2005 through the acquisition of Cornerstone, which installs custom marble and granite countertops for residential customers. Currently, we manufacture cabinets and install cabinets and kitchen countertops for Centex Corporation (Centex), one of the largest homebuilders in the nation, in its southwest Florida market. We also install granite countertops for Home Depot, Inc. (Home Depot) in Florida, Georgia, Alabama and South Carolina. The Home Depot contract may be terminated at any time upon notice to us. Furthermore, Home Depot is not obligated to use our services under these contracts. We have no contract with Centex, and Centex is not obligated to buy our products or use our services. We also have granite fabrication and installation operations in Southern California which services the residential and multi-family markets.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Home Solutions and its wholly and 50% owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation. The minority owner s interest in a subsidiary has been reflected as minority interest in the accompanying consolidated balance sheets.

Fair Value of Financial Instruments

The Company measures its financial assets and liabilities in accordance with accounting principles generally accepted in the United States of America. For certain of the Company s financial instruments, including cash, accounts receivable, notes receivable, accounts payable and accrued expenses, the carrying amounts approximate fair value due to their short maturities. The fair values of long-term debt and capital lease obligations approximate their carrying values due to their short-term maturities or their generally variable interest rate terms.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of the contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates made by management include, among others, the realizability of accounts and notes receivable, inventories, recoverability of property and equipment, intangibles and goodwill and valuation of stock-based compensation and deferred tax assets. Actual results could differ from these estimates.

Concentration of Credit Risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist of cash and receivables. The Company places its cash with financial institutions and may exceed the Federal Deposit Insurance Corporation (FDIC) $100 insurance limit. At March 31, 2007, the Company had approximately $5,009 in these accounts in excess of the FDIC insurance limits.

The Company offers its services predominately in the states of California, Texas, Louisiana and Florida, and it extends credit based on an evaluation of a customer s financial condition, generally without collateral. Exposure to losses on accounts receivable is principally dependent on each customer s financial condition. The Company monitors its exposure for credit losses and maintains allowances for anticipated losses, if required. Although the Company expects to collect amounts due, actual collections may differ from the estimated amounts.

One customer accounted for approximately 11% of total sales for the three months ended March 31, 2007. For the same period in 2006, two customers accounted for approximately 25% and 22% of total sales, and one customer accounted for approximately 56% of accounts receivable.

In June 2006, Southern Family Insurance (Southern) was placed in liquidation. Southern was the insurance carrier on Fireline s two significant customers. At March 31, 2007, the Company had net accounts receivable from these customers aggregating approximately $26,000. In order to protect its interests the Company has filed a claim with the Florida Insurance Guarantee Association (FIGA). Southern was an admitted insurance carrier in Florida and state statutes insures the payment of valid claims by the FIGA. FIGA has certified the Company s claims as valid. Should the Company be unable to collect the balances due, it may have to initiate legal action. Unpaid balances related to this receivable or any other account receivable balance acquired up to a maximum of $19,400 would reduce the payment due on the note payable to the seller of Fireline. In addition, to the right of offset against the seller note, the Company has filed its lien rights against the property in which the work related to the largest FIGA claim was performed. The Company estimates that the amounts collected will be between $24,000 and $30,000 and that any amounts not collected will be applied against the amounts due on the note payable to the seller.

Property and Equipment

Property and equipment are stated at cost, and are being depreciated using the straight-line method over the estimated useful lives of the related assets, ranging from three to 20 years. Leasehold improvements are amortized using the straight-line method over the lesser of the estimated useful lives of the assets or the related lease terms. Equipment under capital lease obligations is depreciated over the shorter of the estimated useful life or the term of the lease. Maintenance and routine repairs are charged to expense as incurred. Significant renewals and betterments are capitalized. At the time of retirement or other disposition of property and equipment, the cost and accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in the consolidated statements of income.

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Long-Lived Assets

The Company s management assesses the recoverability of its long-lived assets upon the occurrence of a triggering event by determining whether the depreciation and amortization of long-lived assets over their remaining lives can be recovered through projected undiscounted future cash flows. The amount of long-lived asset impairment, if any, is measured based on fair value and is charged to operations in the period in which long-lived asset impairment is determined by management. At March 31, 2007, the Company s management believes there is no impairment of its long-lived assets. There can be no assurance, however, that market conditions will not change or demand for the Company s products and services will continue, which could result in impairment of long-lived assets in the future.

Inventories

Inventories consist almost entirely of granite slabs and are valued at the lower of cost or market. As part of the valuation process, excess and slow-moving inventories are reduced to their estimated net realizable value.

Intangibles

Identifiable intangibles acquired in connection with business acquisitions accounted for under the purchase method are recorded at their respective fair values. The Company is amortizing the identifiable intangibles over their estimated useful lives, ranging from six to twenty years. Intangibles consist of the following at March 31, 2007:

	Balance	Estimated Useful Life (Years)
Trade name	$ 4,540	15
Customer list	8,300(1)	15
Supply agreement	1,350	20
Non-compete	641(1)	6
	14,831	
Accumulated amortization	(2,089)	
	$ 12,742	

(1) Additions during the three months ended March 31, 2007 to identifiable intangible assets are based on the Company s estimate pending a final valuation analysis expected to be completed by June 30, 2007.

Amortization expense totaled $390 and $226 for the three months ended March 31, 2007 and 2006, respectively. The estimated amortization for each of the next five years approximates $750.

Goodwill

Goodwill represents the excess of acquisition cost over the net assets acquired in a business combination and is not amortized in accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other*

Intangible Assets. The provisions of SFAS No. 142 require that the Company allocate its goodwill to its various reporting units, determine the carrying value of those businesses, and estimate the fair value of the reporting units so that a two-step goodwill impairment test can be performed. In the first step of the goodwill impairment test, the fair value of each reporting unit is compared to its carrying value. Management reviews, on an annual basis, the carrying value of goodwill in order to determine whether impairment has occurred. Impairment is based on several factors including the Company s projection of future discounted operating cash flows. If an impairment of the carrying value were to be indicated by this review, the Company would perform the second step of the goodwill impairment test in order to determine the amount of goodwill impairment, if any.

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The changes in the carrying amount of goodwill for the three months ended March 31, 2007 are as follows:

Balance as of December 31, 2006	$	122,500
Goodwill adjustment related to acquisitions		(74)
Preliminary estimate of identifiable intangibles related to the Fireline and Associated acquisitions [1]		(4,400)
Balance as of March 31, 2007	$	118,026

[1] See discussion above

Revenue Recognition

The Company recognizes revenue in accordance with Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, as revised by SAB No. 104. As such, the Company recognizes revenue when persuasive evidence of an arrangement exists, title transfer has occurred, the price is fixed or readily determinable and collectibility is probable. Sales are recorded net of sales discounts.

PWS, FSS, HSR of Louisiana and Fireline recognize revenue at the time the contract and related services are performed.

Southern Exposure and Cornerstone recognize revenue for product sales at the time the related products are shipped to the customer. These subsidiaries recognize revenue for installation jobs upon complete installation of the cabinets or countertops and inspection by the customer. Deferred revenue represents amounts billed to customers and collected prior to completion of the installation of the cabinets or countertops and inspection by the customer.

Fireline and HSR of Louisiana recognize revenue from certain jobs using the percentage-of-completion method. Under the percentage-of-completion method, revenues with respect to individual contracts are recognized in the proportion that costs incurred to date bear to total estimated costs and progress towards completion. These estimates are dependent upon judgments including material costs and quantities, labor productivity, subcontractor performance and other costs. In addition, disputes on our projects can and sometimes do occur with our customers, subcontractors and equipment vendors that require significant judgment as to the ultimate resolution and may take an extended period of time to resolve. As projects are executed, estimates of total revenues and total costs at completion are refined and revised. These estimates change due to factors and events affection execution and often include estimates for resolution of disputes that may be settled in negotiations or through arbitration, mediation or other legal methods. The percentage-of-completion method requires that adjustments to estimated revenues and costs, including estimated claim recoveries, be recognized on a cumulative basis, when the adjustments are identified. When these adjustments are identified near or at the end of a project, the full impact of the change in estimate would be recognized as a change in the gross profit on the contract in that period. This can result in a material impact on our results for a single reporting period. General and administrative costs are not allocated to contract costs and are charged to expense as incurred.

Costs in Excess of Billings

Uncompleted contracts at March 31, 2007 were as follows:

Costs incurred on uncompleted contracts	$	51,603
Estimated earnings		19,571
		71,174
Billings to date		(59,906)
	$	11,268
Costs in excess of billings	$	14,981

Billings in excess of costs		(3,713)
	$	11,268

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Stock-Based Compensation

At March 31, 2007, the Company maintained two shareholder approved stock-based incentive compensation plans that permit the issuance of equity-based compensation awards to employees, qualified consultants and directors, including stock options and stock purchase rights.

The Company accounts for employee and director stock-based compensation under the fair value recognition provisions of SFAS No. 123(R), *Share Based Payment*. Compensation cost recognized in the three months ended March 31, 2007 includes: (a) compensation cost for all share-based payments granted and not yet vested prior to January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 *Accounting for Stock-Based Compensation*, and (b) compensation cost for all share-based payments granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Since stock-based compensation expense recognized in the statements of income for the three months ended March 31, 2007 and 2006 is based on awards ultimately expected to vest, the compensation expense has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The estimated average forfeiture rate for the quarters ended March 31, 2007 and 2006 of approximately 2% was based on historical forfeiture experience and estimated future employee forfeitures.

The Company calculates stock-based compensation by estimating the fair value of each option using the Black-Scholes option pricing model. The Company s determination of fair value of share-based payment awards are made as of their respective dates of grant using that option pricing model and is affected by the Company s stock price as well as a number of subjective assumptions. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards and actual and projected employee stock option exercise behavior. The expected term of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The risk-free rate selected to value any particular grant is based on the U.S. Treasury rate that corresponds to the pricing term of the grant effective as of the date of the grant. The expected volatility is based on the historical volatility of the Company s stock price. These factors could change in the future, affecting the determination of stock-based compensation expense in future periods. The Black-Scholes option pricing model was developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company s options have certain characteristics that are significantly different from traded options, the existing valuation models may not provide an accurate measure of the fair value of the Company s options. Although the fair value of the Company s options is determined in accordance with SFAS No. 123(R) using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction. The calculated compensation cost is recognized on a straight-line basis over the vesting period of the options.

Stock Plans

The Company maintains the 1998 Stock Option Plan (the 1998 Plan) and the 2001 Stock Plan (the 2001 Plan and collectively, the Stock Plans). The Stock Plans are shareholder approved stock-based incentive compensation plans that permit the issuance of equity-based compensation awards, including incentive stock options, nonqualified stock options and stock purchase rights. Under the Stock Plans, incentive stock options have been granted to employees, and non-qualified stock options have been granted to employees, qualified consultants and board members. Stock purchase rights, which are available under the 2001 Plan, have been granted to directors and employees. The compensation committee serves as the administrator of the 1998 Plan, and the entire board of directors serves as the administrator of the 2001 Plan. The administrator of each Stock Plan determines eligibility, vesting schedules and exercise prices for awards granted under the Stock Plan which it administers. The Company issues new shares or shares held in treasury to satisfy award exercises under its Stock Plans.

A summary of the shares reserved for grant and awards available for grant under each Stock Plan is as follows:

	March 31, 2007	
	Shares Reserved	Awards Available

	for Grant	for Grant
1998 Stock Plan	3,500	393
2001 Stock Plan	6,500	3,008
	10,000	3,401

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The Company issues awards to employees, qualified consultants and directors that generally vest over time based solely on continued employment or service during the related vesting period and are exercisable over a five to ten year service period. Typically, employee awards vest monthly over a three year period, although awards are sometimes granted with immediate vesting and in certain cases, vesting of awards has been accelerated. Options are generally granted with an exercise price equal to the market price of the Company s stock at the date of grant, although in certain instances, the exercise price has been higher than the market price on the date of grant. Directors have typically received immediately vested stock purchase rights at an exercise price of $-0- per share, which are subject to forfeiture on a proportionate basis in the event that a director s service terminates prior to the end of the current board term.
The fair value of each stock-based award is estimated on the grant date using the Black Scholes option-pricing model. Expected volatilities are based on the historical volatility of the Company s stock price. The expected term of options granted subsequent to the adoption of SFAS No. 123(R) is derived using the simplified method as defined in the SEC s Staff Accounting Bulletin 107*, Implementation of FASB 123R*. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury interest rates in effect at the time of grant. The fair value of options granted was estimated using the following weighted-average assumptions:

	For the Three Months Ended March 31,	
	2007	2006
Expected term (in years)		10
Expected volatility		