

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

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**FORM 10-Q**

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

**For the quarterly period ended June 30, 2006**

OR

**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 0-22418

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**ITRON, INC.**

(Exact name of registrant as specified in its charter)

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Washington  
(State of incorporation)

91-1011792  
(I.R.S. Employer Identification Number)

2818 North Sullivan Road  
Spokane Valley, Washington 99216-1897  
(509) 924-9900  
(Address and telephone number of registrant's principal executive offices)

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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  No

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

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of June 30, 2006, there were outstanding 25,491,538 shares of the registrant's common stock, no par value, which is the only class of common stock of the registrant.

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## PART I: FINANCIAL INFORMATION

## Item 1: Financial Statements (Unaudited)

ITRON, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(in thousands, except per share data)			
Revenues				
Sales	\$ 151,977	\$ 122,811	\$ 294,911	\$ 227,013
Service	11,833	12,312	24,452	24,580
Total revenues	<u>163,810</u>	<u>135,123</u>	<u>319,363</u>	<u>251,593</u>
Cost of revenues				
Sales	88,118	70,810	169,960	130,009
Service	6,660	7,574	13,597	13,847
Total cost of revenues	<u>94,778</u>	<u>78,384</u>	<u>183,557</u>	<u>143,856</u>
Gross profit	69,032	56,739	135,806	107,737
Operating expenses				
Sales and marketing	16,321	13,529	31,802	26,768
Product development	14,920	11,414	27,790	23,328
General and administrative	12,519	11,770	24,641	21,736
Amortization of intangible assets	7,612	9,715	14,925	19,431
Restructurings	-	-	-	390
Total operating expenses	<u>51,372</u>	<u>46,428</u>	<u>99,158</u>	<u>91,653</u>
Operating income	17,660	10,311	36,648	16,084
Other income (expense)				
Interest income	360	94	722	98
Interest expense	(2,585)	(6,385)	(8,331)	(10,952)
Other income (expense), net	(241)	454	(689)	555
Total other income (expense)	<u>(2,466)</u>	<u>(5,837)</u>	<u>(8,298)</u>	<u>(10,299)</u>
Income before income taxes	15,194	4,474	28,350	5,785
Income tax (provision) benefit	(4,990)	4,839	(11,077)	4,345
Net income	<u>\$ 10,204</u>	<u>\$ 9,313</u>	<u>\$ 17,273</u>	<u>\$ 10,130</u>
Earnings per share				
Basic net income per share	<u>\$ 0.40</u>	<u>\$ 0.41</u>	<u>\$ 0.68</u>	<u>\$ 0.46</u>
Diluted net income per share	<u>\$ 0.39</u>	<u>\$ 0.38</u>	<u>\$ 0.66</u>	<u>\$ 0.43</u>
Weighted average number of shares outstanding				
Basic	25,415	22,811	25,237	22,135
Diluted	26,360	24,416	26,216	23,677

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

**ITRON, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED)**

	<b>June 30,</b>	<b>December 31,</b>
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 46,587	\$ 33,638
Accounts receivable, net	89,046	104,428
Inventories	59,979	49,456
Deferred income taxes, net	20,627	23,194
Other	23,598	10,941
Total current assets	<u>239,837</u>	<u>221,657</u>
Property, plant and equipment, net	75,475	77,623
Intangible assets, net	118,161	123,293
Goodwill	119,504	116,032
Deferred income taxes, net	52,330	48,955
Other	8,664	11,324
Total assets	<u>\$ 613,971</u>	<u>\$ 598,884</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable and accrued expenses	\$ 49,418	\$ 46,215
Wages and benefits payable	20,058	23,732
Current portion of debt	-	4,376
Current portion of warranty	7,927	8,497
Unearned revenue	26,376	22,758
Total current liabilities	<u>103,779</u>	<u>105,578</u>
Long-term debt	124,274	160,186
Project financing debt	-	2,367
Warranty	9,027	6,779
Contingent purchase price	5,882	-
Other obligations	7,927	6,440
Total liabilities	<u>250,889</u>	<u>281,350</u>
Commitments and contingencies		
Shareholders' equity		
Preferred stock	-	-
Common stock	339,640	312,046
Accumulated other comprehensive income, net	1,552	871
Retained earnings	21,890	4,617
Total shareholders' equity	<u>363,082</u>	<u>317,534</u>
Total liabilities and shareholders' equity	<u>\$ 613,971</u>	<u>\$ 598,884</u>

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

**ITRON, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

	<u>Six Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>
	(in thousands)	
Operating activities		
Net income	\$ 17,273	\$ 10,130
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	22,291	26,124
Employee stock plans income tax benefits	11,686	7,047
Excess tax benefits from stock-based compensation	(8,371)	-
Stock-based compensation	4,096	220
Amortization of prepaid debt fees	3,155	3,048
Deferred income taxes, net	(953)	(12,380)
Other, net	435	828
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	18,038	4,324
Inventories	(9,575)	(892)
Accounts payable and accrued expenses	1,142	2,179
Wages and benefits payable	(3,623)	2,696
Unearned revenue	4,230	(4,110)
Warranty	1,678	(181)
Other long-term obligations	(181)	(644)
Other, net	(4,550)	(1,800)
Net cash provided by operating activities	<u>56,771</u>	<u>36,589</u>
Investing activities		
Proceeds from the sale of property, plant and equipment	109	2,642
Acquisitions of property, plant and equipment	(14,420)	(5,276)
Proceeds from the sale of an investment in affiliate	1,000	-
Business acquisitions, net of cash and cash equivalents acquired	(7,778)	-
Other, net	335	478
Net cash used in investing activities	<u>(20,754)</u>	<u>(2,156)</u>
Financing activities		
Payments on debt	(42,703)	(108,178)
Issuance of common stock	11,326	72,318
Excess tax benefits from stock-based compensation	8,371	-
Prepaid debt fees	(62)	(267)
Other, net	-	28
Net cash used in financing activities	<u>(23,068)</u>	<u>(36,099)</u>
Increase (decrease) in cash and cash equivalents	12,949	(1,666)
Cash and cash equivalents at beginning of period	33,638	11,624
Cash and cash equivalents at end of period	<u>\$ 46,587</u>	<u>\$ 9,958</u>
<i>Non-cash operating and investing transactions:</i>		
Property, plant and equipment purchased but not yet paid	\$ 3,103	\$ -
Non-cash affects of acquisitions (Note 4)		
<i>Supplemental disclosure of cash flow information:</i>		
Cash paid during the period for:		
Income taxes	\$ 833	\$ 1,294
Interest	5,623	8,088

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

**ITRON, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2006**  
**(Unaudited)**

In this Quarterly Report on Form 10-Q, the terms “we,” “us,” “our,” “Itron” and the “Company” refer to Itron, Inc.

**Note 1: Summary of Significant Accounting Policies**

*Basis of Consolidation*

The condensed consolidated financial statements presented in this Quarterly Report on Form 10-Q are unaudited and reflect entries necessary for the fair presentation of the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2006 and 2005, Condensed Consolidated Balance Sheets as of June 30, 2006 and December 31, 2005 and Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2006 and 2005, of Itron and our consolidated subsidiaries. All entries required for the fair presentation of the financial statements are of a normal recurring nature. Intercompany transactions and balances are eliminated upon consolidation.

We consolidate all entities in which we have a greater than 50% ownership interest. We also consolidate entities in which we have a 50% or less investment and over which we have control. We account for entities in which we have a 50% or less investment and exercise significant influence under the equity method of accounting. Entities in which we have less than a 20% investment and do not exercise significant influence are accounted for under the cost method. We consider for consolidation any variable interest entity of which we are the primary beneficiary. We are not the primary beneficiary of any variable interest entities.

On April 1, 2006, we completed the acquisition of Quantum Consulting, Inc., which is reported within our Software Solutions segment. On June 1, 2006, we completed the acquisition of ELO Sistemas e Tecnologia Ltda., located in Brazil, which is reported within our Electricity Metering segment. The operating results of these acquisitions are included in our condensed consolidated financial statements commencing on the date of each acquisition (see Note 4).

Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim results. These condensed consolidated financial statements should be read in conjunction with the 2005 audited financial statements and notes included in our Annual Report on Form 10-K, as filed with the SEC on February 24, 2006. The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results expected for the full fiscal year or for any other fiscal period.

*Cash and Cash Equivalents*

We consider all highly liquid instruments with remaining maturities of three months or less at the date of acquisition to be cash equivalents. Cash equivalents are recorded at cost, which approximates fair value.

*Accounts Receivable and Allowance for Doubtful Accounts*

Accounts receivable are recorded for invoices issued to customers in accordance with our contractual arrangements. Unbilled receivables are recorded when revenues are recognized upon product shipment or service delivery and invoicing occurs at a later date. The allowance for doubtful accounts is based on our historical experience of bad debts. Accounts receivable are written-off against the allowance when we believe an account, or a portion thereof, is no longer collectible.

*Inventories*

Inventories are stated at the lower of cost or market using the first-in, first-out method. Cost includes raw materials and labor, plus applied direct and indirect costs, including those costs required under Statement of Financial Accounting Standards 151, *Inventory Costs—an amendment of ARB 43, Chapter 4*, (SFAS 151), which was effective for inventory costs incurred on or after January 1, 2006. SFAS 151 did not have a material effect on our financial statements. Service inventories consist primarily of subassemblies and components necessary to support post-sale maintenance. A large portion of our low-volume manufacturing and all of our repair services for domestic handheld meter reading units are provided by an outside vendor, Servatron. At December 31, 2005, we had a 30% equity interest in Servatron, which we sold back to Servatron in the first quarter of 2006 (see Note 11). Consigned inventory held by Servatron totaled \$3.8 million at June 30, 2006 and \$2.9 million at December 31, 2005.

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### *Property, Plant and Equipment and Equipment used in Outsourcing*

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally thirty years for buildings and three to five years for equipment, computers and furniture. Leasehold improvements are capitalized over the term of the applicable lease, including renewable periods if reasonably assured, or over the useful lives, whichever is shorter. Project management costs incurred in connection with installation and equipment used in outsourcing contracts are depreciated using the straight-line method over the shorter of the useful life or the term of the contract. Costs related to internally developed software and software purchased for internal uses are capitalized in accordance with Statement of Position 98-1, *Accounting for Costs of Computer Software Developed or Obtained for Internal Use*. Repair and maintenance costs are expensed as incurred. We have no major planned maintenance activities.

In the second quarter of 2006, we capitalized approximately \$400,000 of interest costs related to qualified expenditures for improvements to our new corporate headquarters facility, which will be substantially complete as of September 30, 2006. The amount capitalized is based on interest rates in place during the construction period.

We review long-lived assets for impairment whenever events or circumstances indicate the carrying amount of an asset may not be recoverable. There were no significant impairments in the three and six months ended June 30, 2006 and 2005, respectively. If there was an indication of impairment, management would prepare an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows were less than the carrying amount of the assets, an impairment loss would be recognized to write down the assets to their estimated fair value. Assets held for sale are classified within other current assets in the Condensed Consolidated Balance Sheets and are reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated.

### *Prepaid Debt Fees*

Prepaid debt fees represent direct costs incurred related to the issuance of long-term debt and are recorded in other noncurrent assets. These costs are amortized to interest expense over the lives of the respective borrowings using the effective interest method. When debt is repaid early, the portion of unamortized prepaid debt fees related to the early principal repayment is written-off and included in interest expense in the Condensed Consolidated Statements of Operations.

### *Acquisitions*

In accordance with SFAS 141, *Business Combinations*, we utilize the purchase method of accounting for business combinations. Business combinations accounted for under the purchase method include the results of operations of the acquired business from the date of acquisition. Net assets of the company acquired and intangible assets that arise from contractual/legal rights, or are capable of being separated, are recorded at their fair values at the date of acquisition. The balance of the purchase price after fair value allocations represents goodwill. Negative goodwill resulting from contingent consideration is recorded as a liability. If the contingent payments are made, they are applied against the liability. Amounts allocated to in-process research and development (IPR&D) are expensed in the period of acquisition.

### *Goodwill and Intangible Assets*

Goodwill is tested for impairment as of October 1 of each year, or more frequently, if a significant event occurs under the guidance of SFAS 142, *Goodwill and Other Intangible Assets*. Intangible assets with a finite life are amortized based on estimated discounted cash flows over estimated useful lives and tested for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We use estimates in determining the value of goodwill and intangible assets, including estimates of useful lives of intangible assets, discounted future cash flows and fair values of the related operations. We forecast discounted future cash flows at the reporting unit level based on estimated future revenues and operating costs, which take into consideration factors such as existing backlog, expected future orders, supplier contracts and general market conditions.

### *Warranty*

We offer industry standard warranties on our hardware products and large application software products. Standard warranty accruals represent the estimated cost of projected warranty claims and are based on historical and projected product performance trends, business volume assumptions, supplier information and other business and economic projections. Thorough testing of new products in the development stage helps identify and correct potential warranty issues prior to manufacturing. Continuing quality control efforts during manufacturing limit our exposure to warranty claims. If our quality control efforts fail to detect a fault in one of our products, we could experience an increase in warranty claims. We track

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warranty claims to identify potential warranty trends. If an unusual trend is noted, an additional warranty accrual may be assessed and recorded when a failure event is probable and the cost can be reasonably estimated. Management continually evaluates the sufficiency of the warranty provisions and makes adjustments when necessary. The warranty allowances may fluctuate due to changes in estimates for material, labor and other costs we may incur to replace projected product failures, and we may incur additional warranty and related expenses in the future with respect to new or established product. The long-term warranty balance includes estimated warranty claims beyond one year.

A summary of the warranty accrual account activity is as follows:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>			
Beginning balance	\$ 15,111	\$ 11,287	\$ 15,276	\$ 13,574
Electricity Metering acquisition adjustments	-	(130)	-	(2,128)
New product warranties	734	883	1,319	1,468
Other changes/adjustments to warranties	3,147	771	4,512	1,489
Claims activity	(2,038)	(1,547)	(4,153)	(3,139)
Ending balance, June 30	16,954	11,264	16,954	11,264
Less: current portion of warranty	(7,927)	(6,148)	(7,927)	(6,148)
Long-term warranty	<u>\$ 9,027</u>	<u>\$ 5,116</u>	<u>\$ 9,027</u>	<u>\$ 5,116</u>

Total warranty expense, which consists of new product warranties issued and other changes and adjustments to warranties, totaled approximately \$3.9 million and \$1.7 million for the three months ended June 30, 2006 and 2005 and approximately \$5.8 million and \$3.0 million for the six months ended June 30, 2006 and 2005, respectively. Warranty expense is classified within cost of sales.

### *Health Benefits*

We are self insured for a substantial portion of the cost of employee group health insurance. We purchase insurance from a third party, which provides individual and aggregate stop loss protection for these costs. Each reporting period, we record the costs of our health insurance plan including paid claims, the change in the estimate of incurred but not reported (IBNR) claims, taxes and administrative fees (collectively the plan costs). Plan costs were approximately \$4.8 million and \$3.7 million for the three months ended June 30, 2006 and 2005 and approximately \$7.1 million and \$7.9 million for the six months ended June 30, 2006 and 2005, respectively. The IBNR accrual, which is included in wages and benefits payable, was \$2.0 million and \$2.1 million at June 30, 2006 and December 31, 2005, respectively. Fluctuations in the IBNR accrual are the result of claims activity.

### *Contingencies*

An estimated loss for a contingency is recorded if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. We evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Changes in these factors could materially affect our financial position, results of operations and cash flows.

### *Income Taxes*

We account for income taxes using the asset and liability method. Under this method, deferred income taxes are recorded for the temporary differences between the financial reporting basis and tax basis of our assets and liabilities. These deferred taxes are measured using the tax rates expected to be in effect when the temporary differences reverse. We establish a valuation allowance for the portion of the deferred tax asset when we believe it is more likely than not that the deferred tax asset will not be utilized. Deferred tax liabilities have been recorded on undistributed earnings of foreign subsidiaries.

### *Foreign Exchange*

Our condensed consolidated financial statements are prepared in U.S. dollars. Assets and liabilities of foreign subsidiaries are denominated in foreign currencies and are translated to U.S. dollars at the exchange rates in effect on the balance sheet date. Revenues, costs of revenues and expenses for these subsidiaries are translated using a weighted average rate for the relevant reporting period. Translation adjustments resulting from this process are included, net of tax, in accumulated other comprehensive income (loss) in shareholders' equity. Gains and losses that arise from exchange rate fluctuations for balances

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that are not denominated in the local currency are included in the Condensed Consolidated Statements of Operations unless those balances arose from intercompany transactions deemed to be long-term in nature. Currency gains and losses for this exception are included, net of tax, in accumulated other comprehensive income (loss) in shareholders' equity.

### *Revenue Recognition*

Sales consist of hardware, software license fees, custom software development, field and project management service and engineering, consulting, implementation, installation and professional service revenues. Service revenues include post-sale maintenance support and outsourcing services. Outsourcing services encompass installation, operation and maintenance of meter reading systems to provide meter information to a customer for billing and management purposes. Outsourcing services can be provided for systems we own as well as those owned by our customers.

Revenue arrangements with multiple deliverables are divided into separate units of accounting if the delivered item(s) have value to the customer on a standalone basis, there is objective and reliable evidence of fair value of the undelivered item(s) and delivery/performance of the undelivered item(s) is probable. The total arrangement consideration is allocated among the separate units of accounting based on their relative fair values and the applicable revenue recognition criteria considered for each unit of accounting. For our standard contract arrangements that combine deliverables such as hardware, meter reading system software, installation and project management services, each deliverable is generally considered a single unit of accounting. The amount allocable to a delivered item is limited to the amount that we are entitled to bill and collect and is not contingent upon the delivery/performance of additional items.

Revenues are recognized when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the sales price is fixed or determinable and (4) collectibility is reasonably assured. Hardware revenues are generally recognized at the time of shipment, receipt by customer, or, if applicable, upon completion of customer acceptance provisions. For software arrangements with multiple elements, revenue recognition is also dependent upon the availability of vendor-specific objective evidence (VSOE) of fair value for each of the elements. The lack of VSOE, or the existence of extended payment terms or other inherent risks, may affect the timing of revenue recognition for software arrangements. If implementation services are essential to a software arrangement, revenue is recognized using either the percentage of completion methodology if project costs can be estimated or the completed contract methodology if project costs cannot be reliably estimated. Hardware and software post-sale maintenance support fees are recognized ratably over the life of the related service contract. Under outsourcing arrangements, revenue is recognized as services are provided. Certain consulting services are recognized as services are performed.

Unearned revenue is recorded for products or services that have not been provided but have been invoiced under contractual agreements or paid for by a customer, or when products or services have been provided but the criteria for revenue recognition have not been met.

### *Product and Software Development Expenses*

Product and software development expenses primarily include payroll and third party contracting fees. For software we develop to be marketed or sold, financial accounting standards require the capitalization of development costs after technological feasibility is established. Due to the relatively short period of time between technological feasibility and the completion of product development, and the immaterial nature of these costs, we do not capitalize software development. Product and software development costs are generally expensed when incurred.

### *Earnings Per Share*

Basic earnings per share (EPS) is calculated using net income (loss) divided by the weighted average common shares outstanding during the period. Diluted EPS is similar to basic EPS except that the weighted average common shares outstanding are increased to include the number of additional common shares that would have been outstanding if dilutive stock-based awards had been exercised. Diluted EPS assumes that common shares were issued upon the exercise of stock-based awards for which the market price exceeded the exercise price, less shares that could have been repurchased with the related proceeds (treasury stock method). Related proceeds include the amount the employee must pay upon exercise, future compensation cost associated with the stock award and the amount of excess tax benefits. Shares that are contingently issuable are included in the dilutive EPS calculation as of the beginning of the period when all necessary conditions have been satisfied. In periods when we report a net loss, diluted net loss per share is the same as basic net loss per share.

### *Stock-Based Compensation*

On January 1, 2006, we adopted SFAS 123(R), *Share-Based Payment*, which requires the measurement and recognition of compensation expense for all stock-based awards made to employees and directors based on estimated fair values. SFAS 123(R) supersedes Accounting Principles Board (APB) Opinion 25, *Accounting for Stock Issued to Employees*. In

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March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin 107 (SAB 107) relating to SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R).

We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our fiscal year 2006. Our condensed consolidated financial statements, as of and for the three and six months ended June 30, 2006, reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our 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 recognized under SFAS 123(R) for the three and six months ended June 30, 2006 was \$2.0 million and \$4.1 million, respectively, before income taxes, which includes awards of stock options, Employee Stock Purchase Plan (ESPP) and restricted and unrestricted stock. The related total tax benefit was \$277,000 and \$549,000, respectively, for the three and six months ended June 30, 2006. There was no stock-based compensation capitalized at June 30, 2006. Stock-based compensation expense of \$71,000 and \$220,000 for the three and six months ended June 30, 2005 was related to stock grants and employee stock purchases that we had been recognizing under previous accounting standards. There was no stock-based compensation expense related to employee stock options recognized during the three and six months ended June 30, 2005. We expense stock-based compensation using the straight-line method.

The adoption of SFAS 123(R) resulted in incremental stock-based compensation expense and a corresponding decrease to pre-tax income of \$1.9 million and \$3.8 million for the three and six month periods ended June 30, 2006. A substantial portion of our stock-based compensation cannot be expensed for tax purposes. This resulted in a decrease to income after tax of \$1.7 million, or \$0.07 per basic and \$0.06 per diluted share for the quarter and \$3.4 million, or \$0.13 per basic and diluted share year to date. Prior to the adoption of SFAS 123(R), we presented all tax benefits resulting from the exercise of stock options as operating cash inflows. Under SFAS 123(R), the benefits of tax deductions in excess of the compensation cost recognized are classified as financing cash inflows rather than operating cash inflows, on a prospective basis. Cash provided by operating activities decreased and cash provided by financing activities increased by \$8.4 million, respectively, related to excess tax benefits from stock awards exercised during the six month period ended June 30, 2006.

The following table shows the effect on net earnings and earnings per share, for the three and six months ended June 30, 2005, had compensation cost been recognized based upon the estimated fair value on the grant date of stock options and ESPP in accordance with SFAS 123, *Accounting for Stock-based Compensation*, as amended by SFAS 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*. Disclosures for the three and six month periods ended June 30, 2006 are not presented because the amounts are recognized in the condensed consolidated financial statements.

	<b>Three Months Ended June 30, 2005</b>	<b>Six Months Ended June 30, 2005</b>
	<b>(in thousands, except per share data)</b>	
Net income		
As reported	\$ 9,313	\$ 10,130
Deduct: stock-based compensation, net of tax	(1,938)	(3,069)
Pro forma net income	<u>\$ 7,375</u>	<u>\$ 7,061</u>
Basic net income per share		
As reported	\$ 0.41	\$ 0.46
Pro forma	<u>0.32</u>	<u>0.32</u>
Diluted net income per share		
As reported	\$ 0.38	\$ 0.43
Pro forma	<u>0.30</u>	<u>0.30</u>

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The fair value of stock options and ESPP awards issued during the three and six month periods ended June 30, 2006 and 2005 were estimated at the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions.

	<b>Employee Stock Options</b>			
	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Dividend yield	-	-	-	-
Expected volatility	41.6%	58.6%	41.6%	59.0%
Risk-free interest rate	4.9%	3.7%	4.9%	3.7%
Expected life (years)	4.37	3.40	4.37	3.40

  

	<b>ESPP</b>			
	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005 <sup>(1)</sup></b>	<b>2006</b>	<b>2005</b>
Dividend yield	-	-	-	-
Expected volatility	54.0%	-	48.2%	50.9%
Risk-free interest rate	4.7%	-	4.4%	2.5%
Expected life (years)	0.25	-	0.25	0.25

<sup>(1)</sup> There was no ESPP activity for the three month period ended June 30, 2005.

For 2006, expected price volatility is based on a combination of historical volatility of the Company's stock and the implied volatility of its traded options, for the related vesting period. Prior to the adoption of SFAS 123(R), expected stock price volatility was estimated using only historical volatility. The risk-free interest rate is the rate available as of the award date on zero-coupon U.S. government issues with a remaining term equal to the expected life of the award. The expected life is the weighted average expected life for the entire award based on the fixed period of time between the date the award is granted and the date the award is fully exercised. Factors to be considered in estimating the expected life are historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. We have not paid dividends in the past and do not plan to pay any dividends in the foreseeable future.

For restricted and unrestricted stock, the fair value is the market close price of the stock on the grant date.

### *Use of Estimates*

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Because of various factors affecting future costs and operations, actual results could differ from estimates.

### *New Accounting Pronouncements*

In February of 2006, the Financial Accounting Standards Board (FASB) issued SFAS 155, *Accounting for Certain Hybrid Instruments—An Amendment of FASB Statements 133 and 140* (SFAS 155). SFAS 155 amends SFAS 133 to allow financial instruments that have embedded derivatives to be accounted for as a whole, if the holder elects to account for the whole instrument on a fair value basis, and provides additional guidance on the applicability of SFAS 133 and SFAS 140 to certain financial instruments and subordinated concentrations of credit risk. SFAS 155 is effective for all hybrid financial instruments acquired or issued by us on or after January 1, 2007. The adoption of SFAS 155 is not expected to have a material impact on our financial position or results of operations.

In July 2006, the FASB issued Financial Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB 109*, which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and is effective for fiscal years beginning after December 15, 2006. We have not yet determined the impact of the adoption of FIN 48 on our results of operations or financial condition.

**Note 2: Earnings Per Share and Capital Structure**

The following table sets forth the computation of basic and diluted EPS:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	(in thousands, except per share data)			
<b>Basic earnings per share:</b>				
Net income available to common shareholders	\$ 10,204	\$ 9,313	\$ 17,273	\$ 10,130
Weighted average number of shares outstanding	25,415	22,811	25,237	22,135
Basic net income per share	\$ 0.40	\$ 0.41	\$ 0.68	\$ 0.46
<b>Diluted earnings per share:</b>				
Net income available to common shareholders	\$ 10,204	\$ 9,313	\$ 17,273	\$ 10,130
Weighted average number of shares outstanding	25,415	22,811	25,237	22,135
Effect of dilutive securities: stock-based awards	945	1,605	979	1,542
Adjusted weighted average number of shares outstanding	26,360	24,416	26,216	23,677
Diluted net income per share	\$ 0.39	\$ 0.38	\$ 0.66	\$ 0.43

The dilutive effect of stock-based awards is calculated using the treasury stock method. Under this method, EPS is computed as if the awards were exercised at the beginning of the period (or at time of issuance, if later) and assumes the related proceeds were used to repurchase common stock at the average market price during the period. Related proceeds include the amount the employee must pay upon exercise, future compensation cost associated with the stock award and the amount of excess tax benefits. Weighted average common shares outstanding, assuming dilution, include the incremental shares that would be issued upon the assumed exercise of stock-based awards. At June 30, 2006 and 2005, we had stock-based awards outstanding of approximately 1.8 million and 3.2 million at average option exercise prices of \$22.99 and \$19.76, respectively. Approximately 27,000 and 10,000 stock-based awards were excluded from the calculation of diluted EPS for the three months ended June 30, 2006 and 2005, respectively, because they were anti-dilutive. Approximately 41,000 and 201,000 stock-based awards were excluded from the calculation of diluted EPS for the six months ended June 30, 2006 and 2005, respectively, because they were anti-dilutive. These stock-based awards could be dilutive in future periods.

We have authorized 10.0 million shares of preferred stock with no par value. In the event of a liquidation, dissolution or winding up of the affairs of the corporation, whether voluntary or involuntary, the holders of any preferred stock at the time outstanding will be entitled to be paid a preferential amount per share to be determined by the Board of Directors prior to any payment to holders of common stock. Shares of preferred stock may be converted into common stock based on terms, conditions, rates and subject to such adjustments set by the Board of Directors. There was no preferred stock issued or outstanding at June 30, 2006 and 2005.

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**Note 3: Certain Balance Sheet Components**

**Accounts receivable, net**

	<u>At June 30, 2006</u>	<u>At December 31, 2005</u>
	(in thousands)	
Trade (net of allowance for doubtful accounts of \$469 and \$598)	\$ 80,923	\$ 96,106
Unbilled revenue	<u>8,123</u>	<u>8,322</u>
Total accounts receivable, net	<u>\$ 89,046</u>	<u>\$ 104,428</u>

A summary of the allowance for doubtful accounts activity is as follows:

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(in thousands)			
Beginning balance	\$ 379	\$ 1,091	\$ 598	\$ 1,312
Provision (benefit) for doubtful accounts	92	(62)	(105)	(157)
Recoveries	-	-	-	-
Accounts charged off	<u>(2)</u>	<u>(318)</u>	<u>(24)</u>	<u>(444)</u>
Ending balance, June 30	<u>\$ 469</u>	<u>\$ 711</u>	<u>\$ 469</u>	<u>\$ 711</u>

**Inventories**

A summary of the inventory balances is as follows:

	<u>At June 30, 2006</u>	<u>At December 31, 2005</u>
	(in thousands)	
Materials	\$ 25,034	\$ 25,744
Work in process	4,394	5,832
Finished goods	<u>29,063</u>	<u>16,241</u>
Total manufacturing inventories	58,491	47,817
Service inventories	<u>1,488</u>	<u>1,639</u>
Total inventories	<u>\$ 59,979</u>	<u>\$ 49,456</u>

**Other current assets**

Assets held for sale are classified within other current assets and are reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. As of March 31, 2006, our headquarters building in Spokane Valley was listed for sale. As a result, the net carrying value of the Spokane Valley facility of approximately \$8.5 million was transferred from property, plant and equipment to other current assets.

**Property, plant and equipment, net**

	<u>At June 30, 2006</u>	<u>At December 31, 2005</u>
	(in thousands)	
Machinery and equipment	\$ 53,452	\$ 47,709
Equipment used in outsourcing	16,042	16,086
Computers and purchased software	35,452	34,736
Buildings, furniture and improvements	39,046	45,611
Land	<u>2,482</u>	<u>4,217</u>
Total cost	146,474	148,359
Accumulated depreciation	<u>(70,999)</u>	<u>(70,736)</u>
Property, plant and equipment, net	<u>\$ 75,475</u>	<u>\$ 77,623</u>

Depreciation expense was \$3.8 million and \$3.4 million for the three months ended June 30, 2006 and 2005, respectively. Depreciation expense was \$7.4 million and \$6.7 million for the six months ended June 30, 2006 and 2005, respectively.

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On December 30, 2005, we completed the purchase of a building in Liberty Lake, Washington, which will become our corporate headquarters in the third quarter of 2006. We expect to invest approximately \$11 million in capital improvements, of which \$4.3 million had been incurred through June 30, 2006. For the three months ended June 30, 2006, we capitalized interest costs of approximately \$400,000 relating to improvements to our new corporate headquarters.

### **Note 4: Business Combinations**

#### *Quantum Consulting, Inc.*

On April 1, 2006, we completed the acquisition of Quantum Consulting, Inc. (Quantum), an energy consulting firm. The acquisition expands our consulting services related to energy efficiency, planning design and market research in our Software Solutions segment. The preliminary purchase price, net of cash acquired of \$81,000, is summarized as follows (in thousands):

Cash consideration, net of cash acquired	\$	3,919
Direct transaction costs		<u>491</u>
Total purchase price	\$	<u><u>4,410</u></u>

Of the purchase price consideration, \$800,000 was retained in an escrow account for working capital adjustments and indemnifications made by Quantum. The amounts in escrow will be released at predetermined intervals through April 2008. Additional contingent consideration of up to \$1.0 million will be paid to Quantum shareholders if certain defined financial targets are achieved in 2006, 2007 and 2008. These additional payments will increase the purchase price and goodwill at the time the financial targets are achieved. An additional payment will also be made to Quantum shareholders, of up to \$1.0 million, if certain key individuals remain employees through March 2009. A substantial portion of the payment will be recognized as compensation expense over the retention period.

The following financial information reflects a preliminary allocation of the purchase price based on estimated fair values of assets and liabilities as of the date of acquisition. We are reviewing fixed assets, deferred taxes and intangible assets and expect to finalize the fair value adjustments by the end of 2006. The excess of the purchase price over the fair value of net assets acquired has been recorded as goodwill.

	<u>Fair Value</u> <u>(in thousands)</u>	<u>Useful Life</u> <u>(in months)</u>
Fair value of net assets assumed	\$ 446	
Identified intangible assets - amortizable		
Non-compete agreements	670	48
Contract backlog	360	36
Goodwill	<u>2,934</u>	
Total net assets acquired	<u><u>\$ 4,410</u></u>	

The values assigned to the identified intangible assets were estimated using the income approach. Under the income approach, the fair value reflects the present value of the projected cash flows that are expected to be generated. The intangible assets will be amortized over the estimated useful lives of the estimated discounted cash flows assumed in the valuation models. Goodwill and intangible assets were allocated to our Software Solutions segment in accordance with SFAS 142.

#### *ELO Sistemas e Tecnologia Ltda.*

On June 1, 2006, we completed the acquisition of ELO Sistemas e Tecnologia Ltda. (ELO) for an initial cash payment of approximately \$1.9 million, subject to a working capital adjustment. Cash consideration also included the settlement of a \$637,000 payable from ELO to us for inventory purchased by ELO prior to the acquisition. Additional contingent consideration will be payable if certain financial targets are achieved over the next five years. Operations will reside in Campinas, Brazil, located near São Paulo, and include sales, manufacturing, service and maintenance, consulting and administrative functions related to meters, automatic meter reading (AMR) technology and related systems in South America. The preliminary purchase price, which includes direct transaction costs, net of cash acquired of \$7,000, is summarized as follows (in thousands):

Cash consideration, net of cash acquired	\$	2,542
Direct transaction costs		<u>1,017</u>
Total purchase price	\$	<u><u>3,559</u></u>

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The purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values as of the date of acquisition. The estimated fair value of the net assets acquired and liabilities assumed exceeded the initial cash consideration paid by approximately \$5.8 million, resulting in negative goodwill. In a business combination with contingent consideration, the lesser of the maximum amount of contingent consideration or the total amount of negative goodwill should be recorded as a liability. As the purchase agreement does not limit the maximum contingent consideration payable, the full amount of the negative goodwill was recorded as a long-term liability. If contingent payments are made, we will apply the payments against the contingent liability. Payments in excess of the contingent liability balance, if any, will be recorded as goodwill.

The following financial information reflects a preliminary allocation of the purchase price based on estimated fair values of assets and liabilities as of the date of acquisition. There may be contingent liabilities we have not yet identified. We are performing a review of the assets acquired and liabilities assumed, including intangible assets and the associated lives, and expect to finalize a majority of the fair value adjustments by the end of 2006.

	<u>Fair Value</u> <u>(in thousands)</u>	<u>Useful Life</u> <u>(in months)</u>
Fair value of net assets assumed	\$ 733	
Identified intangible assets - amortizable		
Customer relationships/contracts	6,697	180
Contract backlog	1,903	12
Contingent purchase price liability	(5,774)	
Total net assets acquired	<u>\$ 3,559</u>	

The values assigned to the identified intangible assets were estimated using the income approach. Under the income approach, the fair value reflects the present value of the projected cash flows that are expected to be generated. The intangible assets will be amortized over the estimated useful lives of the estimated discounted cash flows assumed in the valuation models. Goodwill and intangible assets were allocated to our Electricity Metering segment in accordance with SFAS 142. Due to changes in foreign currency exchange rates, the contingent purchase price liability can increase or decrease, with a corresponding change in accumulated other comprehensive income (loss). The contingent purchase price liability was approximately \$5.9 million at June 30, 2006.

Pro forma results are not presented for the acquisitions of Quantum and ELO because neither acquisition had a material effect on our financial position or results of operations.

### **Note 5: Identified Intangible Assets**

The gross carrying amount and accumulated amortization of our intangible assets, other than goodwill, are as follows:

	<u>At June 30, 2006</u>			<u>At December 31, 2005</u>		
	<u>Gross Assets</u>	<u>Accumulated Amortization</u>	<u>Net</u>	<u>Gross Assets</u>	<u>Accumulated Amortization</u>	<u>Net</u>
	(in thousands)					
Core-developed technology	\$ 154,330	\$ (65,793)	\$ 88,537	\$ 154,330	\$ (54,064)	\$ 100,266
Patents	7,088	(4,875)	2,213	7,088	(4,690)	2,398
Capitalized software	5,065	(5,065)	-	5,065	(5,065)	-
Distribution and production rights	3,935	(3,302)	633	3,935	(3,220)	715
Customer contracts	15,573	(7,441)	8,132	8,750	(7,028)	1,722
Trademarks and tradenames	25,710	(9,826)	15,884	25,710	(7,634)	18,076
Other	9,420	(6,658)	2,762	6,450	(6,334)	116
Total identified intangible assets	<u>\$ 221,121</u>	<u>\$ (102,960)</u>	<u>\$ 118,161</u>	<u>\$ 211,328</u>	<u>\$ (88,035)</u>	<u>\$ 123,293</u>

Identified intangible assets increased during the second quarter of 2006 as a result of the Quantum and ELO acquisitions. The carrying amount of intangible assets can also increase or decrease, with a corresponding change in accumulated other comprehensive income (loss), due to changes in foreign currency exchange rates for those intangible assets owned by our foreign subsidiaries. At June 30, 2006, the intangible assets purchased in the ELO acquisition increased approximately \$163,000 as a result of a change in foreign currency rates. Intangible asset amortization expense was approximately

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\$7.6 million and \$9.7 million for the three months ended June 30, 2006 and 2005, respectively. Intangible asset amortization expense was approximately \$14.9 million and \$19.4 million for the six months ended June 30, 2006 and 2005, respectively.

Estimated annual amortization expense is as follows:

	<b>Estimated Annual Amortization (in thousands)</b>
2006	\$ 15,981
2007	25,530
2008	22,139
2009	18,678
2010	13,012
Beyond 2010	<u>22,821</u>
Total identified intangible assets, net	<u>\$ 118,161</u>

**Note 6: Goodwill**

During the second quarter of 2006, we completed the acquisition of Quantum and recorded a preliminary allocation of the purchase price, resulting in \$2.9 million of estimated goodwill. On July 1, 2004, we completed the acquisition of our Electricity Metering business and continued to make adjustments to the purchase price through June 2005 as the valuation of assets and liabilities were finalized. Goodwill decreased \$1.7 million in the first half of 2005 primarily due to a \$2.1 million adjustment related to the warranty accrual associated with the Electricity Metering acquisition. Goodwill balances can also increase or decrease, with a corresponding change in accumulated other comprehensive income (loss), due to changes in foreign currency exchange rates.

The following table reflects goodwill allocated to each reporting segment during the first six months of 2006 and 2005, respectively.

	<b>Hardware Solutions</b>			<b>Total Company</b>
	<b>Meter Data Collection</b>	<b>Electricity Metering</b>	<b>Software Solutions</b>	
	<b>(in thousands)</b>			
Goodwill balance, January 1, 2005	\$ 73,337	\$ 26,236	\$ 17,898	\$ 117,471
Goodwill adjustments	-	(1,758)	-	(1,758)
Effect of change in exchange rates	<u>(122)</u>	<u>(49)</u>	<u>(30)</u>	<u>(201)</u>
Goodwill balance, June 30, 2005	<u>\$ 73,215</u>	<u>\$ 24,429</u>	<u>\$ 17,868</u>	<u>\$ 115,512</u>
Goodwill balance, January 1, 2006	\$ 73,532	\$ 24,555	\$ 17,945	\$ 116,032
Goodwill acquired	-	-	2,934	2,934
Effect of change in exchange rates	<u>282</u>	<u>187</u>	<u>69</u>	<u>538</u>
Goodwill balance, June 30, 2006	<u>\$ 73,814</u>	<u>\$ 24,742</u>	<u>\$ 20,948</u>	<u>\$ 119,504</u>

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### Note 7: Debt

The components of our borrowings are as follows:

	At June 30, 2006	At December 31, 2005
	(in thousands)	
Senior Secured Credit Facility		
Term Loan	\$ -	\$ 24,676
Revolving Credit Line	-	-
Real Estate Term Note	-	14,800
Senior Subordinated Notes	124,274	124,226
Project Financing Debt	-	3,227
	<u>124,274</u>	<u>166,929</u>
Current Portion of Debt	-	(4,376)
Total Long-term Debt	<u>\$ 124,274</u>	<u>\$ 162,553</u>

#### *Senior Secured Credit Facility*

At December 31, 2005, we had \$24.7 million remaining on our original \$185 million seven-year senior secured term loan (term loan), which we repaid during the first quarter of 2006. The term loan was part of our senior secured credit facility (credit facility), which originated on July 1, 2004 to finance the acquisition of our Electricity Metering business. The credit facility also includes a \$55 million five-year senior secured revolving credit line (revolver). We have the ability to increase the revolver to \$75 million at a future date. Our letter of credit limit under the credit facility is \$55 million and can be increased to \$65 million at a future date. The credit facility is guaranteed by all of our operating subsidiaries, except for our foreign subsidiaries and an outsourcing project finance subsidiary, all of which are wholly owned.

At June 30, 2006, there were no borrowings outstanding under the revolver and \$22.5 million was utilized by outstanding standby letters of credit resulting in \$32.5 million available for additional borrowings. Revolver borrowings can be made at any time through June 2009, at which time any borrowings outstanding must be repaid. We were in compliance with all of our debt covenants at June 30, 2006 and December 31, 2005. Our debt covenants require us to maintain certain consolidated leverage and coverage ratios on a quarterly basis, as well as customary covenants that place restrictions on the incurrence of debt, the payment of dividends, certain investments and mergers.

Interest rates on the revolver vary depending on our consolidated leverage ratio and are based on the London InterBank Offering Rate (LIBOR) plus 2.0% to 3.0%, or Prime plus 1.0% to 2.0%, payable at various intervals depending on the term of the borrowing. The annual commitment fee on the unused portion of the revolver varies from 0.25% to 0.50%. We incur annual letter of credit fees based on (a) a fronting fee of 0.125% and (b) a letter of credit fee that varies from 1.0% to 2.0%.

Prepaid debt fees for all our outstanding borrowings are amortized over the respective terms using the effective interest method. Total unamortized prepaid debt fees were approximately \$5.8 million and \$8.9 million at June 30, 2006 and December 31, 2005, respectively.

#### *Real Estate Term Note*

On December 30, 2005, we signed a real estate term note (real estate note) for \$14.8 million, secured by real property, with principal payments of \$740,000, plus interest, payable quarterly, commencing April 1, 2006 and continuing through January 1, 2011. During the first quarter of 2006, we made an optional prepayment of \$10.0 million on the real estate note. During April 2006, we completed the repayment of the real estate note.

#### *Senior Subordinated Notes*

Our senior subordinated notes consist of \$125 million aggregate principal amount of 7.75% notes, issued in May 2004 and due in 2012. The notes were discounted to a price of 99.265 to yield 7.875%, with a balance of \$124.3 million at June 30, 2006. The notes are registered with the SEC and are generally transferable. The discount on the notes is accreted and the prepaid debt fees are amortized over the life of the notes. Fixed interest payments of approximately \$4.8 million are required every six months, in May and November. The notes are subordinated to our credit facility and are guaranteed by all of our operating subsidiaries, except for our foreign subsidiaries and an outsourcing project finance subsidiary, all of which are wholly owned. The notes contain covenants, which place restrictions on the incurrence of debt, the payment of dividends,

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certain investments and mergers. Some or all of the notes may be redeemed at our option at any time on or after May 15, 2008, at their principal amount plus a specified premium. At any time prior to May 15, 2007, we may, at our option, redeem up to 35% of the notes, at 107.75%, with the proceeds of certain sales of our common stock.

### *Project Financing*

In May 1998, in conjunction with project financing for one of our outsourcing contracts, we issued a note secured by the assets of the project with monthly interest payments at an annual interest rate of 7.6%, maturing May 31, 2009. During April 2006, we repaid the balance of the project financing loan, which included \$107,000 in prepayment fees.

### **Note 8: Restructurings**

In 2004, we incurred restructuring costs associated with the implementation of a new internal organizational structure, which resulted in staffing reductions and other restructuring expenses. These accrued costs were fully paid to employees by December 31, 2005. We have incurred lease termination costs in prior years. Accrued liabilities and expenses associated with these restructuring efforts for the six months ended June 30, 2005 consisted of the following:

	<u>Severance and Related Costs</u>	<u>Lease Termination and Related Costs</u>
	(in thousands)	
Accrual balance at December 31, 2004	\$ 2,317	\$ 175
Addition/adjustments to accruals	390	(109)
Cash payments	<u>(2,668)</u>	<u>-</u>
Accrual balance at June 30, 2005	<u>\$ 39</u>	<u>\$ 66</u>

The liability for employee severance is recorded within wages and benefits payable and the liability for lease terminations is recorded within accrued expenses. Lease termination and related costs are dependent on our ability to sublease vacant space and are reported as general and administrative expenses. The remaining \$39,000 severance related liability at June 30, 2005 was paid as of December 31, 2005. There was no restructuring activity during the three and six months ended June 30, 2006. The accrued liability for lease termination and related costs was \$50,000 at June 30, 2006.

### **Note 9: Income Taxes**

Our effective income tax rates differ from the federal statutory rate of 35%, and can vary from period to period, due to fluctuations in operating results, new or revised tax legislation and accounting pronouncements, research credits and state income taxes.

We estimate that our 2006 annual effective income tax rate will be approximately 42%. Our effective income tax rate was 33% and 39%, respectively, for the three and six months ended June 30, 2006. The rate for the three and six months ended June 30, 2006 is lower than the estimated annual rate due to tax benefits for certain state and Canadian credits and the realization of deferred tax assets related to a foreign subsidiary. Both the six month and estimated 2006 annual effective income tax rates are higher than the statutory rate due to state income taxes and the implementation of SFAS 123(R).

Our 2005 annual effective income tax rate of 34% was lower than the statutory tax rate due to the benefit of research credits. In the second quarter of 2005, we completed a research credit study for the years 1997 – 2004, recognizing a \$5.9 million net tax credit as an offset to the provision for income taxes. Due primarily to this credit, we had a net tax benefit for the three and six months ended June 30, 2005.

Our estimated 2006 annual effective income tax rate does not include a federal research credit, as the credit expired on December 31, 2005. Congress is currently discussing extension and/or revision of the research credit. As of June 30, 2006, the research credit had not been extended or reinstated by Congress. If the research credit is reinstated by Congress, our effective annual income tax rate for 2006 is expected to be lower than the current estimated rate of 42%.

**Note 10: Stock-Based Compensation***Stock Option Plans*

At June 30, 2006, we had three stock-based compensation plans in effect, only one of which we are currently granting options under. Stock options to purchase the Company's common stock are granted at the fair market value of the stock on the date of grant upon approval by our Board of Directors. Options generally become exercisable in three or four equal installments beginning a year from the date of grant and generally expire 10 years from the date of grant.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option-pricing model. The assumptions used to calculate the fair value of options granted are evaluated regularly to reflect market conditions and actual trends. Compensation expense is recognized only for those options expected to vest, with forfeitures estimated at the date of grant based on our historical experience and future expectations. Prior to the adoption of SFAS 123(R), the effect of forfeitures on the pro forma expense amounts was recognized as the forfeitures occurred.

The expense related to stock options recognized under SFAS 123(R) for the three and six months ended June 30, 2006 was \$1.8 million and \$3.6 million, respectively. For the three and six months ended June 30, 2006, we issued 30,000 shares with a weighted average fair value of \$25.82. A summary of our stock option activity during the six months ended June 30, 2006 is as follows:

	<b>Shares Subject to Options (in thousands)</b>	<b>Weighted Average Exercise Price per Share</b>	<b>Weighted Average Remaining Contractual Life (years)</b>	<b>Aggregate Intrinsic Value (in thousands)</b>
Outstanding, January 1, 2006	2,443	\$ 21.24		
Granted	30	63.56		
Exercised	591	17.12		
Forfeited	46	32.04		
Expired	-	-		
Outstanding, June 30, 2006	<u>1,836</u>	<u>\$ 22.99</u>	<u>7.25</u>	<u>\$ 66,741</u>
Exercisable and expected to vest, June 30, 2006	<u>1,747</u>	<u>\$ 22.48</u>	<u>7.21</u>	<u>\$ 64,375</u>
Exercisable, June 30, 2006	<u>964</u>	<u>\$ 17.26</u>	<u>6.25</u>	<u>\$ 40,478</u>

The aggregate intrinsic value in the table above is before applicable income taxes, based on our closing stock price of \$59.26 as of the last business day of the period ended June 30, 2006, which represents amounts that would have been received by the optionees had all options been exercised on that date. As of June 30, 2006, total unrecognized stock-based compensation expense related to nonvested stock options was approximately \$9.8 million, which is expected to be recognized over a weighted average period of approximately 19 months. During the six months ended June 30, 2006, the total intrinsic value of stock options exercised was \$24.7 million and the total fair value of options vested was \$23.6 million.

We issue new shares of common stock upon the exercise of stock options.

As of June 30, 2006, there were 1,024,944 shares of common stock available for issuance pursuant to stock-based awards. Additional information regarding options outstanding as of June 30, 2006, is as follows:

	Outstanding Options			Exercisable Options	
	Shares (in 000's)	Remaining Life (years)	Weighted Average Price	Shares (in 000's)	Weighted Average Price
<b>Range of Exercise Prices</b>					
\$ 4.87 - \$ 6.75	116	3.44	\$ 6.41	116	\$ 6.41
\$ 7.00 - \$ 8.34	233	4.42	7.21	233	7.21
\$13.60 - \$20.00	207	6.53	16.03	172	15.40
\$20.03 - \$26.65	762	7.76	21.23	299	20.74
\$30.32 - \$37.40	465	8.83	37.38	144	37.32
\$42.62 - \$70.99	53	9.57	54.44	-	-
	<u>1,836</u>	<u>7.25</u>	<u>\$ 22.99</u>	<u>964</u>	<u>\$ 17.26</u>

*Employee Stock Purchase Plan*

We are authorized to issue shares of common stock to our eligible employees who have completed three months of service, work more than 20 hours each week and are employed more than five months in any calendar year. Employees who own 5% or more of our common stock are not eligible to participate in the ESPP. Under the terms of the ESPP, eligible employees can choose payroll deductions each year of up to 10% of their regular cash compensation. Such deductions are applied toward the discounted purchase price of our common stock. The purchase price of the common stock is 85% of the fair market value of the stock at the end of each fiscal quarter. We had no unrecognized compensation cost associated with the second quarter 2006 offering of stock under this plan. Under the ESPP, we sold 23,460 and 15,589 shares to employees in the six months ended June 30, 2006 and 2005, respectively. The expense related to ESPP recognized under SFAS 123(R) for the three and six months ended June 30, 2006 was approximately \$112,000 and \$192,000, respectively.

*Long-Term Performance Plan*

We have a Long-Term Performance Plan (LTPP) for senior management with restricted stock awards contingent on the attainment of yearly goals payable in the Company's common stock with a three-year cliff vesting period. Restricted stock awards are granted in the year following attainment, as approved by our Board of Directors. The value of an award is based on a percentage of the participant's base salary and is dependent on performance objectives for the period. We currently have two active plans, one for 2005 and another for 2006.

The award for 2005 was \$1.8 million, with 30,542 shares issued on February 15, 2006, at a weighted average grant-date fair value of \$59.16. For the three and six months ended June 30, 2006 approximately \$84,000 and \$79,000 were recognized as expense. As of June 30, 2006, total unrecognized stock-based compensation expense related to the 2005 LTPP was approximately \$832,000, which will be recognized through December 31, 2008. For the 2006 yearly goals and associated award, approximately \$53,000 and \$95,000 were recognized as expense for the three and six months ended June 30, 2006. A summary of the restricted stock activity during the six months ended June 30, 2006 is as follows:

	Restricted Shares (in thousands)
Nonvested, January 1, 2006	-
Granted	30,542
Vested	(806)
Forfeited	(6,937)
Nonvested, June 30, 2006	<u>22,799</u>

*Board of Directors' Compensation*

We issue unrestricted stock awards to our Board of Directors as part of the Board of Directors' compensation. During the three and six months ended June 30, 2006, we issued 420 and 3,396 of unrestricted stock awards to our Board of Directors, with a weighted average grant-date fair value of \$70.99 and \$44.09, respectively. The expense related to these awards for the three and six months ended June 30, 2006 was \$30,000 and \$150,000, respectively. All awards were fully vested and expensed when granted.

**Note 11: Related Party Transactions**

At December 31, 2005, we had a 30% equity interest in Servatron, a company that serves both as a contract manufacturer for our low volume products and as our handheld service repair depot. During February 2006, we received a dividend of \$193,000, which was recorded as a return on investment. During March 2006, we sold our equity interest back to Servatron for \$1.0 million, recognizing a loss of \$242,000. At March 31, 2006, we had no ownership in Servatron. Our Chief Executive Officer continues to serve as a board member of Servatron. We sublease a portion of our Spokane Valley facility, which is currently held for sale (Note 3), to Servatron.

During the first quarter of 2006, our Chief Financial Officer became a board member of a financial institution, which is a 3.6% participant in our \$55 million revolver.

**Note 12: Commitments and Contingencies**

*Guarantees and Indemnifications*

Under FASB Interpretation 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, we record a liability for certain types of guarantees and indemnifications for agreements entered into or amended subsequent to December 31, 2002. No liabilities were required to be recorded for agreements entered into as of June 30, 2006 and December 31, 2005.

We maintain bid and performance bonds for certain customers. Bonds in force were \$2.7 million and \$3.0 million at June 30, 2006 and December 31, 2005, respectively. Bid bonds guarantee that we will enter into a contract consistent with the terms of the bid. Performance bonds provide a guarantee to the customer for future performance, which usually covers the installation phase of a contract and may on occasion cover the operations and maintenance phase of outsourcing contracts.

We also have standby letters of credit to guarantee our performance under certain contracts. The outstanding amounts of standby letters of credit were \$22.5 million and \$22.6 million at June 30, 2006 and December 31, 2005, respectively.

At December 31, 2005, we guaranteed lease payments for certain equipment leased by Servatron, which had a maximum future lease obligation of approximately \$83,000. The lease and our guarantee terminated in the second quarter of 2006.

We generally provide within our sales contracts an indemnification related to the infringement of any patent, copyright, trademark or other intellectual property right on software or equipment, which indemnifies the customer from and pays the resulting costs, damages and attorney's fees awarded against a customer with respect to such a claim provided that (a) the customer promptly notifies us in writing of the claim and (b) we have the sole control of the defense and all related settlement negotiations. The terms of the indemnification normally do not limit the maximum potential future payments. We also provide an indemnification for third party claims resulting from damages caused by the negligence or willful misconduct of our employees/agents in connection with the performance of certain contracts. The terms of the indemnification generally do not limit the maximum potential payments.

*Legal Matters*

We are subject to various legal proceedings and claims of which the outcomes are subject to significant uncertainty. Our policy is to assess the likelihood of any adverse judgments or outcomes related to legal matters, as well as ranges of probable losses. A determination of the amount of the liability required, if any, for these contingencies is made after an analysis of each known issue in accordance with SFAS 5, *Accounting for Contingencies*, and related pronouncements. In accordance with SFAS 5, a liability is recorded when we determine that a loss is probable and the amount can be reasonably estimated. Additionally, we disclose contingencies for which a material loss is reasonably possible, but not probable. At June 30, 2006, there were no material contingencies requiring accrual or disclosure.

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### **Note 13: Segment Information**

We have two operating groups (Hardware Solutions and Software Solutions) and three segments. Software Solutions is a single segment and Hardware Solutions is comprised of two segments, Meter Data Collection and Electricity Metering. For these three segments, management has three primary measures of segment performance: revenue, gross profit (margin) and operating income. Revenues for each segment are reported according to product lines. There are no inter-segment revenues. Within Hardware Solutions, cost of sales includes materials, direct labor, warranty expense and an overhead allocation. Software cost of sales include distribution and documentation costs for applications sold, along with other labor and operating costs for custom software development, project management, consulting and systems support. Hardware and software cost of services include materials, labor and overhead. Operating expenses directly associated with each segment may include sales, marketing, product development or administrative expenses.

Corporate operating expenses, interest income, interest expense, other income (expense), amortization expense and income tax expense (benefit) are not allocated to the segments, nor included in the measure of segment profit or loss. We do not allocate assets and liabilities to our segments. Prior to January 1, 2006, Itron Electricity Metering, Inc., or Electricity Metering, was a wholly owned subsidiary with separately identifiable assets and liabilities. Effective January 1, 2006, Electricity Metering merged with Itron, Inc. Approximately 50% and 65% of depreciation expense was allocated to the segments at June 30, 2006 and 2005, respectively, with the remaining portion unallocated. Unallocated depreciation increased in 2006, compared with 2005, due to the purchase of our new corporate headquarters facility at the end of 2005, which is not allocated to the segments.

We classify sales in the United States and Canada as domestic revenues. International revenues were \$9.2 million and \$9.8 million for the three months ended June 30, 2006 and 2005 and \$14.4 million and \$17.9 million for the six months ended June 30, 2006 and 2005, respectively.

### **Segment Products**

<u>Segment</u>	<u>Major Products</u>
<i>Hardware Solutions— Meter Data Collection:</i>	Residential and commercial AMR standalone modules, OEM (original equipment manufacturer) equipment, contract manufacturing and royalties for our AMR technology in other vendors' electricity meters, mobile and network AMR data collection technologies, handheld computers for meter data collection or mobile workforce applications and related installation, implementation and maintenance support services.
<i>Hardware Solutions— Electricity Metering:</i>	Residential, commercial and industrial (C&I) and generation, transmission and distribution (GT&D) electricity meters and related installation, implementation and other services.
<i>Software Solutions:</i>	Software applications for commercial, industrial and residential meter data collection and management, distribution system design and optimization, energy and water management, asset optimization, mobile workforce solutions, forecasting and related implementation, consulting and maintenance support services.

**Segment Information**

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(in thousands)			
<b>Revenues</b>				
Hardware Solutions				
Meter Data Collection	\$ 60,110	\$ 62,192	\$ 121,861	\$ 111,868
Electricity Metering	88,467	60,622	168,845	114,728
Total Hardware Solutions	<u>148,577</u>	<u>122,814</u>	<u>290,706</u>	<u>226,596</u>
Software Solutions	<u>15,233</u>	<u>12,309</u>	<u>28,657</u>	<u>24,997</u>
Total Company	<u>\$ 163,810</u>	<u>\$ 135,123</u>	<u>\$ 319,363</u>	<u>\$ 251,593</u>
<b>Gross profit</b>				
Hardware Solutions				
Meter Data Collection	\$ 25,464	\$ 27,288	\$ 54,167	\$ 48,332
Electricity Metering	37,017	24,710	68,926	48,987
Total Hardware Solutions	<u>62,481</u>	<u>51,998</u>	<u>123,093</u>	<u>97,319</u>
Software Solutions	<u>6,551</u>	<u>4,741</u>	<u>12,713</u>	<u>10,418</u>
Total Company	<u>\$ 69,032</u>	<u>\$ 56,739</u>	<u>\$ 135,806</u>	<u>\$ 107,737</u>
<b>Operating income (loss)</b>				
Hardware Solutions				
Meter Data Collection	\$ 19,658	\$ 21,917	\$ 42,791	\$ 37,945
Electricity Metering	33,199	20,437	61,774	40,326
Other unallocated costs	(9,706)	(6,184)	(18,433)	(12,205)
Total Hardware Solutions	<u>43,151</u>	<u>36,170</u>	<u>86,132</u>	<u>66,066</u>
Software Solutions	<u>(3,335)</u>	<u>(2,922)</u>	<u>(5,824)</u>	<u>(5,574)</u>
Corporate unallocated	<u>(22,156)</u>	<u>(22,937)</u>	<u>(43,660)</u>	<u>(44,408)</u>
Total Company	<u>17,660</u>	<u>10,311</u>	<u>36,648</u>	<u>16,084</u>
Total other income (expense)	<u>(2,466)</u>	<u>(5,837)</u>	<u>(8,298)</u>	<u>(10,299)</u>
Income before income taxes	<u>\$ 15,194</u>	<u>\$ 4,474</u>	<u>\$ 28,350</u>	<u>\$ 5,785</u>

Revenues from AMR related to electricity meters can be reflected in either our Meter Data Collection or Electricity Metering segments. Included in Meter Data Collection are standalone electric AMR modules that can be attached to electromechanical electricity meters in the field or manufactured by others, AMR circuit boards we manufacture that are embedded in other vendors' electronic electricity meters and royalties for licensing our electric AMR technology. Included in Electricity Metering revenue are sales of our electronic meters with our embedded AMR technology as well as some contract manufacturing for incorporating other vendors' AMR technology into our electronic meters.

One customer, Progress Energy, accounted for 19% and 21% of total Company revenues, and 36% and 39% of Electricity Metering segment revenues, for the three and six months ended June 30, 2006, respectively.

One customer, Piedmont Natural Gas, accounted for 16% and 14% of Meter Data Collection segment revenues for the three and six months ended June 30, 2006, respectively.

No customers represented more than 10% of Software Solutions segment revenues for the three and six months ended June 30, 2006.

No customers represented more than 10% of total Company revenues or individual segment revenues for the three and six months ended June 30, 2005.

**Note 14: Other Comprehensive Income**

Other comprehensive income adjustments are reflected as an increase (decrease) to shareholders' equity and are not reflected in the results of operations. Operating results adjusted to reflect other comprehensive income items during the period, net of tax, were as follows:

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
	(in thousands)			
Net income	\$ 10,204	\$ 9,313	\$ 17,273	\$ 10,130
Change in foreign currency translation adjustments, net of tax	791	(197)	681	(462)
Total other comprehensive income	<u>\$ 10,995</u>	<u>\$ 9,116</u>	<u>\$ 17,954</u>	<u>\$ 9,668</u>

Accumulated other comprehensive income, net of tax, was approximately \$1.6 million and \$871,000 at June 30, 2006 and December 31, 2005, respectively, and consisted of the adjustments for foreign currency translation as indicated above.

**Note 15: Consolidating Financial Information**

The credit facility and the senior subordinated notes are guaranteed by all of our operating subsidiaries, except for our foreign subsidiaries and an outsourcing project finance subsidiary, all of which are wholly owned. The guarantees are joint and several, full, complete and unconditional. There are currently no restrictions on the ability of the subsidiary guarantors to transfer funds to the parent company. The following consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered."

During the second quarter of 2006, we acquired Quantum and ELO, which are reflected within parent and within the non-guarantor subsidiaries, respectively, in the condensed consolidated financial statements commencing on the date of each acquisition (see Note 4).

Effective January 1, 2006, the legal entity holding the U.S. operations of our Electricity Metering business (a guarantor subsidiary) was merged into the parent company. As a result of this merger, the assets, liabilities and operations of this guarantor subsidiary have been combined with the parent company as of and for the three and six month periods ended June 30, 2006. In addition, as a result of our legal entity merger on January 1, 2006, we have restated the parent and guarantor subsidiary information for the 2005 periods presented to reflect the new legal entity structure.

In addition, we have five wholly owned domestic guarantor subsidiaries, which were established for various business purposes. Two of these subsidiaries have no assets or operations. The other three subsidiaries hold investments totaling \$8.4 million and \$7.3 million in related non-guarantor subsidiaries at June 30, 2006 and December 31, 2005, respectively. Due to the small nature of these guarantor subsidiaries, we have combined them with the parent company as of January 1, 2006. The net income (loss) from guarantor subsidiaries was (\$40,000) and \$61,000 for the three months ended June 30, 2006 and 2005, and (\$43,000) and \$76,000 for the six months ended June 30, 2006 and 2005, respectively.

**Condensed Consolidating Statement of Operations**  
**Three Months Ended June 30, 2006**

	<u>Parent</u>	<u>Combined Non-guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
		(in thousands)		
Revenues				
Sales	\$ 143,953	\$ 12,267	\$ (4,243)	\$ 151,977
Service	14,124	2,922	(5,213)	11,833
Total revenues	<u>158,077</u>	<u>15,189</u>	<u>(9,456)</u>	<u>163,810</u>
Cost of revenues				
Sales	85,772	6,466	(4,120)	88,118
Service	6,136	5,726	(5,202)	6,660
Total cost of revenues	<u>91,908</u>	<u>12,192</u>	<u>(9,322)</u>	<u>94,778</u>
Gross profit	66,169	2,997	(134)	69,032
Operating expenses				
Sales and marketing	14,773	1,548	-	16,321
Product development	15,035	107	(222)	14,920
General and administrative	11,646	750	123	12,519
Amortization of intangible assets	7,404	208	-	7,612
Total operating expenses	<u>48,858</u>	<u>2,613</u>	<u>(99)</u>	<u>51,372</u>
Operating income	17,311	384	(35)	17,660
Other income (expense)				
Interest income	368	46	(54)	360
Interest expense	(2,416)	(223)	54	(2,585)
Other income (expense), net	(305)	29	35	(241)
Total other income (expense)	<u>(2,353)</u>	<u>(148)</u>	<u>35</u>	<u>(2,466)</u>
Income before income taxes	14,958	236	-	15,194
Income tax (provision) benefit	(5,594)	604	-	(4,990)
Equity in earnings of non-guarantor subsidiaries	840	-	(840)	-
Net income	<u>\$ 10,204</u>	<u>\$ 840</u>	<u>\$ (840)</u>	<u>\$ 10,204</u>

**Condensed Consolidating Statement of Operations**  
**Three Months Ended June 30, 2005**

	<u>Parent</u>	<u>Combined Non-guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
		(in thousands)		
Revenues				
Sales	\$ 118,983	\$ 11,221	\$ (7,393)	\$ 122,811
Service	11,465	1,976	(1,129)	12,312
Total revenues	<u>130,448</u>	<u>13,197</u>	<u>(8,522)</u>	<u>135,123</u>
Cost of revenues				
Sales	69,356	9,068	(7,614)	70,810
Service	6,787	1,171	(384)	7,574
Total cost of revenues	<u>76,143</u>	<u>10,239</u>	<u>(7,998)</u>	<u>78,384</u>
Gross profit	54,305	2,958	(524)	56,739
Operating expenses				
Sales and marketing	12,391	1,138	-	13,529
Product development	11,417	522	(525)	11,414
General and administrative	11,233	537	-	11,770
Amortization of intangible assets	9,715	-	-	9,715
Restructurings	(6)	6	-	-
Total operating expenses	<u>44,750</u>	<u>2,203</u>	<u>(525)</u>	<u>46,428</u>
Operating income	9,555	755	1	10,311
Other income (expense)				
Interest income	252	3	(161)	94
Interest expense	(6,315)	(231)	161	(6,385)
Other income (expense), net	330	125	(1)	454
Total other income (expense)	<u>(5,733)</u>	<u>(103)</u>	<u>(1)</u>	<u>(5,837)</u>
Income before income taxes	3,822	652	-	4,474
Income tax (provision) benefit	4,926	(87)	-	4,839
Equity in earnings of non-guarantor subsidiaries	565	-	(565)	-
Net income	<u>\$ 9,313</u>	<u>\$ 565</u>	<u>\$ (565)</u>	<u>\$ 9,313</u>

**Condensed Consolidating Statement of Operations**  
**Six Months Ended June 30, 2006**

	<u>Parent</u>	<u>Combined Non-guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
		(in thousands)		
Revenues				
Sales	\$ 279,921	\$ 24,786	\$ (9,796)	\$ 294,911
Service	29,111	5,331	(9,990)	24,452
Total revenues	<u>309,032</u>	<u>30,117</u>	<u>(19,786)</u>	<u>319,363</u>
Cost of revenues				
Sales	166,232	13,553	(9,825)	169,960
Service	12,452	10,927	(9,782)	13,597
Total cost of revenues	<u>178,684</u>	<u>24,480</u>	<u>(19,607)</u>	<u>183,557</u>
Gross profit	130,348	5,637	(179)	135,806
Operating expenses				
Sales and marketing	28,915	2,887	-	31,802
Product development	27,880	248	(338)	27,790
General and administrative	23,222	1,260	159	24,641
Amortization of intangible assets	14,717	208	-	14,925
Total operating expenses	<u>94,734</u>	<u>4,603</u>	<u>(179)</u>	<u>99,158</u>
Operating income	35,614	1,034	-	36,648
Other income (expense)				
Interest income	708	94	(80)	722
Interest expense	(8,100)	(311)	80	(8,331)
Other income (expense), net	(676)	(13)	-	(689)
Total other income (expense)	<u>(8,068)</u>	<u>(230)</u>	<u>-</u>	<u>(8,298)</u>
Income before income taxes	27,546	804	-	28,350
Income tax (provision) benefit	(11,508)	431	-	(11,077)
Equity in earnings of non-guarantor subsidiaries	1,235	-	(1,235)	-
Net income	<u>\$ 17,273</u>	<u>\$ 1,235</u>	<u>\$ (1,235)</u>	<u>\$ 17,273</u>

**Condensed Consolidating Statement of Operations**  
**Six Months Ended June 30, 2005**

	<u>Parent</u>	<u>Combined Non-guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
		(in thousands)		
Revenues				
Sales	\$ 220,707	\$ 20,334	\$ (14,028)	\$ 227,013
Service	22,327	3,943	(1,690)	24,580
Total revenues	<u>243,034</u>	<u>24,277</u>	<u>(15,718)</u>	<u>251,593</u>
Cost of revenues				
Sales	128,003	16,265	(14,259)	130,009
Service	12,334	1,949	(436)	13,847
Total cost of revenues	<u>140,337</u>	<u>18,214</u>	<u>(14,695)</u>	<u>143,856</u>
Gross profit	102,697	6,063	(1,023)	107,737
Operating expenses				
Sales and marketing	24,376	2,392	-	26,768
Product development	23,246	1,105	(1,023)	23,328
General and administrative	20,893	843	-	21,736
Amortization of intangible assets	19,431	-	-	19,431
Restructurings	197	193	-	390
Total operating expenses	<u>88,143</u>	<u>4,533</u>	<u>(1,023)</u>	<u>91,653</u>
Operating income	14,554	1,530	-	16,084
Other income (expense)				
Interest income	498	6	(406)	98
Interest expense	(10,797)	(561)	406	(10,952)
Other income (expense), net	451	104	-	555
Total other income (expense)	<u>(9,848)</u>	<u>(451)</u>	<u>-</u>	<u>(10,299)</u>
Income before income taxes	4,706	1,079	-	5,785
Income tax (provision) benefit	4,654	(309)	-	4,345
Equity in earnings of non-guarantor subsidiaries	770	-	(770)	-
Net income	<u>\$ 10,130</u>	<u>\$ 770</u>	<u>\$ (770)</u>	<u>\$ 10,130</u>

**Condensed Consolidating Balance Sheet**  
**June 30, 2006**

	<u>Parent</u>	<u>Combined Non-guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
	(in thousands)			
<b>ASSETS</b>				
Current assets				
Cash and cash equivalents	\$ 35,973	\$ 10,614	\$ -	\$ 46,587
Accounts receivable, net	76,213	12,833	-	89,046
Intercompany accounts receivable	7,170	5,755	(12,925)	-
Inventories	57,766	2,213	-	59,979
Deferred income taxes, net	19,857	770	-	20,627
Other	21,886	1,712	-	23,598
Intercompany other	2,883	3,500	(6,383)	-
Total current assets	<u>221,748</u>	<u>37,397</u>	<u>(19,308)</u>	<u>239,837</u>
Property, plant and equipment, net	71,460	4,015	-	75,475
Intangible assets, net	109,546	8,615	-	118,161
Goodwill	106,239	13,265	-	119,504
Deferred income taxes, net	50,145	2,185	-	52,330
Intercompany notes receivable	6,533	1,298	(7,831)	-
Other	36,920	1,059	(29,315)	8,664
Total assets	<u>\$ 602,591</u>	<u>\$ 67,834</u>	<u>\$ (56,454)</u>	<u>\$ 613,971</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
Current liabilities				
Accounts payable and accrued expenses	\$ 44,659	\$ 4,759	\$ -	\$ 49,418
Intercompany accounts payable	5,754	7,171	(12,925)	-
Wages and benefits payable	18,748	1,310	-	20,058
Current portion of warranty	7,287	640	-	7,927
Short-term intercompany advances	3,500	2,883	(6,383)	-
Unearned revenue	24,934	1,442	-	26,376
Total current liabilities	<u>104,882</u>	<u>18,205</u>	<u>(19,308)</u>	<u>103,779</u>
Long-term debt	124,274	-	-	124,274
Intercompany notes payable	1,298	6,533	(7,831)	-
Warranty	9,027	-	-	9,027
Contingent purchase price	5,882	-	-	5,882
Other obligations	70	7,857	-	7,927
Total liabilities	<u>245,433</u>	<u>32,595</u>	<u>(27,139)</u>	<u>250,889</u>
Shareholders' equity				
Preferred stock	-	-	-	-
Common stock	339,640	29,261	(29,261)	339,640
Accumulated other comprehensive income (loss), net	(4,372)	5,924	-	1,552
Retained earnings	21,890	54	(54)	21,890
Total shareholders' equity	<u>357,158</u>	<u>35,239</u>	<u>(29,315)</u>	<u>363,082</u>
Total liabilities and shareholders' equity	<u>\$ 602,591</u>	<u>\$ 67,834</u>	<u>\$ (56,454)</u>	<u>\$ 613,971</u>

**Condensed Consolidating Balance Sheet**  
December 31, 2005

	<b>Parent</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
	<b>(in thousands)</b>			
<b>ASSETS</b>				
Current assets				
Cash and cash equivalents	\$ 28,064	\$ 5,574	\$ -	\$ 33,638
Accounts receivable, net	96,707	7,721	-	104,428
Intercompany accounts receivable	3,460	8,977	(12,437)	-
Inventories	46,792	2,664	-	49,456
Deferred income taxes, net	22,895	299	-	23,194
Other	8,575	2,366	-	10,941
Intercompany other	227	3,500	(3,727)	-
Total current assets	206,720	31,101	(16,164)	221,657
Property, plant and equipment, net	74,097	3,526	-	77,623
Intangible assets, net	123,233	60	-	123,293
Goodwill	103,305	12,727	-	116,032
Deferred income taxes, net	47,987	1,806	(838)	48,955
Intercompany notes receivable	1,966	-	(1,966)	-
Other	38,200	48	(26,924)	11,324
Total assets	\$ 595,508	\$ 49,268	\$ (45,892)	\$ 598,884
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
Current liabilities				
Accounts payable and accrued expenses	\$ 44,720	\$ 1,495	\$ -	\$ 46,215
Intercompany accounts payable	8,966	3,471	(12,437)	-
Wages and benefits payable	22,761	971	-	23,732
Current portion of debt	3,516	860	-	4,376
Current portion of warranty	7,972	525	-	8,497
Short-term intercompany advances	-	3,727	(3,727)	-
Unearned revenue	21,801	957	-	22,758
Total current liabilities	109,736	12,006	(16,164)	105,578
Long-term debt	160,186	-	-	160,186
Project financing debt	-	2,367	-	2,367
Intercompany notes payable	-	1,966	(1,966)	-
Warranty	6,708	71	-	6,779
Deferred income taxes, net	-	838	(838)	-
Other obligations	6,333	107	-	6,440
Total liabilities	282,963	17,355	(18,968)	281,350
Shareholders' equity				
Preferred stock	-	-	-	-
Common stock	312,047	28,132	(28,133)	312,046
Accumulated other comprehensive income (loss), net	(4,119)	4,962	28	871
Retained earnings (accumulated deficit)	4,617	(1,181)	1,181	4,617
Total shareholders' equity	312,545	31,913	(26,924)	317,534
Total liabilities and shareholders' equity	\$ 595,508	\$ 49,268	\$ (45,892)	\$ 598,884

**Condensed Consolidating Statement of Cash Flows**  
**Six Months Ended June 30, 2006**

	<u>Parent</u>	<u>Combined Non-guarantor Subsidiaries</u>	<u>Eliminations</u>	<u>Consolidated</u>
		(in thousands)		
<b>Operating activities</b>				
Net income	\$ 17,273	\$ 1,235	\$ (1,235)	\$ 17,273
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	21,734	557	-	22,291
Employee stock plans income tax benefits	11,686	-	-	11,686
Excess tax benefits from stock-based compensation	(8,371)	-	-	(8,371)
Stock-based compensation	4,096	-	-	4,096
Amortization of prepaid debt fees	3,107	48	-	3,155
Deferred income taxes, net	712	(1,665)	-	(953)
Equity in earnings (losses) of non-guarantor subsidiaries	(1,235)	-	1,235	-
Other, net	453	(18)	-	435
Changes in operating assets and liabilities, net of acquisitions:				
Accounts receivable	22,357	(4,319)	-	18,038
Inventories	(10,974)	1,399	-	(9,575)
Long-term note receivable, net	1,298	(1,298)	-	-
Accounts payable and accrued expenses	(17)	1,159	-	1,142
Wages and benefits payable	(3,590)	(33)	-	(3,623)
Unearned revenue	3,755	475	-	4,230
Warranty	1,634	44	-	1,678
Other long-term obligations	(1,008)	827	-	(181)
Intercompany transactions, net	(6,922)	6,922	-	-
Other, net	(5,069)	519	-	(4,550)
Net cash provided by operating activities	<u>50,919</u>	<u>5,852</u>	<u>-</u>	<u>56,771</u>
<b>Investing activities</b>				
Proceeds from the sale of property, plant and equipment	56	53	-	109
Acquisitions of property, plant and equipment	(13,787)	(633)	-	(14,420)
Proceeds from the sale of an investment in affiliate	1,000	-	-	1,000
Business acquisitions, net	(5,347)	(2,431)	-	(7,778)
Cash transferred to parent	-	(946)	946	-
Cash transferred to non-guarantor subsidiaries	(100)	-	100	-
Intercompany notes, net	(4,567)	-	4,567	-
Other, net	(1,370)	1,705	-	335
Net cash used in investing activities	<u>(24,115)</u>	<u>(2,252)</u>	<u>5,613</u>	<u>(20,754)</u>
<b>Financing activities</b>				
Payments on debt	(39,476)	(3,227)	-	(42,703)
Issuance of common stock	11,326	-	-	11,326
Excess tax benefits from stock-based compensation	8,371	-	-	8,371
Prepaid debt fees	(62)	-	-	(62)
Cash transferred from parent	-	100	(100)	-
Cash transferred from non-guarantor subsidiaries	946	-	(946)	-
Intercompany notes payable	-	4,567	(4,567)	-
Net cash provided by (used in) financing activities	<u>(18,895)</u>	<u>1,440</u>	<u>(5,613)</u>	<u>(23,068)</u>
Increase in cash and cash equivalents	7,909	5,040	-	12,949
Cash and cash equivalents at beginning of period	28,064	5,574	-	33,638
Cash and cash equivalents at end of period	<u>\$ 35,973</u>	<u>\$ 10,614</u>	<u>\$ -</u>	<u>\$ 46,587</u>
<b>Non-cash operating and financing transactions:</b>				
Property, plant and equipment purchased but not yet paid	\$ 3,082	\$ 21	\$ -	\$ 3,103
Non-cash affects of acquisitions (Note 4)				
<b>Supplemental disclosure of cash flow information:</b>				
Cash paid during the period for:				
Income taxes	\$ 637	\$ 196	\$ -	\$ 833
Interest	5,440	183	-	5,623

**Condensed Consolidating Statement of Cash Flows**  
**Six Months Ended June 30, 2005**

	<b>Parent</b>	<b>Combined Non-guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
	<b>(in thousands)</b>			
<b>Operating activities</b>				
Net income	\$ 10,130	\$ 770	\$ (770)	\$ 10,130
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	25,685	439	-	26,124
Employee stock plans income tax benefits	7,047	-	-	7,047
Stock-based compensation	220	-	-	220
Amortization of prepaid debt fees	3,048	-	-	3,048
Deferred income taxes, net	(12,427)	47	-	(12,380)
Equity in earnings (losses) of guarantor and non-guarantor subsidiaries	(770)	-	770	-
Other, net	887	(59)	-	828
Changes in operating assets and liabilities, net of acquisitions:				
Accounts receivable	3,848	476	-	4,324
Inventories	(605)	(287)	-	(892)
Accounts payable and accrued expenses	3,057	(878)	-	2,179
Wages and benefits payable	3,248	(552)	-	2,696
Unearned revenue	(4,441)	331	-	(4,110)
Warranty	3	(184)	-	(181)
Other long-term obligations	(644)	-	-	(644)
Intercompany transactions, net	(521)	521	-	-
Other, net	(1,621)	(179)	-	(1,800)
Net cash provided by operating activities	36,144	445	-	36,589
<b>Investing activities</b>				
Proceeds from the sale of property, plant and equipment	7	2,635	-	2,642
Acquisitions of property, plant and equipment	(5,308)	32	-	(5,276)
Cash transferred to parent	-	(1,580)	1,580	-
Cash transferred to non-guarantor subsidiaries	(85)	-	85	-
Intercompany notes, net	3,140	-	(3,140)	-
Other, net	(1,287)	351	1,414	478
Net cash provided by (used in) investing activities	(3,533)	1,438	(61)	(2,156)
<b>Financing activities</b>				
Payments on debt	(107,787)	(391)	-	(108,178)
Issuance of common stock	72,318	1,414	(1,414)	72,318
Prepaid debt fees	(267)	-	-	(267)
Intercompany notes, net	-	(3,140)	3,140	-
Cash received from non-guarantor subsidiaries	1,580	-	(1,580)	-
Cash received from parent	-	85	(85)	-
Other, net	-	28	-	28
Net cash used in financing activities	(34,156)	(2,004)	61	(36,099)
Decrease in cash and cash equivalents	(1,545)	(121)	-	(1,666)
Cash and cash equivalents at beginning of period	5,854	5,770	-	11,624
Cash and cash equivalents at end of period	\$ 4,309	\$ 5,649	\$ -	\$ 9,958
<i>Supplemental disclosure of cash flow information:</i>				
Cash paid during the period for:				
Income taxes	\$ 1,079	\$ 215	\$ -	\$ 1,294
Interest	7,941	147	-	8,088

## **Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations**

In this Quarterly Report on Form 10-Q, the terms "we," "us," "our," "Itron" and the "Company" refer to Itron, Inc.

The following discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements and notes included in this report, and with our Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on February 24, 2006.

Our SEC filings are available free of charge under the Investor Relations section of our website at [www.itron.com](http://www.itron.com) as soon as practicable after they are filed with or furnished to the SEC. In addition, our filings are available at the SEC's website ([www.sec.gov](http://www.sec.gov)) and at the SEC's Headquarters at 100 F Street, NE, Washington, DC 20549, or by calling 1-800-SEC-0330.

### **Certain Forward-Looking Statements**

*This document contains forward-looking statements concerning our operations, financial performance, revenues, earnings growth, estimated stock-based compensation expense, cost reduction programs and other items. These statements reflect our current plans and expectations and are based on information currently available as of the date of this Quarterly Report on Form 10-Q. When included in this discussion, the words "expects," "intends," "anticipates," "believes," "plans," "projects," "estimates," "future," "objective," "may," "will," "will continue" and similar expressions are intended to identify forward-looking statements. However, these words are not the exclusive means of identifying such statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. The forward-looking statements rely on a number of assumptions and estimates, which could be inaccurate, and which are subject to risks and uncertainties that could cause our actual results to vary materially from those anticipated. Such risks and uncertainties include, among others, 1) the rate and timing of customer demand for our products, 2) delays, rescheduling or cancellations of current customer orders, 3) changes in estimated liabilities for product warranties, 4) changes in laws and regulations (including Federal Communications Commission (FCC) licensing actions), 5) our dependence on new product development and intellectual property, 6) future acquisitions, including potential disruptions in operations associated with integration activities and performance expectations and 7) other factors. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this Quarterly Report on Form 10-Q. We do not have any obligation or undertaking to update publicly or revise any forward-looking statement contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based. For a more complete description of these and other risks, see "Risk Factors" within Item 1A included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, which was filed with the SEC on February 24, 2006.*

### **Results of Operations**

We derive the majority of our revenues from sales of products and services to utilities. Sales revenues may include hardware, software licenses, custom software development, field and project management services and engineering, consulting and installation services. Service revenues include post-sale maintenance support and outsourcing services. Outsourcing services encompass installation, operation and maintenance of meter reading systems to provide meter information to a customer for billing and management purposes for systems we own as well as those owned by our customers. Hardware cost of sales are based on standard costs, which include materials, direct labor, warranty expense and an overhead allocation, as well as variances from standard costs. Software cost of sales include distribution and documentation costs for applications sold, along with other labor and operating costs for custom software development, project management, consulting and systems support. Hardware and software cost of services include materials, labor and overhead.

### **Highlights**

New orders in the first six months of 2006 were \$313 million, 6% higher than the \$294 million in new orders in the first six months of 2005, driven primarily by new orders for automatic meter reading (AMR), in particular two large orders for gas AMR and one large order for electricity meters with AMR. Total backlog was \$351 million at June 30, 2006, compared with \$243 million at June 30, 2005. Backlog shippable over the next twelve months was \$225 million, up from \$151 million a year ago. Approximately \$33 million of shippable and total backlog at June 30, 2006 is related to a contract with one customer, Progress Energy, the majority of which will be recognized as revenue prior to December 31, 2006.

Operating margins improved during the second quarter and first six months of 2006, compared with the same periods last year as revenue growth was higher than growth in operating expenses, and due to less intangible asset amortization expense in 2006. Operating cash flows were higher in 2006 with the majority of cash flow used to pay down debt. At June 30, 2006, we had \$124.3 million of total debt, compared with \$170.1 million in total debt at June 30, 2005.

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On January 1, 2006, we adopted Statement of Financial Accounting Standards 123(R), *Share-Based Payment*, (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all stock-based payment awards. We recognized \$2.0 million and \$4.1 million in stock-based compensation expense for the three and six months ended June 30, 2006, respectively, compared with \$71,000 and \$220,000 for the same periods in 2005. The primary increase in stock-based compensation expense is due to the expensing of stock awards prospectively.

### Revenues and Gross Margins

#### *Total Revenues and Gross Margins*

The following tables summarize our revenues, gross profit and gross margin for the three and six months ended June 30, 2005 and 2006.

	Three Months Ended June 30,			Six Months Ended June 30,		
	2006	2005	% Change	2006	2005	% Change
	(millions)			(millions)		
<i>Revenues</i>						
Sales	\$ 152.0	\$ 122.8	24%	\$ 294.9	\$ 227.0	30%
Service	11.8	12.3	-4%	24.5	24.6	1%
Total revenues	<u>\$ 163.8</u>	<u>\$ 135.1</u>	21%	<u>\$ 319.4</u>	<u>\$ 251.6</u>	27%

	Three Months Ended June 30,				Six Months Ended June 30,			
	2006		2005		2006		2005	
	Gross Profit	Gross Margin	Gross Profit	Gross Margin	Gross Profit	Gross Margin	Gross Profit	Gross Margin
	(millions)		(millions)		(millions)		(millions)	
<i>Gross Profit and Margin</i>								
Sales	\$ 63.9	42%	\$ 52.0	42%	\$ 124.9	42%	\$ 97.0	43%
Service	5.1	44%	4.7	38%	10.9	44%	10.7	44%
Total gross profit and margin	<u>\$ 69.0</u>	42%	<u>\$ 56.7</u>	42%	<u>\$ 135.8</u>	43%	<u>\$ 107.7</u>	43%

#### *Revenues*

Sales revenues increased \$29.2 million and \$67.9 million for the three and six months ended June 30, 2006, compared with the same periods in 2005, as a result of increased hardware sales, including electricity meters, AMR gas modules and installation. Service revenues, consisting primarily of maintenance contracts, remained comparable in 2006 with 2005.

One customer, Progress Energy, represented 19% and 21% of total revenues for the three and six months ended June 30, 2006, respectively. No customer represented more than 10% of total revenues for the three and six months ended June 30, 2005. The 10 largest customers accounted for approximately 43% and 42% of total revenues during the three and six months ended June 30, 2006. During the same periods in 2005, our 10 largest customers accounted for approximately 23% and 20%, respectively.

#### *Gross Margins*

As a percentage of revenue, sales gross margin for the three and six months ended June 30, 2006 remained constant, compared with the same periods in 2005, although we experienced a shift in product mix. Service gross margin increased for the three months ended June 30, 2006, compared with the three months ended June 30, 2005, primarily due to lower outsourcing costs, but remained constant for the six months ended June 30, 2006, compared with the same period in 2005.

### Segment Revenues, Gross Profit and Margin and Operating Income (Loss)

We have two operating groups (Hardware Solutions and Software Solutions) and three segments. Software Solutions is a single segment and Hardware Solutions is comprised of two segments, Meter Data Collection and Electricity Metering. For these three segments, management has three primary measures of segment performance: revenue, gross profit (margin) and operating income. Revenues for each segment are reported according to product lines. There are no inter-segment revenues. Within Hardware Solutions, cost of sales includes materials, direct labor, warranty expense and an overhead allocation. Software Solutions cost of sales include distribution and documentation costs for applications sold, along with other labor

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and operating costs for custom software development, project management, consulting and systems support. Hardware and software cost of services include materials, labor and overhead. Operating expenses directly associated with each segment may include sales, marketing, product development or administrative expenses.

Corporate operating expenses, interest income, interest expense, other income (expense), amortization expense and income tax expense (benefit) are not allocated to the segments, nor included in the measure of segment profit or loss. We do not allocate assets and liabilities to our segments. Prior to January 1, 2006, Itron Electricity Metering, Inc., or Electricity Metering, was a wholly owned subsidiary with separately identifiable assets and liabilities. Effective January 1, 2006, Electricity Metering merged with Itron, Inc. Approximately 50% and 65% of depreciation expense was allocated to the segments at June 30, 2006 and 2005, respectively, with the remaining portion unallocated. Unallocated depreciation increased in 2006, compared with 2005, due to the purchase of our new corporate headquarters facility at the end of 2005, which is not allocated to the segments.

We classify sales in the United States and Canada as domestic revenues. International revenues were \$9.2 million and \$9.8 million for the three months ended June 30, 2006 and 2005 and \$14.4 million and \$17.9 million for the six months ended June 30, 2006 and 2005, respectively.

### Segment Products

<u>Segment</u>	<u>Major Products</u>
<i>Hardware Solutions— Meter Data Collection:</i>	Residential and commercial AMR standalone modules, OEM (original equipment manufacturer) equipment, contract manufacturing and royalties for our AMR technology in other vendors' electricity meters, mobile and network AMR data collection technologies, handheld computers for meter data collection or mobile workforce applications and related installation, implementation and maintenance support services.
<i>Hardware Solutions— Electricity Metering:</i>	Residential, commercial and industrial (C&I) and generation, transmission and distribution (GT&D) electricity meters and related installation, implementation and other services.
<i>Software Solutions:</i>	Software applications for commercial, industrial and residential meter data collection and management, distribution system design and optimization, energy and water management, asset optimization, mobile workforce solutions, forecasting and related implementation, consulting and maintenance support services.

Revenues from AMR related to electricity meters can be reflected in either our Meter Data Collection or Electricity Metering segments. Included in Meter Data Collection are standalone electric AMR modules that can be attached to electromechanical electricity meters in the field or manufactured by others, AMR circuit boards we manufacture that are embedded in other vendors' electronic electricity meters and royalties for licensing our electric AMR technology. Included in Electricity Metering revenues are sales of our electronic meters with our embedded AMR technology as well as some contract manufacturing for incorporating other vendors' AMR technology into our electronic meters.

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The following tables and discussion highlight significant changes in trends or components of each segment.

	<b>Three Months Ended June 30,</b>			<b>Six Months Ended June 30,</b>		
	<b>2006</b>	<b>2005</b>	<b>% Change</b>	<b>2006</b>	<b>2005</b>	<b>% Change</b>
	<b>(millions)</b>			<b>(millions)</b>		
<b>Segment Revenues</b>						
Hardware Solutions						
Meter Data Collection	\$ 60.1	\$ 62.2	-3%	\$ 121.9	\$ 111.9	9%
Electricity Metering	88.4	60.6	46%	168.8	114.7	47%
Total Hardware Solutions	148.5	122.8	21%	290.7	226.6	28%
Software Solutions	15.3	12.3	24%	28.7	25.0	15%
Total Company	\$ 163.8	\$ 135.1	21%	\$ 319.4	\$ 251.6	27%

	<b>Three Months Ended June 30,</b>				<b>Six Months Ended June 30,</b>			
	<b>2006</b>		<b>2005</b>		<b>2006</b>		<b>2005</b>	
	<b>Gross Profit</b>	<b>Gross Margin</b>	<b>Gross Profit</b>	<b>Gross Margin</b>	<b>Gross Profit</b>	<b>Gross Margin</b>	<b>Gross Profit</b>	<b>Gross Margin</b>
	<b>(millions)</b>		<b>(millions)</b>		<b>(millions)</b>		<b>(millions)</b>	
<b>Segment Gross Profit and Margin</b>								
Hardware Solutions								
Meter Data Collection	\$ 25.5	42%	\$ 27.3	44%	\$ 54.2	44%	\$ 48.3	43%
Electricity Metering	37.0	42%	24.7	41%	68.9	41%	49.0	43%
Total Hardware Solutions	62.5	42%	52.0	42%	123.1	42%	97.3	43%
Software Solutions	6.5	42%	4.7	38%	12.7	44%	10.4	42%
Total Company	\$ 69.0	42%	\$ 56.7	42%	\$ 135.8	43%	\$ 107.7	43%

	<b>Three Months Ended June 30,</b>				<b>Six Months Ended June 30,</b>			
	<b>2006</b>		<b>2005</b>		<b>2006</b>		<b>2005</b>	
	<b>Operating Income</b>	<b>Operating Margin</b>	<b>Operating Income</b>	<b>Operating Margin</b>	<b>Operating Income</b>	<b>Operating Margin</b>	<b>Operating Income</b>	<b>Operating Margin</b>
	<b>(millions)</b>		<b>(millions)</b>		<b>(millions)</b>		<b>(millions)</b>	
<b>Segment Operating Income (Loss) and Operating Margin</b>								
Hardware Solutions								
Meter Data Collection	\$ 19.6	33%	\$ 22.0	35%	\$ 42.7	35%	\$ 38.0	34%
Electricity Metering	33.2	38%	20.4	34%	61.8	37%	40.3	35%
Other unallocated costs	(9.7)		(6.2)		(18.4)		(12.2)	
Total Hardware Solutions	43.1	29%	36.2	29%	86.1	30%	66.1	29%
Software Solutions	(3.3)	-22%	(3.0)	-24%	(5.8)	-20%	(5.6)	-22%
Corporate unallocated	(22.2)		(22.9)		(43.7)		(44.4)	
Total Company	\$ 17.6	11%	\$ 10.3	8%	\$ 36.6	11%	\$ 16.1	6%

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	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
<b>Unit Shipments by Segment</b>				
Meter Data Collection				
AMR standalone modules	1,000	1,125	2,075	1,900
Licensed AMR (other vendors' meters)	50	125	175	300
Electricity Metering				
Total meters	1,850	1,125	3,575	2,200
With Itron AMR	1,300	425	2,500	800
With other AMR	225	225	375	425
Total units with Itron AMR <sup>(1)</sup>	2,350	1,675	4,750	3,000

<sup>(1)</sup> Includes Itron AMR standalone modules, Itron meters with Itron AMR and other vendors' electronic electricity meters with Itron AMR.

**Hardware Solutions—Meter Data Collection:** Meter Data Collection revenues decreased \$2.1 million, or 3%, in the second quarter of 2006, compared with the same period in 2005. Shipments of standalone gas AMR modules increased, offset primarily by lower shipments of standalone electric AMR modules. Meter Data Collection revenues increased \$10.0 million, or 9%, for the six months ended June 30, 2006, compared with the same period in 2005, due to increased shipments of standalone gas AMR modules, offset primarily by fewer shipments of standalone electric AMR modules. Standalone electric AMR module shipments have declined in 2006 due to increasing sales of electricity meters with embedded AMR.

Gross margins decreased two percentage points in the second quarter of 2006, compared with the second quarter of 2005, but increased one percentage point on a year-to-date basis in 2006. Gross margins can fluctuate from period to period primarily due to changes in the mix of product sold, manufacturing volumes and provisions for product warranties.

One customer, Piedmont Natural Gas, accounted for 16% and 14% of Meter Data Collection segment revenues for the three and six months ended June 30, 2006, respectively. There were no customers that represented more than 10% of Meter Data Collection revenues for the three and six months ended June 30, 2005.

**Hardware Solutions—Electricity Metering:** Electricity Metering revenues increased \$27.8 million and \$54.1 million for the three and six months ended June 30, 2006, compared with the same periods in 2005, due to a 64% and 63% increase in the number of meters shipped in each period, respectively. The growth in meter shipments in 2006 was primarily related to shipments under a contract with Progress Energy for 2.7 million residential meters with AMR, which was signed in the third quarter of 2005. Approximately 70% of meters shipped in each period in 2006 were equipped with our AMR technology compared with 38% and 36%, respectively, for the three and six month periods in 2005.

Electricity Metering gross margin was 42% for the second quarter of 2006, compared with 41% in 2005. Year-to-date, Electricity Metering gross margin was 41% in 2006 compared with 43% in 2005. Gross margin fluctuations from period to period reflect changes in the mix of meters sold, such as residential vs. C&I, AMR meters vs. non-AMR meters, changes in manufacturing volumes and changes in the amount of installation and other related services. In particular, for the six months ended 2006, lower gross margin reflects a higher proportion of installation revenues compared with meter sales.

Progress Energy represented 36% and 39% of Electricity Metering revenues for the three and six month periods ended June 30, 2006. There were no customers that represented more than 10% of Electricity Metering revenues in the three and six months ended June 30, 2005.

**Hardware Solutions—Total operating expenses:** Total Hardware Solutions operating expenses were \$19.4 million and \$37.0 million for the three and six months ended June 30, 2006, compared with \$15.8 million and \$31.2 million for the same periods in 2005. In the 2006 periods, these costs were 13% of total Hardware Solutions revenues compared with 13% and 14% of total Hardware Solutions revenues in the three and six month periods in 2005.

**Software Solutions:** Revenues increased \$3.0 million and \$3.7 million for the three and six months ended June 30, 2006, compared with the same periods in 2005, due to increases in software license sales for a broad mix of products. Gross margins for the three and six months ended June 30, 2006 increased four and two percentage points, respectively, compared with the same periods in 2005, due to a proportionately higher content of revenues from software licenses. Software licenses were 28% and 27% of segment revenues for the three and six months ended June 30, 2006, respectively, compared with 21% in each of the same periods in 2005.

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There were no customers that represented more than 10% of Software Solutions revenues for the three and six months ended June 30, 2006 and 2005.

Gross profit for Software Solutions is not yet sufficient to cover current operating expenses due primarily to significant investments in product development. In 2006, operating expenses include approximately \$800,000 in expenses related to the relocation of operations from Vancouver, B.C. to our headquarters in Spokane and approximately \$600,000 associated with stock-based compensation. Stock-based compensation was approximately \$1.2 million for the six months ended June 30, 2006. There was no stock-based compensation expense in 2005.

*Corporate unallocated:* Operating expenses not directly associated with a segment are classified as "Corporate unallocated." The largest single component of these is amortization of intangible assets, which was \$7.6 million and \$14.9 million in the three and six months ended June 30, 2006 compared with \$9.7 million and \$19.4 million for the same periods in 2005.

### **New Order Bookings and Backlog**

Bookings for a reported period represent contracts and purchase orders received during the specified period. Total backlog represents committed but undelivered contracts and purchase orders at period end. Twelve-month backlog represents the portion of total backlog that we estimate will be earned over the next twelve months. Bookings and backlog exclude maintenance-related activity. Backlog is not a complete measure of our future business as we have a significant portion of our business that is book-and-ship. Bookings and backlog can fluctuate significantly due to the timing of large project awards. In addition, annual or multi-year contracts are subject to rescheduling and cancellation by customers due to the long-term nature of the contracts. Beginning total backlog, plus bookings, less sales revenues will not always equal ending total backlog due to miscellaneous contract adjustments and other factors.

Information on new orders during the quarter and backlog at quarter-end is summarized as follows:

<u>Quarter Ended</u>	<u>Total Bookings</u>	<u>Total Backlog</u> (in millions)	<u>12-Month Backlog</u>
June 30, 2006	\$ 107	\$ 351	\$ 225
March 31, 2006	206	387	241
December 31, 2005	149	324	188
September 30, 2005	212	325	198
June 30, 2005	177	243	151
March 31, 2005	117	190	116
December 31, 2004	128	179	97
September 30, 2004	98	177	104

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**Operating Expenses**

The following table details our total operating expenses in dollars and as a percentage of revenues.

	Three Months Ended June 30,				Six Months Ended June 30,			
	% of		% of		% of		% of	
	2006	Revenue	2005	Revenue	2006	Revenue	2005	Revenue
	(millions)		(millions)	(millions)		(millions)		
<i>Operating Expenses</i>								
Sales and marketing	\$ 16.3	10%	\$ 13.6	10%	\$ 31.8	10%	\$ 26.8	11%
Product development	14.9	9%	11.4	8%	27.8	9%	23.3	9%
General and administrative	12.6	7%	11.8	9%	24.7	8%	21.8	8%
Amortization of intangibles assets	7.6	5%	9.7	7%	14.9	4%	19.4	8%
Restructurings	-	-	-	-	-	-	0.4	-
Total operating expenses	<u>\$ 51.4</u>	<u>31%</u>	<u>\$ 46.5</u>	<u>34%</u>	<u>\$ 99.2</u>	<u>31%</u>	<u>\$ 91.7</u>	<u>36%</u>

For the three and six months ended June 30, 2006, operating expenses included approximately \$1.8 million and \$3.6 million associated with our January 1, 2006 adoption of SFAS 123(R), which requires expensing of stock-based compensation. While total operating expenses increased, they decreased as a percentage of revenue due to higher sales volumes.

**Other Income (Expense)**

The following table shows the components of other income (expense).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
	(in thousands)			
Interest income	\$ 360	\$ 94	\$ 722	\$ 98
Interest expense	(2,202)	(4,047)	(5,176)	(7,904)
Amortization of prepaid debt fees	(383)	(2,338)	(3,155)	(3,048)
Other income (expense), net	(241)	454	(689)	555
Total other income (expense)	<u>\$ (2,466)</u>	<u>\$ (5,837)</u>	<u>\$ (8,298)</u>	<u>\$ (10,299)</u>

Interest income consists primarily of interest earned from operating cash balances. Our average operating cash balances were \$38.9 million and \$41.8 million for the three and six months ended June 30, 2006 compared with \$15.7 million and \$14.9 million for the same periods in 2005, respectively.

The reduction in interest expense is the result of lower outstanding borrowings and capitalized interest. Average outstanding borrowings were \$124.6 million and \$139.6 million for the three and six months ended June 30, 2006, compared with \$217.2 million and \$243.3 million for the same period in 2005, respectively. In the second quarter of 2006, we capitalized approximately \$400,000 of interest costs related to qualified expenditures for improvements to our new corporate headquarters facility, which will be substantially complete as of September 30, 2006. The amount capitalized is based on interest rates in place during the construction period and we expect to capitalize a similar amount in the third quarter. Amortization of prepaid debt fees has fluctuated as a result of voluntary prepayments of our senior secured term loan.

Other income (expense) consists primarily of foreign currency gains and losses, which can vary from period to period, as well as other non-operating events or transactions. During the six months ended June 30, 2006, other income (expense) also included a \$242,000 loss on the sale of our investment in Servatron, which was recorded in the first quarter. During the second quarter of 2005, other income (expense) included a state tax refund of \$500,000.

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### Income Taxes

Our effective income tax rates differ from the federal statutory rate of 35%, and can vary from period to period, due to fluctuations in operating results, new or revised tax legislation and accounting pronouncements, research credits and state income taxes.

We estimate that our 2006 annual effective income tax rate will be approximately 42%. Our effective income tax rate was 33% and 39%, respectively, for the three and six months ended June 30, 2006. The rate for the three and six months ended June 30, 2006 is lower than the estimated annual rate due to tax benefits for certain state and Canadian credits and the realization of deferred tax assets related to a foreign subsidiary. Both the six month and estimated 2006 annual effective income tax rates are higher than the statutory rate due to state income taxes and the implementation of SFAS 123(R).

Our 2005 annual effective income tax rate of 34% was lower than the statutory tax rate due to the benefit of research credits. In the second quarter of 2005, we completed a research credit study for the years 1997 – 2004, recognizing a \$5.9 million net tax credit as an offset to the provision for income taxes. Due primarily to this credit, we had a net tax benefit for the three and six months ended June 30, 2005.

Our estimated 2006 annual effective income tax rate does not include a federal research credit, as the credit expired on December 31, 2005. Congress is currently discussing extension and/or revision of the research credit. As of June 30, 2006, the research credit had not been extended or reinstated by Congress. If the research credit is reinstated by Congress, our effective annual income tax rate for 2006 is expected to be lower than the current estimated rate of 42%.

As a matter of course, we are subject to audit by various taxing authorities. From time to time, these audits may result in proposed assessments where the ultimate resolution may result in additional taxes. We regularly assess our position with regard to individual tax exposures and we believe that our tax positions comply with applicable tax law and that we have adequately provided for these matters.

### Financial Condition

#### Cash Flow Information:

	Six Months Ended June 30,	
	2006	2005
	(in millions)	
Operating activities	\$ 56.8	\$ 36.6
Investing activities	(20.8)	(2.2)
Financing activities	(23.1)	(36.1)
Increase in cash and cash equivalents	<u>\$ 12.9</u>	<u>\$ (1.7)</u>

*Operating activities:* Cash provided by operating activities increased \$20.2 million in the first half of 2006, compared with the same period in 2005. Increased revenues generated an additional \$89.8 million in cash, which was offset by an increase of \$64.8 million in cash paid to suppliers and employees. In addition, we paid \$3.6 million less in net interest and taxes. In 2006 excess tax benefits from stock-based compensation associated with our January 1, 2006 adoption of SFAS 123(R) are reflected in financing activities.

*Investing activities:* In the first half of 2006, property, plant and equipment purchases were \$14.4 million, compared with \$5.3 million in the first half of 2005. The increase in 2006 is primarily related to capital improvements to our new corporate headquarters and an ERP (Enterprise Resource Planning) system upgrade. Also, in 2005, proceeds of \$2.6 million were received from the sale of our manufacturing facility in Quebec, Canada. Investing activities in the first half of 2006 also included \$7.8 million used for the Quantum Consulting, Inc. (Quantum) and ELO Sistemas e Tecnologia Ltda. (ELO) acquisitions with no similar activity in the first half of 2005.

*Financing activities:* During the first half of 2006, we paid off various debt balances from December 31, 2005, including \$24.7 million on our term loan, \$14.8 million on our real estate term note and \$3.2 million of project financing debt. In the first half of 2005 we made \$107.8 million in payments on the term note, \$59.8 million of which were from net proceeds from an equity offering in May 2005. Cash generated from the exercise of stock-based awards was \$11.3 million during the first half of 2006, compared with \$12.5 million for the same period in 2005. Financing activities in the first half of 2006 included \$8.4 million in excess tax benefits from stock-based compensation associated with our January 1, 2006 adoption of SFAS 123(R).

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We had no off-balance sheet financing agreements at June 30, 2006 and December 31, 2005, except for operating lease commitments.

### *Liquidity, Sources and Uses of Capital:*

We have historically funded our operations and growth with cash flow from operations, borrowings and issuances of our stock. At June 30, 2006, we had \$46.6 million in cash and cash equivalents. Cash equivalents are invested in investments rated A or better by Standard & Poor's or Moody's. We are exposed to changes in interest rates on cash equivalents.

At December 31, 2005, we had \$24.7 million remaining on our original \$185 million seven-year senior secured term loan (term loan), which we repaid during the first quarter of 2006. The term loan was part of our senior secured credit facility (credit facility), which originated on July 1, 2004 to finance the acquisition of our Electricity Metering business. The credit facility also includes a \$55 million five-year senior secured revolving credit line (revolver). We have the ability to increase the revolver to \$75 million at a future date. Our letter of credit limit under the credit facility is \$55 million and can be increased to \$65 million at a future date. The credit facility is guaranteed by all of our operating subsidiaries, except for our foreign subsidiaries and an outsourcing project finance subsidiary, all of which are wholly owned.

At June 30, 2006, there were no borrowings outstanding under the revolver and \$22.5 million was utilized by outstanding standby letters of credit resulting in \$32.5 million available for additional borrowings. Revolver borrowings can be made at any time through June 2009, at which time any borrowings outstanding must be repaid. We were in compliance with all of our debt covenants at June 30, 2006 and December 31, 2005. Our debt covenants require us to maintain certain consolidated leverage and coverage ratios on a quarterly basis, as well as customary covenants that place restrictions on the incurrence of debt, the payment of dividends, certain investments and mergers.

Interest rates on the revolver vary depending on our consolidated leverage ratio and are based on the London InterBank Offering Rate (LIBOR) plus 2.0% to 3.0%, or Prime plus 1.0% to 2.0%, payable at various intervals depending on the term of the borrowing. The annual commitment fee on the unused portion of the revolver varies from 0.25% to 0.50%. We incur annual letter of credit fees based on (a) a fronting fee of 0.125% and (b) a letter of credit fee that varies from 1.0% to 2.0%.

Prepaid debt fees for all our outstanding borrowings are amortized over the respective terms using the effective interest method. Unamortized prepaid debt fees were approximately \$5.8 million and \$8.9 million at June 30, 2006 and December 31, 2005, respectively.

Our senior subordinated notes consist of \$125 million aggregate principal amount of 7.75% notes, issued in May 2004 and due in 2012. The notes were discounted to a price of 99.265 to yield 7.875%, with a balance of \$124.3 million at June 30, 2006. The notes are registered with the SEC and are generally transferable. The discount on the notes is accreted and the prepaid debt fees are amortized over the life of the notes. Fixed interest payments of approximately \$4.8 million are required every six months, in May and November. The notes are subordinated to our credit facility and are guaranteed by all of our operating subsidiaries, except for our foreign subsidiaries and an outsourcing project finance subsidiary, all of which are wholly owned. The notes contain covenants, which place restrictions on the incurrence of debt, the payment of dividends, certain investments and mergers. Some or all of the notes may be redeemed at our option at any time on or after May 15, 2008, at their principal amount plus a specified premium. At any time prior to May 15, 2007, we may, at our option, redeem up to 35% of the notes, at 107.75%, with the proceeds of certain sales of our common stock.

The real estate term note we signed on December 31, 2005 for \$14.8 million was repaid in April 2006. The project financing note, which had a balance of \$3.2 million at December 31, 2005, was repaid in April 2006.

We maintain bid and performance bonds for certain customers. Bonds in force were \$2.7 million and \$3.0 million at June 30, 2006 and December 31, 2005, respectively. Bid bonds guarantee that we will enter into a contract consistent with the terms of the bid. Performance bonds provide a guarantee to the customer for future performance, which usually covers the installation phase of a contract and may on occasion cover the operations and maintenance phase of outsourcing contracts.

We have employee bonus and profit sharing plans, based on performance and financial targets. Actual award amounts are determined at the end of the year if the targets are met. As the bonuses are being earned during the year, we estimate a compensation accrual each quarter based on the progress towards achieving the goals, the estimated financial forecast for the year and the probability of achieving various results. An accrual is recorded if management deems it probable that a target will be achieved and the amount can be reasonably estimated. Although we monitor our annual forecast and the progress towards achievement of goals, the actual results at the end of the year may warrant a bonus award that is significantly greater or less than the assessments made in earlier quarters. We accrued approximately \$2.5 million and \$2.2 million under these plans for the three months ended June 30, 2006 and 2005, and \$5.0 million and \$3.5 million for the six months ended June 30, 2006 and 2005, respectively.

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Our net deferred tax assets consist of accumulated net operating losses and tax credits, some of which are limited by Internal Revenue Code Sections 382 and 383 (Section 382 and Section 383). The limited deferred tax assets resulted primarily from acquisitions. We expect to utilize tax loss carryforwards and available tax credits to offset taxes otherwise due on regular taxable income in upcoming years. During 2006, we expect to pay approximately \$2.7 million in cash for federal alternative minimum tax, international taxes and various state tax obligations.

Working capital at June 30, 2006 was \$136.1 million compared with \$116.1 million at December 31, 2005. A portion of the increase of \$20.0 million in working capital resulted from an \$8.5 million reclassification of our Spokane Valley headquarters' facility to assets held for sale within other current assets at June 30, 2006.

We expect to continue to expand our operations and grow our business through a combination of internal new product development, licensing technology from or to others, distribution agreements, partnership arrangements and acquisitions of technology or other companies. We expect these activities to be funded with existing cash, cash flow from operations, borrowings and the issuance of common stock or other securities. We believe existing sources of liquidity will be sufficient to fund our existing operations and obligations for at least the next year and foreseeable future, but offer no assurances. Our liquidity could be affected by the stability of the energy and water industries, competitive pressures, international risks, intellectual property claims and other factors described under "Risk Factors" within Item 1A to Part 1 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, which was filed with the SEC on February 24, 2006, as well as in our "Quantitative and Qualitative Disclosures About Market Risk" within Item 3 of Part 1 included in this Quarterly Report on Form 10-Q.

### **Contingencies**

We are subject to various legal proceedings and claims of which the outcomes are subject to significant uncertainty. Our policy is to assess the likelihood of any adverse judgments or outcomes related to legal matters, as well as ranges of probable losses. A determination of the amount of the liability required, if any, for these contingencies is made after an analysis of each known issue in accordance with SFAS 5, *Accounting for Contingencies*, and related pronouncements. In accordance with SFAS 5, a liability is recorded when we determine that a loss is probable and the amount can be reasonably estimated. Additionally, we disclose contingencies for which a material loss is reasonably possible, but not probable. At June 30, 2006, there were no material contingencies requiring accrual or disclosure.

We generally provide within our sales contracts an indemnification related to the infringement of any patent, copyright, trademark or other intellectual property right on software or equipment, which indemnifies the customer from and pays the resulting costs, damages and attorney's fees awarded against a customer with respect to such a claim provided that (a) the customer promptly notifies us in writing of the claim and (b) we have the sole control of the defense and all related settlement negotiations. The terms of the indemnification normally do not limit the maximum potential future payments. We also provide an indemnification for third party claims resulting from damages caused by the negligence or willful misconduct of our employees/agents in connection with the performance of certain contracts. The terms of the indemnification generally do not limit the maximum potential payments.

### **Critical Accounting Policies**

*Revenue Recognition:* The majority of our revenues are recognized when products are shipped to or received by a customer or when services are provided. We have certain customer arrangements with multiple elements. For such arrangements, we determine the estimated fair value of each element and then allocate the total arrangement consideration among the separate elements based on the relative fair value percentages. Revenues for each element are then recognized based on the type of element, such as 1) when the products are shipped, 2) services are delivered, 3) percentage of completion when implementation services are essential to the software performance, 4) upon customer acceptance provisions or 5) transfer of title. Fair values represent the estimated price charged when an item is sold separately. We review our fair values on an annual basis or more frequently if a significant trend is noted.

We recognize revenue for delivered elements when the delivered elements have standalone value and we have objective and reliable evidence of fair value for each undelivered element. In the absence of fair value of a delivered element, we allocate revenue first to the fair value of the undelivered elements and the residual revenue to the delivered elements. If the fair value of any undelivered element included in a multiple element arrangement cannot be objectively determined, revenue is deferred until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements.

Under outsourcing arrangements, revenue is recognized as services are provided. Hardware and software post-sale maintenance support fees are recognized ratably over the performance period. Certain consulting services are recognized as

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services are performed. Revenue can vary significantly from period to period based on the timing of orders and the application of revenue recognition criteria. Use of the percentage of completion method for revenue recognition requires estimating the cost to complete a project. The estimation of costs through completion of a project is subject to many variables such as the length of time to complete, changes in wages, subcontractor performance, supplier information and business volume assumptions. Changes in underlying assumptions/estimates may adversely or positively affect financial performance.

Unearned revenue is recorded for products or services when the criteria for revenue recognition have not been met. The majority of unearned revenue relates to annual billing terms for post-sale maintenance and support agreements.

*Warranty:* We offer industry standard warranties on our hardware products and large application software products. Standard warranty accruals represent the estimated cost of projected warranty claims and are based on historical and projected product performance trends, business volume assumptions, supplier information and other business and economic projections. Thorough testing of new products in the development stage helps identify and correct potential warranty issues prior to manufacturing. Continuing quality control efforts during manufacturing limit our exposure to warranty claims. If our quality control efforts fail to detect a fault in one of our products, we could experience an increase in warranty claims. We track warranty claims to identify potential warranty trends. If an unusual trend is noted, an additional warranty accrual may be assessed and recorded when a failure event is probable and the cost can be reasonably estimated. Management continually evaluates the sufficiency of the warranty provisions and makes adjustments when necessary. The warranty allowances may fluctuate due to changes in estimates for material, labor and other costs we may incur to replace projected product failures, and we may incur additional warranty and related expenses in the future with respect to new or established products.

*Inventories:* Items are removed from inventory using the first-in, first-out method. Inventories include raw materials, sub-assemblies and finished goods. Inventory amounts include the cost to manufacture the item, such as the cost of raw materials, labor and other applied direct and indirect costs. We also review idle facility expense, freight, handling costs and wasted materials to determine if abnormal amounts should be recognized as current-period charges. We review our inventory for obsolescence and marketability. If the estimated market value, which is based upon assumptions about future demand and market conditions, falls below the original cost, the inventory value is reduced to the market value. If technology rapidly changes or actual market conditions are less favorable than those projected by management, inventory write-downs may be required.

*Goodwill and Intangible Assets:* Goodwill and intangible assets result from our acquisitions. We use estimates in determining the value of goodwill and intangible assets, including estimates of useful lives of intangible assets, discounted future cash flows and fair values of the related operations. We test goodwill for impairment each year as of October 1, under the guidance of SFAS 142, *Goodwill and Other Intangible Assets*. We forecast discounted future cash flows at the reporting unit level, which consists of our segments, based on estimated future revenues and operating costs, which take into consideration factors such as existing backlog, expected future orders, supplier contracts and general market conditions. Changes in our forecasts or cost of capital may result in asset value adjustments, which could have a significant effect on our current and future results of operations, financial condition and cash flows. Intangible assets with a finite life are amortized based on estimated discounted cash flows over estimated useful lives and are tested for impairment when events or changes in circumstances indicate the carrying value may not be recoverable.

*Stock-based Compensation:* As of January 1, 2006, we adopted SFAS 123(R), which requires us to measure compensation cost for stock-based awards at fair value and recognize compensation over the service period for awards expected to vest. The estimation of stock awards that will ultimately vest requires us to approximate the number of options that will be forfeited prior to completing their vesting requirement (forfeitures). We consider many factors when estimating expected forfeitures, including types of awards, employee class and historical experience. To the extent actual results or updated estimates differ from our current estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. We use the Black-Scholes option-pricing model, which requires the input of assumptions, including the estimated length of time employees will retain their vested stock options before exercising them (expected term) and the estimated volatility of the Company's common stock price over the expected term.

*Deferred Income Taxes:* We estimate the expected realizable value of deferred tax assets. As of June 30, 2006, we have a valuation allowance of \$1.1 million to reduce our deferred tax assets relating to certain net operating losses and federal tax credits as we believe it is more likely than not that these assets will not be realized. We do not have a valuation allowance on any other deferred tax asset because we believe that the assets are more likely than not to be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the appropriateness of a valuation allowance, in the event we were to determine that we would have a change in the realization of the net deferred tax asset in the future, an adjustment to the deferred tax asset or valuation allowance would be made.

*Compensation Plans:* We have compensation plans that offer a range of award amounts for the achievement of various annual performance and financial targets. Actual award amounts will be determined at the end of the year if the performance

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and financial targets are met. As the bonuses are being earned during the year, we must estimate a compensation accrual each quarter based on the progress towards achieving the goals, the estimated financial forecast for the year and the probability of achieving various results. An accrual is recorded if management deems it probable that a target will be achieved and the amount can be reasonably estimated. Although we monitor our annual forecast and the progress towards achievement of goals, the actual results at the end of the year may warrant a bonus award that is significantly greater or less than the assessments made in earlier quarters.

*Legal Contingencies:* We are subject to various legal proceedings and claims of which the outcomes are subject to significant uncertainty. Our policy is to assess the likelihood of any adverse judgments or outcomes related to legal matters, as well as ranges of probable losses. A determination of the amount of the liability required, if any, for these contingencies is made after an analysis of each known issue in accordance with SFAS 5, and related pronouncements. In accordance with SFAS 5, a liability is recorded when we determine that a loss is probable and the amount can be reasonably estimated. Additionally, we disclose contingencies for which a material loss is reasonably possible, but less than probable.

### **New Accounting Pronouncements**

In February of 2006, the Financial Accounting Standards Board (FASB) issued SFAS 155, *Accounting for Certain Hybrid Instruments—An Amendment of FASB Statements 133 and 140* (SFAS 155). SFAS 155 amends SFAS 133 to allow financial instruments that have embedded derivatives to be accounted for as a whole, if the holder elects to account for the whole instrument on a fair value basis, and provides additional guidance on the applicability of SFAS 133 and SFAS 140 to certain financial instruments and subordinated concentrations of credit risk. SFAS 155 is effective for all hybrid financial instruments acquired or issued by the company on or after January 1, 2007. The adoption of SFAS 155 is not expected to have a material impact on our financial position or results of operations.

In July 2006, the FASB issued Financial Interpretation 48 (FIN 48), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB 109*, which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and is effective for fiscal years beginning after December 15, 2006. We have not yet determined the impact of the adoption of FIN 48 on our results of operations or financial condition.

**Item 3: Quantitative and Qualitative Disclosures About Market Risk**

*Interest Rate Risk:* We had no outstanding debt subject to variable interest rates at June 30, 2006. We held no derivative instruments at June 30, 2006.

*Foreign Currency Exchange Rate Risk:* We conduct business in a number of foreign countries and, therefore, face exposure to adverse movements in foreign currency exchange rates. International revenues were 6% and 5% of total revenues for the three and six months ended June 30, 2006, respectively. Since we have not used derivative instruments to manage foreign currency exchange rate risks, the consolidated results of operations in U.S. dollars are subject to fluctuation as foreign exchange rates change. In addition, our foreign currency exchange rate exposures may change over time as business practices evolve and could have a material effect on our financial results.

Our primary exposure is related to non-U.S. dollar denominated sales, cost of sales and operating expenses in our foreign subsidiary operations. This means we are subject to changes in the consolidated results of operations expressed in U.S. dollars. Other international business, consisting primarily of shipments from the United States to international distributors and customers in the Pacific Rim and Latin America, is predominantly denominated in U.S. dollars, which reduces our exposure to fluctuations in foreign currency exchange rates. In some cases where sales from the United States are not denominated in U.S. dollars, we may hedge our foreign exchange risk by selling the expected foreign currency receipts forward. There have been, and there may continue to be, large period-to-period fluctuations in the relative portions of international revenues that are denominated in foreign currencies.

Risk-sensitive financial instruments in the form of intercompany trade receivables are mostly denominated in U.S. dollars, while intercompany notes may be denominated in local foreign currencies. As foreign currency exchange rates change, intercompany trade receivables may affect current earnings, while intercompany notes may be revalued and result in unrealized translation gains or losses that are reported in accumulated other comprehensive income (loss).

Because our earnings are affected by fluctuations in the value of the U.S. dollar against foreign currencies, we have performed a sensitivity analysis assuming a hypothetical 10% increase or decrease in the value of the dollar relative to the currencies in which our transactions are denominated. At June 30, 2006, the analysis indicated that such market movements would not have had a material effect on our consolidated results of operations or on the fair value of any risk-sensitive financial instruments. The model assumes foreign currency exchange rates will shift in the same direction and relative amount. However, exchange rates rarely move in the same direction. This assumption may result in the overstatement or understatement of the effect of changing exchange rates on assets and liabilities denominated in a foreign currency. Consequently, the actual effects on operations in the future may differ materially from results of the analysis for the six months ended June 30, 2006. We may, in the future, experience greater fluctuations in U.S. dollar earnings from fluctuations in foreign currency exchange rates. We will continue to monitor and assess the effect of currency fluctuations and may institute hedging alternatives.

**Item 4: Controls and Procedures**

- (a) *Evaluation of disclosure controls and procedures.* An evaluation was performed under the supervision and with the participation of our Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e), under the Securities Exchange Act of 1934 as amended. Based on that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective as of June 30, 2006, the end of the period covered by this report.
- (b) *Changes in internal control.* There have been no changes in internal control over financial reporting during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**PART II: OTHER INFORMATION****Item 1: Legal Proceedings**

We are subject to various legal proceedings and claims of which the outcomes are subject to significant uncertainty. Our policy is to assess the likelihood of any adverse judgments or outcomes related to legal matters, as well as ranges of probable losses. A determination of the amount of the liability required, if any, for these contingencies is made after an analysis of each known issue in accordance with Statement of Financial Accounting Standards (SFAS) 5, *Accounting for Contingencies*. In accordance with SFAS 5, a liability is recorded when we determine that a loss is probable and the amount can be reasonably estimated. Additionally, we disclose contingencies for which a material loss is reasonably possible, but less than probable. At June 30, 2006, there were no material contingencies requiring accrual or disclosure.

**Item 1A: Risk Factors**

There were no material changes during the second quarter of 2006 from risk factors as previously disclosed in Item 1A included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, which was filed with the SEC on February 24, 2006.

**Item 4: Submission of Matters to a Vote of Security Holders**

Itron held its annual meeting of shareholders on May 9, 2006. One director, Charles H. Gaylord, Jr., was elected for a term of two years and three directors, Michael B. Bracy, Thomas S. Foley and Graham M. Wilson were elected for a term of three years. Ted C. DeMerritt, Jon E. Eliassen, Thomas S. Glanville, Sharon L. Nelson and LeRoy D. Nosbaum continued their terms as directors and Mary Ann Peters retired from the board. The following summarizes all matters voted on at the meeting.

Matter 1: The vote for the nominated directors was as follows:

<u>NOMINEE</u>	<u>IN FAVOR</u>	<u>WITHHELD</u>
Charles H. Gaylord, Jr.	22,599,492	508,084
Michael B. Bracy	21,347,999	1,759,577
Thomas S. Foley	20,502,077	2,605,499
Graham M. Wilson	20,296,500	2,811,076

Matter 2: Approval of amendment to the Amended and Restated 2000 Stock Incentive Plan to increase the authorized shares.

<u>IN FAVOR</u>	<u>AGAINST</u>	<u>ABSTAIN</u>	<u>BROKER NON-VOTES</u>
15,270,777	5,614,325	16,411	2,206,063

**Item 5: Other Information**

(a) No information was required to be disclosed in a report on Form 8-K during the second quarter of 2006 that was not reported.

(b) Not applicable.

**Item 6: Exhibits**

<u>Exhibit Number</u>	<u>Description of Exhibits</u>
10.4	Amended and Restated Stock Option Grant Program for Non-Employee Directors.
12.1	Statement re Computation of Ratios.
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



## ITRON, INC.

AMENDED AND RESTATED  
2000 STOCK INCENTIVE PLAN

As adopted by the board on February 16, 2006 and approved by the shareholders on May 9, 2006

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**SECTION 1. PURPOSE**

The purpose of the Itron, Inc. Amended and Restated 2000 Stock Incentive Plan (the "Plan") is to enhance the long-term shareholder value of Itron, Inc., a Washington corporation (the "Company"), by offering opportunities to selected persons to participate in the Company's growth and success, and to encourage them to remain in the service of the Company and its Related Corporations (as defined in Section 2) and to acquire and maintain stock ownership in the Company.

**SECTION 2. DEFINITIONS**

For purposes of the Plan, the following terms shall be defined as set forth below:

"Award" means any Option, Stock Award or Performance Shares and Performance Units granted pursuant to the provisions of the Plan.

"Board" means the Board of Directors of the Company.

"Cause," unless otherwise defined in the instrument evidencing the Award or in a written employment or services agreement between the Participant and the Company or a Related Corporation in connection with an Award, means dishonesty, fraud, misconduct, unauthorized use or disclosure of confidential information or trade secrets, or conviction or confession of a crime punishable by law (except minor violations), in each case as determined by the Plan Administrator, and its determination shall be conclusive and binding.

"Code" means the Internal Revenue Code of 1986, as amended from time to time.

"Common Stock" means the common stock, no par value per share, of the Company.

"Corporate Transaction" has the meaning set forth in Section 14.3.1.

"Covered Employee" means a "covered employee" as that term is defined in Section 162(m)(3) of the Code or any successor provision.

"Disability," unless otherwise defined by the Plan Administrator, means a mental or physical impairment of the Participant that is expected to result in death or that has lasted or is expected to last for a continuous period of 12 months or more and that causes the Participant to be unable, in the opinion of the Company, to perform his or her duties for the Company or a Related Corporation and to be engaged in any substantial gainful activity.

"Effective Date" has the meaning set forth in Section 16.

"Exchange Act" means the Securities Exchange Act of 1934, as amended.

"Fair Market Value" shall be as established in good faith by the Plan Administrator or (a) if the Common Stock is listed on The NASDAQ Stock Market, the closing sales price for the Common Stock as reported by The NASDAQ Stock Market for a single trading day or (b) if the Common Stock is listed on the New York Stock Exchange or the American Stock Exchange, the closing sales price for the Common Stock as such price is officially quoted in the composite tape of transactions on such exchange for a single

trading day. If there is no such reported price for the Common Stock for the date in question, then such price on the last preceding date for which such price exists shall be determinative of Fair Market Value.

“Grant Date” means the date on which the Plan Administrator completes the corporate action authorizing the grant of an Award or such later date specified by the Plan Administrator, and on which all conditions precedent to the grant have been satisfied, provided that conditions to the exercisability or vesting of Awards shall not defer the Grant Date.

“Incentive Stock Option” means an Option to purchase Common Stock granted under Section 7 with the intention that it qualify as an “incentive stock option” as that term is defined in Section 422 of the Code.

“Nonqualified Stock Option” means an Option to purchase Common Stock granted under Section 7 other than an Incentive Stock Option.

“Option” means the right to purchase Common Stock granted under Section 7.

“Option Term” has the meaning set forth in Section 7.3.

“Parent,” except as otherwise provided in Section 8.8 in connection with Incentive Stock Options, means any entity, whether now or hereafter existing, that directly or indirectly controls the Company.

“Participant” means the person to whom an Award is granted.

“Performance Award” means any Award of Performance Shares or Performance Units granted pursuant to Section 10.

“Performance Share” has the meaning set forth in Section 10.1.

“Performance Unit” has the meaning set forth in Section 10.2.

“Plan Administrator” has the meaning set forth in Section 3.1.

“Related Corporation” means any Parent or Subsidiary of the Company.

“Related Party Transaction” has the meaning set forth in Section 14.3.1.

“Retirement,” unless otherwise defined by the Plan Administrator from time to time for purposes of the Plan, means retirement on or after the individual’s normal retirement date under the Company’s 401(k) plan or other similar successor plan applicable to salaried employees.

“Securities Act” means the Securities Act of 1933, as amended.

“Stock Award” means shares of Common Stock or units denominated in Common Stock granted under Section 9, the rights of ownership of which may be subject to restrictions prescribed by the Plan Administrator.

“Subsidiary,” except as otherwise provided in Section 8.8 in connection with Incentive Stock Options, means any entity that is directly or indirectly controlled by the Company.

“Successor Corporation” has the meaning set forth in Section 14.3.2.

“Termination Date” has the meaning set forth in Section 7.6.

“Vesting Base Date” means the Grant Date or such other date selected by the Plan Administrator as the date from which an Option begins to vest for purposes of Section 7.4.

## **SECTION 3. ADMINISTRATION**

### **3.1 Plan Administrator**

The Plan shall be administered by the Board and/or a committee or committees (which term includes subcommittees) appointed by, and consisting of two or more members of, the Board (a "Plan Administrator"). If and so long as the Common Stock is registered under Section 12(b) or 12(g) of the Exchange Act, the Board shall consider in selecting the members of any committee acting as Plan Administrator, with respect to any persons subject or likely to become subject to Section 16 of the Exchange Act, the provisions regarding (a) "outside directors" as contemplated by Section 162(m) of the Code and (b) "nonemployee directors" as contemplated by Rule 16b-3 under the Exchange Act. Notwithstanding the foregoing, the Board may delegate the responsibility for administering the Plan with respect to designated classes of eligible persons to different committees consisting of two or more members of the Board, subject to such limitations as the Board deems appropriate. Committee members shall serve for such term as the Board may determine, subject to removal by the Board at any time. To the extent consistent with applicable law, the Board may authorize one or more senior executive officers of the Company to grant Awards to designated classes of eligible persons, within the limits specifically prescribed by the Board.

### **3.2 Administration and Interpretation by Plan Administrator**

Except for the terms and conditions explicitly set forth in the Plan, the Plan Administrator shall have exclusive authority, in its discretion, to determine all matters relating to Awards under the Plan, including the selection of individuals to be granted Awards, the type of Awards, the number of shares of Common Stock subject to an Award, all terms, conditions, restrictions and limitations, if any, of an Award and the terms of any instrument that evidences the Award. The Plan Administrator shall also have exclusive authority to interpret the Plan and the terms of any instrument evidencing the Award and may from time to time adopt and change rules and regulations of general application for the Plan's administration. The Plan Administrator's interpretation of the Plan and its rules and regulations, and all actions taken and determinations made by the Plan Administrator pursuant to the Plan, shall be conclusive and binding on all parties involved or affected. In no event, however, shall the Plan Administrator have the right to (a) without shareholder approval, cancel or amend outstanding Options for the purpose of repricing, replacing or regranteeing such Options with a purchase price that is less than the purchase price for the original Options, except in connection with adjustments provided in Section 14.1, or (b) issue an Option or amend an outstanding Option to provide for the grant or issuance of a new Option on exercise of the original Option. The Plan Administrator may delegate ministerial duties to such of the Company's officers as it so determines. The Plan Administrator, for purposes of determining the effect on an Award of a Company-approved leave of absence or a Participant's working less than full-time, shall be the chief executive officer of the Company or his designee.

## **SECTION 4. STOCK SUBJECT TO THE PLAN**

### **4.1 Authorized Number of Shares**

Subject to adjustment from time to time as provided in Section 14.1, the number of shares of Common Stock that shall be available for issuance under the Plan shall be 4,525,000. Shares issued under the Plan shall be drawn from authorized and unissued shares or shares now held or subsequently acquired by the Company.

### **4.2 Limitations**

Subject to adjustment from time to time as provided in Section 14.1, not more than an aggregate of 300,000 shares shall be available for issuance pursuant to grants of Awards other than Options under the Plan. This Section 4.2(a) is not intended as a limit on the number of Options that may be granted under the Plan.

### **4.3 Reuse of Shares**

Any shares of Common Stock that have been made subject to an Award that cease to be subject to the Award (other than by reason of exercise or payment of the Award to the extent it is exercised for or settled in vested and nonforfeitable shares) shall again be available for issuance in connection with future grants of Awards under the Plan; provided, however, that for purposes of Section 4.2, any such shares shall be counted in accordance with the requirements of Section 162(m) of the Code.

## **SECTION 5. ELIGIBILITY**

Awards may be granted under the Plan to those officers, directors and employees of the Company and its Related Corporations as the Plan Administrator from time to time selects. Awards may also be made to consultants, agents, advisors and independent contractors who provide services to the Company and its Related Corporations; provided, however, that such Participants render bona fide services that are not in connection with the offer and sale of the Company's securities in a capital-raising transaction and do not directly or indirectly promote or maintain a market for the Company's securities.

## **SECTION 6. AWARDS**

### **6.1 Form and Grant of Awards**

The Plan Administrator shall have the authority, in its sole discretion, to determine the type or types of Awards to be made under the Plan. Such Awards may include, but are not limited to, Incentive Stock Options, Nonqualified Stock Options and Stock Awards. Awards may be granted singly or in combination.

### **6.2 Settlement of Awards**

The Company may settle Awards through the delivery of shares of Common Stock, the granting of replacement Awards or any combination thereof as the Plan Administrator shall determine. Any Award settlement, including payment deferrals, may be subject to such conditions, restrictions and contingencies as the Plan Administrator shall determine. The Plan Administrator may permit or require the deferral of any Award payment, subject to such rules and procedures as it may establish, which may include provisions for the payment or crediting of interest, or dividend equivalents, including converting such credits into deferred stock equivalents.

### **6.3 Acquired Company Awards**

Notwithstanding anything in the Plan to the contrary, the Plan Administrator may grant Awards under the Plan in substitution for awards issued under other plans, or assume under the Plan awards issued under other plans, if the other plans are or were plans of other acquired entities ("Acquired Entities") (or the parent of the Acquired Entity) and the new Award is substituted, or the old award is assumed, by reason of a merger, consolidation, acquisition of property or stock, reorganization or liquidation (the "Acquisition Transaction"). In the event that a written agreement pursuant to which the Acquisition Transaction is completed is approved by the Board and said agreement sets forth the terms and conditions of the substitution for or assumption of outstanding awards of the Acquired Entity, said terms and conditions shall be deemed to be the action of the Plan Administrator without any further action by the Plan Administrator, except as may be required for compliance with Rule 16b-3 under the Exchange Act, and the persons holding such awards shall be deemed to be Participants.

## **SECTION 7. AWARDS OF OPTIONS**

### **7.1 Grant of Options**

The Plan Administrator is authorized under the Plan, in its sole discretion, to issue Options as Incentive Stock Options or as Nonqualified Stock Options, which shall be appropriately designated.

## 7.2 Option Exercise Price

The exercise price for shares purchased under an Option shall be as determined by the Plan Administrator, but shall not be less than 100% of the Fair Market Value of the Common Stock on the Grant Date. For Incentive Stock Options granted to a more than 10% shareholder, the Option exercise price shall be as specified in Section 8.2.

## 7.3 Term of Options

The term of each Option (the "Option Term") shall be as established by the Plan Administrator or, if not so established, shall be ten years from the Grant Date. For Incentive Stock Options, the maximum Option Term shall be as specified in Sections 8.2 and 8.4.

## 7.4 Exercise of Options

The Plan Administrator shall establish and set forth in each instrument that evidences an Option the time at which, or the installments in which, the Option shall vest and become exercisable, which provisions may be waived or modified by the Plan Administrator at any time. If not so established in the instrument evidencing the Option, the Option shall vest and become exercisable according to the following schedule, which may be waived or modified by the Plan Administrator at any time:

<u>Period of Participant's Continuous Employment or Service With the Company or Its Related Corporations From the Vesting Base Date</u>	<u>Percent of Total Option That Is Vested and Exercisable</u>
After 1 year	25%
After 2 years	50%
After 3 years	75%
After 4 years	100%

The Plan Administrator may adjust the vesting schedule of an Option held by a Participant who works less than "full-time" as that term is defined by the Plan Administrator or who takes a Company-approved leave of absence.

To the extent that an Option has vested and become exercisable, the Option may be exercised from time to time by delivery to the Company of a written stock option exercise agreement or notice, in a form and in accordance with procedures established by the Plan Administrator, setting forth the number of shares with respect to which the Option is being exercised, the restrictions imposed on the shares purchased under such exercise agreement, if any, and such representations and agreements as may be required by the Plan Administrator, accompanied by payment in full as described in Section 7.5. An Option may not be exercised for less than a reasonable number of shares at any one time, as determined by the Plan Administrator.

## 7.5 Payment of Exercise Price

The exercise price for shares purchased under an Option shall be paid in full to the Company by delivery of consideration equal to the product of the Option exercise price and the number of shares purchased. Such consideration must be paid in cash or by check or, unless the Plan Administrator in its sole discretion determines otherwise, either at the time the Option is granted or at any time before it is exercised, in any combination of:

(a) cash or check;

(b) tendering (either actually or, if and so long as the Common Stock is registered under Section 12(b) or 12(g) of the Exchange Act, by attestation) shares of Common Stock already owned by the Participant for at least six months (or any shorter period necessary to avoid a charge to the Company's

earnings for financial reporting purposes) having a Fair Market Value on the day prior to the exercise date equal to the aggregate Option exercise price;

(c) if and so long as the Common Stock is registered under Section 12(b) or 12(g) of the Exchange Act, delivery of a properly executed exercise notice, together with irrevocable instructions, to (i) a brokerage firm designated by the Company to deliver promptly to the Company the aggregate amount of sale or loan proceeds to pay the Option exercise price and any withholding tax obligations that may arise in connection with the exercise and (ii) the Company to deliver the certificates for such purchased shares directly to such brokerage firm, all in accordance with the regulations of the Federal Reserve Board; or

(d) such other consideration as the Plan Administrator may permit.

In addition, to assist a Participant (including a Participant who is an officer or a director of the Company) in acquiring shares of Common Stock pursuant to an Award granted under the Plan, the Plan Administrator, in its sole discretion, may authorize, either at the Grant Date or at any time before the acquisition of Common Stock pursuant to the Award, (i) the payment by a Participant of a promissory note or (ii) the guarantee by the Company of a loan obtained by the Participant from a third party; provided, however, that any such note or loan must be full-recourse to the extent necessary to avoid charges to the Company's earnings for financial reporting purposes. Subject to the foregoing, the Plan Administrator shall in its sole discretion specify the terms of any loans or loan guarantees, including the interest rate and terms of and security for repayment.

## 7.6 Post-Termination Exercises

The Plan Administrator shall establish and set forth in each instrument that evidences an Option whether the Option shall continue to be exercisable, and the terms and conditions of such exercise, if a Participant ceases to be employed by, or to provide services to, the Company or its Related Corporations, which provisions may be waived or modified by the Plan Administrator at any time. If not so established in the instrument evidencing the Option, the Option shall be exercisable according to the following terms and conditions, which may be waived or modified by the Plan Administrator at any time:

(a) Any portion of an Option that is not vested and exercisable on the date of termination of the Participant's employment or service relationship (the "Termination Date") shall expire on such date.

(b) Any portion of an Option that is vested and exercisable on the Termination Date shall expire upon the earliest to occur of

(i) the last day of the Option Term;

(ii) if the Participant's Termination Date occurs for reasons other than Cause, Retirement, death or Disability, the three-month anniversary of such Termination Date; and

(iii) if the Participant's Termination Date occurs by reason of Retirement, Disability or death, the one-year anniversary of such Termination Date.

Notwithstanding the foregoing, if the Participant dies after the Termination Date while the Option is otherwise exercisable, the portion of the Option that is vested and exercisable on such Termination Date shall expire upon the earlier to occur of (y) the last day of the Option Term and (z) the first anniversary of the date of death, unless the Plan Administrator determines otherwise.

Also notwithstanding the foregoing, in case of termination of the Participant's employment or service relationship for Cause, the Option shall automatically expire upon first notification to the Participant of such termination, unless the Plan Administrator determines otherwise. If a Participant's employment or service relationship with the Company is suspended pending an investigation of whether the Participant shall be terminated for Cause, all the Participant's rights under any Option likewise shall be suspended during the period of investigation. If any facts that would constitute termination for Cause are discovered

after a Participant's Termination Date, any Option then held by the Participant may be immediately terminated by the Plan Administrator, in its sole discretion.

A Participant's transfer of employment or service relationship between or among the Company and its Related Corporations, or a change in status from an employee to a consultant, agent, advisor or independent contractor or vice versa, shall not be considered a termination of employment or service relationship for purposes of this Section 7. The effect of a Company-approved leave of absence on the terms and conditions of an Option shall be determined by the Plan Administrator, in its sole discretion.

## **SECTION 8. INCENTIVE STOCK OPTION LIMITATIONS**

To the extent required by Section 422 of the Code, Incentive Stock Options shall be subject to the following additional terms and conditions:

### **8.1 Dollar Limitation**

To the extent the aggregate Fair Market Value (determined as of the Grant Date) of Common Stock with respect to which Incentive Stock Options are exercisable for the first time during any calendar year (under the Plan and all other stock option plans of the Company) exceeds \$100,000, such portion in excess of \$100,000 shall be treated as a Nonqualified Stock Option. In the event the Participant holds two or more such Options that become exercisable for the first time in the same calendar year, such limitation shall be applied on the basis of the order in which such Options are granted.

### **8.2 More Than 10% Shareholders**

If an individual owns more than 10% of the total combined voting power of all classes of the stock of the Company or of its parent or subsidiary corporations, then the exercise price per share of an Incentive Stock Option shall not be less than 110% of the Fair Market Value of the Common Stock on the Grant Date and the Option Term shall not exceed five years. The determination of more than 10% ownership shall be made in accordance with Section 422 of the Code.

### **8.3 Eligible Employees**

Individuals who are not employees of the Company or one of its parent corporations or subsidiary corporations may not be granted Incentive Stock Options.

### **8.4 Term**

Subject to Section 8.2, the Option Term shall not exceed ten years.

### **8.5 Exercisability**

An Option designated as an Incentive Stock Option shall cease to qualify for favorable tax treatment as an Incentive Stock Option to the extent it is exercised (if permitted by the terms of the Option) (a) more than three months after the Termination Date for reasons other than death or Disability, (b) more than one year after the Termination Date by reason of Disability, or (c) after the Participant has been on leave of absence for more than 90 days, unless the Participant's reemployment rights are guaranteed by statute or contract.

### **8.6 Taxation of Incentive Stock Options**

In order to obtain certain tax benefits afforded to Incentive Stock Options under Section 422 Internal Revenue Code of 1986 ("the Code"), the Participant must hold the shares issued upon the exercise of an Incentive Stock Option for two years after the Grant Date and one year from the date of exercise. A Participant may be subject to the alternative minimum tax at the time of exercise of an Incentive Stock

Option. The Participant shall give the Company prompt notice of any disposition of shares acquired by the exercise of an Incentive Stock Option prior to the expiration of such holding periods.

### **8.7 Promissory Notes**

The amount of any promissory note delivered pursuant to Section 7.5 in connection with an Incentive Stock Option shall bear interest at a rate specified by the Plan Administrator, but in no case less than the rate required to avoid imputation of interest (taking into account any exceptions to the imputed interest rules) for federal income tax purposes.

### **8.8 Code Definitions**

For purposes of this Section 8, “parent corporation” and “subsidiary corporation” shall have the meanings attributed to those terms for purposes of Section 422 of the Code.

## **SECTION 9. STOCK AWARDS**

### **9.1 Grant of Stock Awards**

The Plan Administrator is authorized to make Awards of Common Stock or Awards denominated in units of Common Stock on such terms and conditions and subject to such restrictions, if any (which may be based on continuous service with the Company or the achievement of performance goals), as the Plan Administrator shall determine, in its sole discretion, which terms, conditions and restrictions shall be set forth in the instrument evidencing the Award. The terms, conditions and restrictions that the Plan Administrator shall have the power to determine shall include, without limitation, the manner in which shares subject to Stock Awards are held during the periods they are subject to restrictions and the circumstances under which forfeiture of the Stock Award shall occur by reason of termination of the Participant’s employment or service relationship.

### **9.2 Issuance of Shares**

Upon the satisfaction of any terms, conditions and restrictions prescribed in respect to a Stock Award, or upon the Participant’s release from any terms, conditions and restrictions of a Stock Award, as determined by the Plan Administrator, the Company shall release, as soon as practicable, to the Participant or, in the case of the Participant’s death, to the personal representative of the Participant’s estate or as the appropriate court directs, the appropriate number of shares of Common Stock.

### **9.3 Waiver of Restrictions**

Notwithstanding any other provisions of the Plan, the Plan Administrator may, in its sole discretion, waive the forfeiture period and any other terms, conditions or restrictions on any Stock Award under such circumstances and subject to such terms and conditions as the Plan Administrator shall deem appropriate; provided, however, that the Plan Administrator may not adjust performance goals for any Stock Award intended to be exempt under Section 162(m) of the Code for the year in which the Stock Award is settled in such a manner as would increase the amount of compensation otherwise payable to a Participant.

## **SECTION 10. PERFORMANCE AWARDS**

### **10.1 Performance Shares**

The Plan Administrator may grant Awards of performance shares (“Performance Shares”) and designate the Participants to whom Performance Shares are to be awarded and determine the number of Performance Shares and the terms and conditions of each such Award. Performance Shares shall consist of a unit valued by reference to a designated number of shares of Common Stock, the value of which may be paid to the Participant by delivery of such property as the Plan Administrator shall determine, including, without limitation, cash, shares of Common Stock, other property, or any combination thereof, upon the

attainment of performance goals, as established by the Plan Administrator, and other terms and conditions specified by the Plan Administrator. Notwithstanding the satisfaction of any performance goals, the amount to be paid under an Award of Performance Shares may be adjusted on the basis of such further consideration as the Plan Administrator shall determine in its sole discretion.

## **10.2 Performance Units**

The Plan Administrator may grant Awards of performance units (“Performance Units”) and designate the Participants to whom Performance Units are to be awarded and determine the number of Performance Units and the terms and conditions of each such Award. Performance Units shall consist of a unit valued by reference to a designated amount of property other than shares of Common Stock, which value may be paid to the Participant by delivery of such property as the Plan Administrator shall determine, including, without limitation, cash, shares of Common Stock, other property, or any combination thereof, upon the attainment of performance goals, as established by the Plan Administrator, and other terms and conditions specified by the Plan Administrator. Notwithstanding the satisfaction of any performance goals, the amount to be paid under an Award of Performance Units may be adjusted on the basis of such further consideration as the Plan Administrator shall determine in its sole discretion.

## **SECTION 11. CODE SECTION 162(m) PROVISIONS**

(a) Notwithstanding any other provision of the Plan, if the Plan Administrator determines at the time a Stock Award or a Performance Award is granted to a Participant who is then an officer that such Participant is, or is likely to be as of the end of the tax year in which the Company would claim a tax deduction in connection with such Award, a Covered Employee, then the Plan Administrator may provide that this Section 11 is applicable to such Award.

(b) If a Stock Award or a Performance Award is subject to this Section 11, then the lapsing of restrictions thereon and the distribution of cash, shares of Common Stock or other property pursuant thereto, as applicable, shall be subject to the achievement of one or more objective performance goals established by the Plan Administrator, which shall be based on the attainment of specified levels of one or any combination of the following business criteria of the Company as a whole or any business unit of the Company, as reported or calculated by the Company: cash flows (including, but not limited to, operating cash flow, free cash flow or cash flow return on capital); working capital; earnings per share; book value per share; operating income (including or excluding depreciation, amortization or other expenses); revenues; operating margins; return on assets; return on equity; debt; debt plus equity; market or economic value added; stock price appreciation; total stockholder return; cost control; strategic initiatives; market share; net income; return on invested capital; improvements in capital structure; or customer satisfaction, employee satisfaction, services performance, subscriber, cash management or asset management metrics. Such performance goals also may be based on the achievement of specified levels of Company performance (or performance of an applicable affiliate or business unit of the Company) under one or more of the measures described above relative to the performance of other corporations. Such performance goals shall be set by the Plan Administrator within the time period prescribed by, and shall otherwise comply with the requirements of, Section 162(m) of the Code, or any successor provision thereto, and the regulations thereunder.

(c) Notwithstanding any provision of the Plan other than Section 14, with respect to any Stock Award or Performance Award that is subject to this Section 11, the Plan Administrator may adjust downwards, but not upwards, the amount payable pursuant to such Award, and the Plan Administrator may not waive the achievement of the applicable performance goals except in the case of the death or disability of the Covered Employee.

(d) The Plan Administrator shall have the power to impose such other restrictions on Awards subject to this Section 11 as it may deem necessary or appropriate to ensure that such Awards satisfy all requirements for “performance-based compensation” within the meaning of Section 162(m)(4)(C) of the Code, or any successor provision thereto.

(e) Subject to adjustment from time to time as provided in Section 14.1, no Covered Employee may be granted Options, Stock Awards or Performance Shares subject to this Section 11 in any calendar year period with respect to more than 300,000 shares of Common Stock for such Award, except that the Company may make additional one time grants of such Awards for up to 600,000 shares to newly hired individuals, and the maximum dollar value payable with respect to Performance Units subject to this Section 11 granted to any Covered Employee in any one calendar year is \$1,000,000.

## **SECTION 12. WITHHOLDING**

The Company may require the Participant to pay to the Company the amount of any withholding taxes that the Company is required to withhold with respect to the grant, vesting or exercise of any Award. Subject to the Plan and applicable law, the Plan Administrator may, in its sole discretion, permit the Participant to satisfy withholding obligations, in whole or in part, (a) by paying cash, (b) by electing to have the Company withhold shares of Common Stock (up to the minimum required federal tax withholding rate), or (c) by transferring to the Company shares of Common Stock (already owned by the Participant for the period necessary to avoid a charge to the Company's earnings for financial reporting purposes), in such amounts as are equivalent to the Fair Market Value of the withholding obligation.

## **SECTION 13. ASSIGNABILITY**

Awards granted under the Plan and any interest therein may not be assigned, pledged or transferred by the Participant and may not be made subject to attachment or similar proceedings otherwise than by will or by the applicable laws of descent and distribution, except to the extent a Participant designates a beneficiary on a Company-approved form who may exercise the Award or receive payment under the Award after the Participant's death. During a Participant's lifetime, Awards may be exercised only by the Participant. Notwithstanding the foregoing, and to the extent permitted by Section 422 of the Code, the Plan Administrator, in its sole discretion, may permit such assignment or transfer; provided, however, that any Award so assigned or transferred shall be subject to all the same terms and conditions contained in the instrument evidencing the Award.

## **SECTION 14. ADJUSTMENTS**

### **14.1 Adjustment of Shares**

In the event that, at any time or from time to time, a stock dividend, stock split, spin-off, combination or exchange of shares, recapitalization, merger, consolidation, distribution to shareholders other than a normal cash dividend, or other change in the Company's corporate or capital structure results in (a) the outstanding shares, or any securities exchanged therefor or received in their place, being exchanged for a different number or class of securities of the Company or of any other corporation or (b) new, different or additional securities of the Company or of any other corporation being received by the holders of shares of Common Stock of the Company, then the Plan Administrator shall make proportional adjustments in (i) the maximum number and kind of securities subject to the Plan as set forth in Section 4.1 and the maximum number and kind of securities that may be made subject to Stock Awards and to Awards to any individual as set forth in Section 4.2, (ii) the number and kind of securities that are subject to any outstanding Award and the per share price of such securities, without any change in the aggregate price to be paid therefor, and (iii) and the number and kind of securities automatically granted pursuant to a formula program established under the Plan. The determination by the Plan Administrator as to the terms of any of the foregoing adjustments shall be conclusive and binding. Notwithstanding the foregoing, a dissolution or liquidation of the Company or a Corporate Transaction shall not be governed by this Section 14.1 but shall be governed by Sections 14.2 and 14.3, respectively.

### **14.2 Dissolution or Liquidation**

In the event of the proposed dissolution or liquidation of the Company, the Plan Administrator shall notify each Participant as soon as practicable prior to the effective date of such proposed transaction. The Plan Administrator in its discretion may permit a Participant to exercise an Option until ten days prior to

such transaction with respect to all vested and exercisable shares of Common Stock covered thereby and with respect to such number of unvested shares as the Plan Administrator shall determine. In addition, the Plan Administrator may provide that any forfeiture provision or Company repurchase option applicable to any Award shall lapse as to such number of shares as the Plan Administrator shall determine, contingent upon the occurrence of the proposed dissolution or liquidation at the time and in the manner contemplated. To the extent an Option has not been previously exercised, the Option shall terminate automatically immediately prior to the consummation of the proposed action. To the extent a forfeiture provision applicable to a Stock Award has not been waived by the Plan Administrator, the Stock Award shall be forfeited automatically immediately prior to the consummation of the proposed action.

### **14.3 Corporate Transaction**

#### **14.3.1 Definitions**

“*Corporate Transaction*” means any of the following events:

(a) Consummation of any merger or consolidation of the Company with or into another corporation;

(b) Consummation of any sale, lease, exchange or other transfer in one transaction or a series of related transactions of all or substantially all the Company’s outstanding securities or substantially all the Company’s assets other than a transfer of the Company’s assets to a majority-owned subsidiary corporation (as defined in Section 8.8) of the Company; or

(c) Acquisition by a person, within the meaning of Section 3(a)(9) or of Section 13(d)(3) (as in effect on the date of adoption of the Plan) of the Exchange Act of a majority or more of the Company’s outstanding voting securities (whether directly or indirectly, beneficially or of record). Ownership of voting securities shall take into account and shall include ownership as determined by applying Rule 13d-3(d)(1)(i) (as in effect on the date of adoption of the Plan) under the Exchange Act.

“*Related Party Transaction*” means (i) a merger of the Company in which the holders of shares of Common Stock immediately prior to the merger hold at least a majority of the shares of Common Stock in the surviving corporation or parent thereof immediately after the merger, (ii) a mere reincorporation of the Company, or (iii) a transaction undertaken for the sole purpose of creating a holding company.

#### **14.3.2 Options**

In the event of a Corporate Transaction, except as otherwise provided in the instrument evidencing the Award or in written employment or services agreement between a Participant and the Company or a Related Corporation in connection with an Award, each outstanding Option shall be assumed, continued or an equivalent option or right substituted by the surviving corporation, the successor corporation or its parent corporation, as applicable, (the “*Successor Corporation*”). If the Corporate Transaction is not a Related Party Transaction, upon consummation of the Corporate Transaction the assumed or substituted options shall automatically become fully vested and exercisable whether or not the vesting requirements set forth in the applicable option agreement have been satisfied. If the Corporate Transaction is a Related Party Transaction, the vesting schedule set forth in the instrument evidencing the Option shall continue to apply to the assumed or substituted options.

In the event that the Successor Corporation refuses to assume or substitute for the Option, the Participant shall fully vest in and have the right to exercise the Option as to all of the shares of Common Stock subject thereto, including shares as to which the Option would not otherwise be vested or exercisable. If an Option will become fully vested and exercisable in lieu of assumption or substitution in the event of a Corporate Transaction, the Plan Administrator shall notify the Participant in writing or electronically that the Option shall be fully vested and exercisable for a specified time period after the date of such notice, and the Option shall terminate upon the expiration of such period, in each case conditioned on the consummation of the Corporate Transaction. For the purposes of this Section 14.3, the Option shall be considered assumed if, following the Corporate Transaction, the option or right confers the right to

purchase or receive, for each share of Common Stock subject to the Option, immediately prior to the Corporate Transaction, the consideration (whether stock, cash, or other securities or property) received in the Corporate Transaction by holders of Common Stock for each share held on the effective date of the transaction (and if holders were offered a choice of consideration, the type of consideration chosen by the holders of a majority of the outstanding shares); provided, however, that if such consideration received in the Corporate Transaction is not solely common stock of the Successor Corporation, the Plan Administrator may, with the consent of the Successor Corporation, provide for the consideration to be received upon the exercise of the Option, for each share of Common Stock subject thereto, to be solely common stock of the Successor Corporation equal in fair market value to the per share consideration received by holders of Common Stock in the Corporate Transaction. All Options shall terminate and cease to remain outstanding immediately following the consummation of the Corporate Transaction, except to the extent assumed by the Successor Corporation.

#### **14.3.3 Stock Awards**

In the event of a Corporate Transaction, except as otherwise provided in the instrument evidencing the Award or in a written employment or services agreement between a Participant and the Company or a Related Corporation in connection with an Award, the vesting of shares subject to Stock Awards shall accelerate, and the forfeiture provisions to which such shares are subject shall lapse, if and to the same extent that the vesting and exercisability of outstanding Options accelerate in connection with the Corporate Transaction. If unvested Options are to be assumed, continued or substituted by a Successor Corporation without acceleration upon the occurrence of a Corporate Transaction, the forfeiture provisions to which such shares are subject will continue with respect to shares of the Successor Corporation that may be issued in exchange for such shares.

#### **14.3.4 Performance Awards**

In the event of a Corporate Transaction, the vesting and payout of Performance Awards shall be as provided in the instrument evidencing the Award or in a written employment or services agreement between a Participant and the Company or a Related Corporation.

#### **14.4 Further Adjustment of Awards**

Subject to Sections 14.2 and 14.3, the Plan Administrator shall have the discretion, exercisable at any time before a sale, merger, consolidation, reorganization, liquidation or change in control of the Company, as defined by the Plan Administrator, to take such further action as it determines to be necessary or advisable, and fair and equitable to the Participants, with respect to Awards. Such authorized action may include (but shall not be limited to) establishing, amending or waiving the type, terms, conditions or duration of, or restrictions on, Awards so as to provide for earlier, later, extended or additional time for exercise, lifting restrictions and other modifications, and the Plan Administrator may take such actions with respect to all Participants, to certain categories of Participants or only to individual Participants. The Plan Administrator may take such action before or after granting Awards to which the action relates and before or after any public announcement with respect to such sale, merger, consolidation, reorganization, liquidation or change in control that is the reason for such action.

#### **14.5 Limitations**

The grant of Awards shall in no way affect the Company's right to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

#### **14.6 Fractional Shares**

In the event of any adjustment in the number of shares covered by any Award, each such Award shall cover only the number of full shares resulting from such adjustment.

## **SECTION 15. AMENDMENT AND TERMINATION OF PLAN**

### **15.1 Amendment of Plan**

The Plan may be amended only by the Board in such respects as it shall deem advisable; provided, however, that to the extent required for compliance with Section 422 of the Code or any applicable law or regulation, shareholder approval shall be required for any amendment that would (a) increase the total number of shares available for issuance under the Plan, (b) modify the class of persons eligible to receive Options, or (c) otherwise require shareholder approval under any applicable law or regulation. Any amendment made to the Plan that would constitute a “modification” to Incentive Stock Options outstanding on the date of such amendment shall not, without the consent of the Participant, be applicable to such outstanding Incentive Stock Options but shall have prospective effect only.

### **15.2 Suspension or Termination of Plan**

The Board may suspend or terminate the Plan at any time. The Plan shall have no fixed expiration date; provided, however, that no Incentive Stock Options may be granted more than ten years after the later of (a) the Plan’s adoption by the Board and (b) the adoption by the Board of any amendment to the Plan that constitutes the adoption of a new plan for purposes of Section 422 of the Code.

### **15.3 Consent of Participant**

The suspension, amendment or termination of the Plan or a portion thereof or the amendment of an outstanding Award shall not, without the Participant’s consent, impair or diminish any rights or obligations under any Award theretofore granted to the Participant under the Plan. Any change or adjustment to an outstanding Incentive Stock Option shall not, without the consent of the Participant, be made in a manner so as to constitute a “modification” that would cause such Incentive Stock Option to fail to continue to qualify as an Incentive Stock Option. Notwithstanding the foregoing, any adjustments made pursuant to Section 14 shall not be subject to these restrictions.

## **SECTION 16. GENERAL**

### **16.1 Evidence of Awards**

Awards granted under the Plan shall be evidenced by a written instrument that shall contain such terms, conditions, limitations and restrictions as the Plan Administrator shall deem advisable and that are not inconsistent with the Plan.

### **16.2 No Individual Rights**

Nothing in the Plan or any Award granted under the Plan shall be deemed to constitute an employment contract or confer or be deemed to confer on any Participant any right to continue in the employ of, or to continue any other relationship with, the Company or any Related Corporation or limit in any way the right of the Company or any Related Corporation to terminate a Participant’s employment or other relationship at any time, with or without Cause.

### **16.3 Registration**

Notwithstanding any other provision of the Plan, the Company shall have no obligation to issue or deliver any shares of Common Stock under the Plan or make any other distribution of benefits under the Plan unless such issuance, delivery or distribution would comply with all applicable laws (including, without limitation, the requirements of the Securities Act), and the applicable requirements of any securities exchange or similar entity.

The Company shall be under no obligation to any Participant to register for offering or resale or to qualify for exemption under the Securities Act, or to register or qualify under state securities laws, any

shares of Common Stock, security or interest in a security paid or issued under, or created by, the Plan, or to continue in effect any such registrations or qualifications if made. The Company may issue certificates for shares with such legends and subject to such restrictions on transfer and stop-transfer instructions as counsel for the Company deems necessary or desirable for compliance by the Company with federal and state securities laws.

To the extent that the Plan or any instrument evidencing an Award provides for issuance of stock certificates to reflect the issuance of shares of Common Stock, the issuance may be effected on a noncertificated basis, to the extent not prohibited by applicable law or the applicable rules of any stock exchange.

#### **16.4 No Rights as a Shareholder**

No Option or Stock Award denominated in units shall entitle the Participant to any cash dividend, voting or other right of a shareholder unless and until the date of issuance under the Plan of the shares that are the subject of such Award.

#### **16.5 Compliance With Laws and Regulations**

Notwithstanding anything in the Plan to the contrary, the Plan Administrator, in its sole discretion, may bifurcate the Plan so as to restrict, limit or condition the use of any provision of the Plan to Participants who are officers or directors subject to Section 16 of the Exchange Act without so restricting, limiting or conditioning the Plan with respect to other Participants. Additionally, in interpreting and applying the provisions of the Plan, any Option granted as an Incentive Stock Option pursuant to the Plan shall, to the extent permitted by law, be construed as an "incentive stock option" within the meaning of Section 422 of the Code.

#### **16.6 Participants in Foreign Countries**

The Plan Administrator shall have the authority to adopt such modifications, procedures and subplans as may be necessary or desirable to comply with provisions of the laws of foreign countries in which the Company or its Related Corporations may operate to ensure the viability of the benefits from Awards granted to Participants employed in such countries and to meet the objectives of the Plan.

#### **16.7 No Trust or Fund**

The Plan is intended to constitute an "unfunded" plan. Nothing contained herein shall require the Company to segregate any monies or other property, or shares of Common Stock, or to create any trusts, or to make any special deposits for any immediate or deferred amounts payable to any Participant, and no Participant shall have any rights that are greater than those of a general unsecured creditor of the Company.

#### **16.8 Severability**

If any provision of the Plan or any Award is determined to be invalid, illegal or unenforceable in any jurisdiction, or as to any person, or would disqualify the Plan or any Award under any law deemed applicable by the Plan Administrator, such provision shall be construed or deemed amended to conform to applicable laws, or, if it cannot be so construed or deemed amended without, in the Plan Administrator's determination, materially altering the intent of the Plan or the Award, such provision shall be stricken as to such jurisdiction, person or Award, and the remainder of the Plan and any such Award shall remain in full force and effect.

#### **16.9 Choice of Law**

The Plan and all determinations made and actions taken pursuant hereto, to the extent not otherwise governed by the laws of the United States, shall be governed by the laws of the State of Washington without giving effect to principles of conflicts of laws.

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**SECTION 17. EFFECTIVE DATE**

The Effective Date is the date on which the Plan is adopted by the Board, so long as it is approved by the Company's shareholders at any time within 12 months of such adoption.

## STATEMENT RE COMPUTATION OF RATIOS

	Six Months Ended	2005	Year Ended December 31,			2001
	June 30, 2006		2004	2003	2002	
			(in thousands, except ratios)			
Earnings:						
Pre-tax income (loss)	\$ 28,350	\$ 27,528	\$ (9,406)	\$ 17,899	\$ 18,859	\$ 21,366
Less: equity in affiliates	33	82	-	79	126	(616)
	<u>28,317</u>	<u>27,446</u>	<u>(9,406)</u>	<u>17,820</u>	<u>18,733</u>	<u>21,982</u>
Fixed charges <sup>(1)</sup> :						
Interest expense, gross <sup>(2)</sup>	8,331	18,944	13,145	2,638	2,061	5,112
Interest portion of rent expense	<u>1,154</u>	<u>2,512</u>	<u>2,696</u>	<u>2,661</u>	<u>1,902</u>	<u>1,062</u>
a) Fixed charges	9,485	21,456	15,841	5,299	3,963	6,174
b) Earnings for ratio <sup>(3)</sup>	\$ 37,802	\$ 48,902	\$ 6,435	\$ 23,119	\$ 22,696	\$ 28,156
Ratios:						
Earnings to fixed charges <sup>(b/a)</sup>	4.0	2.3	n/a <sup>(4)</sup>	4.4	5.7	4.6
Deficit of earnings to fixed charges	n/a	n/a	\$ (9,406)	n/a	n/a	n/a

- (1) Fixed charges consist of interest on indebtedness and amortization of prepaid debt fees plus that portion of lease rental expense representative of the interest factor.
- (2) Interest expense, gross, includes amortization of prepaid debt fees and discount.
- (3) Earnings consist of income from continuing operations before income taxes plus fixed charges.
- (4) Due to Itron's loss in 2004, the ratio coverage was less than 1:1. Additional earnings of \$9,406 would have been needed to achieve a coverage of 1:1.





**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO SECTION 906 OF THE  
SARBANES-OXLEY ACT OF 2002**

The certification set forth below is being submitted in connection with the Quarterly Report of Itron, Inc. (the Company) on Form 10-Q for the quarterly period ended June 30, 2006 (the Report) for the purpose of complying with Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 and Section 1350 of Chapter 63 of Title 18 of the United States Code.

LeRoy D. Nosbaum, the Chief Executive Officer and Steven M. Helmbrecht, the Chief Financial Officer of the Company, each certifies that to the best of his knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ LEROY D. NOSBAUM

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**LeRoy D. Nosbaum**  
**Chairman of the Board and Chief Executive Officer**  
**July 26, 2006**

/s/ STEVEN M. HELMBRECHT

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**Steven M. Helmbrecht**  
**Sr. Vice President and Chief Financial Officer**  
**July 26, 2006**