SOUTHWALL TECHNOLOGIES INC /DE/
Form 10-Q
November 12, 2010

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

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2010
or

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

For the transition period from to

Commission File Number: 0-15930

SOUTHWALL TECHNOLOGIES INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	94-2551470 (I.R.S. Employer Identification Number)
3788 Fabian Way, Palo Alto, California (Address of principal executive offices)	94303 (Zip Code)

Registrant's telephone number, including area code: (650) 798-1200

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check One).

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company
¨	¨	¨	x

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

As of November 1, 2010, there were 28,874,339 shares of the registrant's Common Stock outstanding.

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PART I. FINANCIAL INFORMATION

Item 1--Financial Statements:

SOUTHWALL TECHNOLOGIES INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	September 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 15,573	$ 12,454
Accounts receivable, net of allowance for doubtful accounts of $208 at September 30, 2010 and $115 at December 31, 2009	7,367	5,907
Inventories	4,691	4,522
Other current assets	1,401	1,479
Total current assets	29,032	24,362
Property, plant and equipment, net	15,309	14,393
Goodwill	1,839	-
Intangibles assets	1,037	-
Deferred tax and other assets	1,132	156
Total assets	$ 48,349	$ 38,911
LIABILITIES, PREFERRED STOCK AND EQUITY		
Current liabilities:		
Current portion of long term debt and capital lease obligations	$ 960	$ 808
Accounts payable	2,295	1,258
Accrued compensation	1,399	1,395
Income taxes payable	2,229	130
Other accrued liabilities	5,446	4,751
Total current liabilities	12,329	8,342
Term debt and capital lease obligations	3,708	3,358
Other long term liabilities	-	58
Total liabilities	16,037	11,758
Commitments and contingencies (Note 6)		
Series A 10% cumulative convertible preferred stock, $0.001 par value; $1.00 stated value; 5,000 shares authorized, 4,893 shares outstanding at September 30, 2010 and December 31, 2009 respectively (Liquidation preference: $7,623 and $7,255 at September 30, 2010 and December 31, 2009, respectively)	4,810	4,810
Southwall stockholders' equity:		
Common stock, $0.001 par value per share; 50,000 shares authorized, 28,874 shares outstanding at September 30, 2010 and 28,791 shares outstanding at December 31, 2009	29	29

Capital in excess of par value		78,403		78,291
Accumulated other comprehensive income		3,773		4,382
Accumulated deficit		(54,915)		(60,359)
Total Southwall stockholders' equity		27,290		22,343
Noncontrolling interest		212		-
Total equity		27,502		22,343
Total liabilities, preferred stock and equity	$	48,349	$	38,911

See accompanying notes to unaudited condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three months ended		Nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Net revenues	$ 12,198	$ 8,600	$ 34,469	$ 23,430
Cost of revenues	6,890	4,867	18,549	13,554
Gross profit	5,308	3,733	15,920	9,876
Operating expenses:				
Research and development	1,024	771	2,608	2,118
Selling, general and administrative	2,772	1,960	7,038	5,810
Total operating expenses	3,796	2,731	9,646	7,928
Income from operations	1,512	1,002	6,274	1,948
Interest expense, net	(67)	(321)	(225)	(492)
Other income (expense), net	560	12	202	3,211
Income before provision for income taxes	2,005	693	6,251	4,667
Provision for (benefit from) income taxes	1,057	(17)	959	174
Net income	948	710	5,292	4,493
Net loss attributable to noncontrolling interest	(122)	-	(152)	-
Net income attributable to Southwall	1,070	710	5,444	4,493
Deemed dividend on preferred stock	122	122	366	366
Net income attributable to common stockholders	$ 948	$ 588	$ 5,078	$ 4,127
Net income per common share:				
Basic	$ 0.03	$ 0.02	$ 0.18	$ 0.14
Diluted	$ 0.03	$ 0.02	$ 0.15	$ 0.13
Weighted average shares used in computing net income per common share:				
Basic	28,840	28,728	28,820	28,715
Diluted	36,334	34,685	36,105	34,085

See accompanying notes to unaudited condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine months ended September 30, 2010	Nine months ended September 30, 2009
Cash flows from operating activities:		
Net income	$ 5,292	$ 4,493
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Gain on acquisition of controlling interest in SIG	(706)	-
Gain on settlement of liability	-	(2,359)
Deferred income tax	(1,334)	(77)
Loss on disposal of property, plant and equipment	10	(24)
Inventory reserves	(201)	43
Depreciation and amortization	1,989	1,911
Stock-based compensation	433	294
Non-cash effect of acquisition of controlling interest in SIG	(232)	-
Changes in operating assets and liabilities (net of assets acquired and liabilities assumed in purchase acquisition:		
Accounts receivable, net	(75)	(1,072)
Inventories	207	1,293
Other current and non-current assets	(240)	(65)
Accounts payable and accrued liabilities	1,532	(258)
Net cash provided by operating activities	6,675	4,179
Cash flows from investing activities:		
Acquisition of assets of Crown Operations International	(3,302)	-
Acquisition of controlling interest in SIG, net of cash acquired	(195)	-
Restricted cash	-	261
Proceeds from sale of property, plant and equipment	-	34
Expenditures for property, plant and equipment	(1,160)	(975)
Net cash used in investing activities	(4,657)	(680)
Cash flows from financing activities:		
Repayments of term debt and capital lease obligations	(599)	(1,719)
Proceeds from stock option exercises	63	42
Borrowings from term loan	1,250	-
Borrowings from equipment financing	-	26
Investment credit in Germany	376	221
Net cash provided by (used in) financing activities	1,090	(1,430)
Effect of foreign exchange rate changes on cash and cash equivalents	11	8
Net increase in cash and cash equivalents	3,119	2,077
Cash and cash equivalents, beginning of period	12,454	10,768

Cash and cash equivalents, end of period	$	15,573	$	12,845
Supplemental cash flow disclosure:				
Interest paid	$	180	$	310
Income taxes paid	$	359	$	700
Supplemental schedules of non-cash flow investing and financing activities:				
Dividends accrued	$	366	$	366
Acquisition of interest in SIG (Note 12)	$	250	$	-
Abandonment of leased asset and cancellation of lease	$	411	$	-
Deposits applied to acquisition of property, plant and equipment	$	-	$	210
Property, plant and equipment acquired through capital leases	$	-	$	88

See accompanying notes to unaudited condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(dollar and share amounts in thousands, except per share data)

Note 1 – Basis of Presentation:

Southwall Technologies Inc., including its wholly owned subsidiaries, Southwall Europe GmbH, Southwall IG Holdings, Inc., Southwall Insulating Glass, LLC (“SIG”) and Crown Operations International, LLC, are hereafter referred to as the “Company,” “Southwall,” “Registrant,” “We,” “Our” or “Us.”

The accompanying interim condensed consolidated financial statements of Southwall are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain information and footnote disclosure normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments considered necessary to present fairly the financial position, results of operations and cash flows of Southwall for all periods presented. The year-end consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP. The Company suggests that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Form 10-K for the year ended December 31, 2009 filed with the Securities and Exchange Commission on March 25, 2010. The results of operations for the interim periods presented are not necessarily indicative of the operating results to be expected for any future periods.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions, based on all known facts and circumstances that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the periods. Management makes these estimates using the best information available at the time of the estimates. The estimates included in preparing our financial statements include: the accrual for product returns and warranties, allowance for doubtful accounts, quarterly income taxes, inventory valuations (including reserves for excess and obsolete and impaired inventories), reserves for decommissioning costs associated with leasehold asset retirement obligations and the valuation of stock-based compensation. Actual results could differ from those estimates.

Note 2 – Fair Value Measurements:

The Company has estimated the fair value amounts of its financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities using available market information and valuation methodologies considered to be appropriate and has determined that the book value of those instruments at September 30, 2010 approximates fair value.

Based on borrowing rates currently available to the Company for debt and capital lease obligations with similar terms, the carrying value of our term debt and capital lease obligations approximates fair value.

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Southwall invests its cash primarily in money market funds. We utilize the market approach to measure fair value of our financial assets.

Cash and cash equivalents are summarized as follows:

	September 30, 2010	
	Fair Value	Book Value
Money Market Funds, Level I	$ 10,347	$ 10,347
Certificates of Deposit, Level I	1,500	1,500
Total cash equivalents	11,847	11,847
Cash	3,726	3,726
Total cash and cash equivalents	$ 15,573	$ 15,573

	December 31, 2009	
	Fair Value	Book Value
Money Market Funds, Level I	$ 8,027	$ 8,027
Certificates of Deposit, Level I	1,750	1,750
Total cash equivalents	9,777	9,777
Cash	2,677	2,677
Total cash and cash equivalents	$ 12,454	$ 12,454

The Company's financial assets and liabilities are valued using market prices on active markets (Level 1). Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets. As of September 30, 2010, the Company did not have any Level 2 instrument valuations which were obtained from readily available pricing sources for comparable instruments or any Level 3 instruments without observable market values that would require a high level of judgment to determine fair value.

Note 3 – Inventories:

Inventories are stated at the lower of cost (determined by the average cost method) or market. Cost includes materials, labor and manufacturing overhead. The Company establishes provisions for excess and obsolete inventories to reduce such inventories to their estimated net realizable value. Such provisions are charged to cost of revenues.

At September 30, 2010 and December 31, 2009, inventories consisted of the following:

	September 30 2010	December 31 2009
Raw materials	$ 2,723	$ 2,010
Work-in-process	391	1,176
Finished goods	1,577	1,336
	$ 4,691	$ 4,522

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Note 4 – Property, Plant and Equipment, net:

At September 30, 2010 and December 31, 2009, property, plant and equipment consisted of the following:

	September 30 2010	December 31 2009
Land, buildings and leasehold improvements	$ 9,329	$ 8,015
Machinery and equipment	35,026	31,539
Furniture and fixtures	908	3,986
	45,263	43,540
Less – accumulated depreciation and amortization	(29,954)	(29,147)
	$ 15,309	$ 14,393

Note 5 – Net Income Per Common Share:

Basic net income per common share is computed by dividing net income attributable to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) for the period. Diluted net income per common share gives effect to all dilutive common shares potentially outstanding during the period, including stock options and convertible preferred stock. The Company excludes options from the computation of diluted weighted average shares outstanding if the exercise price of the options is greater than the average market price of the shares because the inclusion of these options would be anti-dilutive to net income per share. The Company also excludes preferred shares convertible into common stock from the computation of diluted weighted average shares outstanding when the effect would be anti-dilutive.

At September 30, 2010 and 2009, 938 and 2,411 outstanding options, respectively, were excluded from the dilutive net income per common share calculation, as they were anti-dilutive because the option prices were higher than the average market price during each of the nine month periods.

The Company has accrued a deemed dividend on preferred stock of $122 for each of the three month periods ended September 30, 2010 and 2009. The dilutive effect of convertible securities shall be reflected in diluted net income per share by application of the if-converted method. Under this method, if an entity has convertible preferred stock outstanding, the preferred dividends applicable to convertible preferred stock shall be added back to the numerator unless their effect is anti-dilutive.

Tables summarizing net income attributable to common stockholders, basic and diluted net income per common share, and weighted shares outstanding are shown below:

	Three months ended		Nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Net income attributable to common stockholders-basic	$ 948	$ 588	$ 5,078	$ 4,127
Add: Deemed dividend on preferred stock	122	122	366	366
Net income attributable to common stockholders-diluted	$ 1,070	$ 710	$ 5,444	$ 4,493
Weighted average common shares outstanding-basic	28,840	28,728	28,820	28,715
Dilutive effect of Series A preferred shares	4,893	4,893	4,893	4,893
Dilutive effect of stock options	2,601	1,064	2,392	477
Weighted average common shares outstanding - diluted	36,334	34,685	36,105	34,085

Basic net income per common share	$	0.03	$	0.02	$	0.18	$	0.14
Diluted net income per common share	$	0.03	$	0.02	$	0.15	$	0.13

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Note 6 – Product Reporting:

Southwall operates in one segment. The total net revenues for the automotive glass, window film, architectural and electronic display / other product lines for the three month and nine month periods ended September 30, 2010 and 2009 were as follows:

	Three months ended		Nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Automotive glass	$ 4,849	$ 4,096	$ 14,736	$ 10,872
Window film	4,981	2,175	14,291	7,265
Architectural	2,246	2,243	5,249	5,043
Electronic display and other	122	86	193	250
Total net revenues	$ 12,198	$ 8,600	$ 34,469	$ 23,430

The following is a summary of net revenues by geographic area (based on the location of the Company's customers) for the three month and nine month periods ended September 30, 2010 and 2009:

	Three months ended		Nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Europe	$ 4,596	$ 3,521	$ 14,206	$ 10,015
Asia Pacific	4,423	3,210	13,313	6,670
United States	2,327	1,040	5,050	4,632
Rest of the world	852	829	1,900	2,113
Total net revenues	$ 12,198	$ 8,600	$ 34,469	$ 23,430

Note 7 – Commitments and Contingencies:

Commitments

The Company leases certain property and equipment as well as its facilities under noncancellable operating leases. These leases expire at various dates through 2013.

In January 2006, the Company renewed a lease agreement for its research and development facility in Palo Alto, California. The lease was renewed in January 2010 for an additional twelve months. Under this lease agreement, the Company had accrued $480 for leasehold retirement obligations, which is included in other accrued liabilities in the accompanying condensed consolidated balance sheets. The method and timing of payments are not yet finalized, and therefore, this estimate of our liability could differ from the actual future settlement amount.

As of September 30, 2010, the Company had unconditional purchase obligations to procure equipment of $173.

Credit Agreement with Wells Fargo Bank

In June 2010, we renewed our Credit Agreement with Wells Fargo Bank (“Bank”). The Credit Agreement provides for a $3,000 revolving line of credit. Advances under the line exceeding $1,500 will be limited to 80% of eligible accounts receivable. The Company will not be eligible for additional borrowings if the Company’s consolidated cash balance falls below $3,500. Amounts borrowed under the line of credit bear interest at either prime plus 0.75% or LIBOR plus 3.5%, determined at the discretion of the Company, and is annualized on the average daily financed amount outstanding. All borrowings under the line of credit facility are collateralized by our assets in the United States and are subject to certain covenants including minimum quarterly net income and minimum liquid asset requirements.

In August 2010, our Credit Agreement with the Bank was amended to provide for a $1,250 term loan, which was funded on September 2, 2010. Amounts borrowed under the term loan are payable over 36 months in equal installments and bear interest at a fixed rate of 4.05%. The Credit Agreement was further amended to provide covenants for tangible net worth and fixed charge coverage ratio.

As of September 30, 2010 the Company was in compliance with all financial covenants.

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Term Debt and Capital Lease Obligations

As of September 30, 2010, the Company's term debt and capital lease obligations consisted of the following:

Description	Rate	Term Debt Balance at September 30, 2010	Capital Lease Balance at September 30, 2010	Total Debt Balance at September 30, 2010	Due Over Next 12 Months	Balance at December 31, 2009
German bank loan dated May 12, 1999 (10 year)	6.13%	$ -	$ -	$ -	$ -	$ 6
German bank loan dated May 28, 1999 (20 year)	5.73%(1)	3,062	-	3,062	340	3,403
German bank loan dated May 28, 2000 (10 year)	7.15%	-	-	-	-	254
Wells Fargo Bank dated September 2, 2010 (3 year)	4.05%(2)	1,250	-	1,250	417	-
Total term debt		4,312	-	4,312	757	3,663
German bank financed lease dated June 1, 2008	7.518%(3)	-	141	141	86	220
US financing agreement dated May 20, 2008	19.80%(4)	-	265	265	157	382
Total capital leases		-	406	406	243	602
Less interest on capital leases		-	50	50	40	99
Total term debt and capital lease obligations		4,312	356	4,668	$ 960	4,166
Less current portion		757	203	960		808
Total term debt and capital lease obligations, non-current		$ 3,555	$ 153	$ 3,708		$ 3,358

(1) Interest rate was reset on September 16, 2009 to 5.73%.

(2) Interest rate is fixed at 4.05%.

(3) Interest rate is fixed at 7.518% until payoff.

(4) Implied interest rate based on a lease rate factor.

Contingencies

We are involved in certain other legal actions arising in the ordinary course of business. We believe, however, that none of these actions, either individually or in the aggregate, will have a material adverse effect on our business, our consolidated financial position, results of operations or cash flows.

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Note 8 – Stock-Based Compensation:

The Company has a stock-based compensation program that provides its Board of Directors broad discretion in creating employee equity incentives. The Company has granted stock options under various option plans and agreements in the past and currently grants stock options under the 2007 Long Term Incentive Plan (“2007 Plan”) which authorizes the granting of up to 10,000 shares of common stock. Under the terms of the 2007 Plan, the Company can grant both Incentive Stock Options and Nonstatutory Stock Options. Grants issued under the 2007 Plan vest and become exercisable at a rate of 25% on each anniversary of the date of grant and become fully vested on the fourth anniversary of the date of grant provided that the participant remains an employee or service provider of the Company or a related company. Each option granted under the 2007 Plan is non-transferable and expires over terms not exceeding ten years from the date of grant or 30 days after an option holder’s voluntary termination from the Company. If an option holder’s employment is terminated involuntarily for misconduct, the option will terminate immediately and may no longer be exercised. Involuntary termination not for misconduct allows for the option holder to exercise options within a period of three months after such termination of service occurs. The 2007 Plan provides for longer expiration periods for employees who terminate, but who were employed with the Company in excess of five years. Pursuant to the provisions set forth in the 2007 Plan, the option expiration will be extended anywhere from three months to one year, dependent upon the employee’s years of service. These provisions apply to options that expire as the result of involuntary termination not for misconduct. As of September 30, 2010, there were 6,520 shares of common stock available for grant under the 2007 Plan.

The following table sets forth the total stock-based compensation expense resulting from stock options included in the condensed consolidated statements of operations:

	Three months ended		Nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Cost of sales	$ 4	$ 2	$ 10	$ 7
Research and development	29	17	74	49
Selling, general and administrative	135	85	349	238
Stock-based compensation expense before income taxes	168	104	433	294
Provision for income taxes	-	-	-	-
Net stock-based compensation expense	$ 168	$ 104	$ 433	$ 294

There were $25 and $42 of cash proceeds from the exercise of stock options for the three month periods ended September 30, 2010 and 2009, respectively. The Company presents excess tax benefits from the exercise of stock options, if any, as financing cash flows.

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The fair value of stock-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions for stock options granted during the three month and nine month periods ended September 30, 2010 and 2009, respectively:

	Three months ended		Nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Expected life (in years)	5.0	5.0	5.0	5.17
Risk-free interest rate	1.39%	2.39%	2.39%	2.00%
Volatility	103%	107%	103%	108%
Dividend	-	-	-	-
Per share weighted-average fair value at grant date	$ 1.34	$ 0.78	$ 1.24	$ 0.51

The Company's computation of expected volatility was based on historical volatility. The Company's computation of expected life was based on historical exercise patterns. The interest rate for periods within the expected life of the award is based on the U.S. Treasury yield in effect at the time of grant.

The Company has not in the past and does not plan to issue dividends in the future.

Stock option activity for the nine months ended September 30, 2010 was as follows:

	Weighted-Average Shares	Contractual Term Exercise Price	Weighted-Average Remaining Aggregate (in years)	Intrinsic Value
Outstanding at December 31, 2009	5,654	$ 0.78		
Grants	1,119	$ 1.62		
Exercises	(83)	$ 0.77		
Forfeitures or expirations	(167)	$ 1.40		
Outstanding at September 30, 2010	6,523	$ 0.91	6.79	$ 6,483
Vested and expected to vest at September 30, 2010	5,792	$ 0.88	6.54	$ 5,907
Exercisable at September 30, 2010	3,728	$ 0.79	5.50	$ 4,158

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (i.e.: the difference between Southwall's closing stock price on the last trading day of its third quarter of fiscal 2010 and the exercise price, times the number of shares) that would have been received by the option holders had all option holders exercised their options on September 30, 2010. This amount changes based on the fair market value of Southwall's stock. Total intrinsic value of options exercised was $52 and $77 for the three month and nine month periods ended September 30, 2010, respectively. Total fair value of options granted was $1,388 for the nine month period ended September 30, 2010.

As of September 30, 2010, $1,175 of total unrecognized compensation cost, net of forfeitures, related to stock options was expected to be recognized over a weighted-average period of approximately 3.01 years.

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Note 9 – Reserve for Sales Returns and Warranties:

The Company establishes a reserve for sales returns and warranties for specifically identified, as well as anticipated sales returns and warranties based on experience. The activity in the reserve for sales returns and warranties account during the nine month periods ended September 30, 2010 and 2009 was as follows:

	Balance at December 31, 2008	Provision	Utilized	Balance at September 30, 2009
Reserve for sales returns and warranty	$ 1,321	$ (215)	$ (372)	$ 734

	Balance at December 31, 2009	Provision	Utilized	Balance at September 30, 2010
Reserve for sales returns and warranty	$ 607	$ 866	$ (393)	$ 1,080

These amounts are included in other accrued liabilities in the condensed consolidated balance sheets.

Note 10 – Comprehensive Income:

Accounting Standards Codification ("ASC") 220, Comprehensive Income, establishes standards for reporting and display in the financial statements of total net income and the components of all other non-owner changes in equity, referred to as comprehensive income. Accordingly, the Company has reported the translation gain (loss) from the consolidation of its foreign subsidiary in comprehensive income.

The components of comprehensive income for the three month and nine month periods ended September 30, 2010 and 2009, respectively, were as follows:

	Three months ended		Nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Net income	$ 948	$ 710	$ 5,292	$ 4,493
Interest Rate Swap Instrument	(9)	-	(9)	-
Foreign currency translation adjustment	1,116	501	(601)	295
Comprehensive income	$ 2,055	$ 1,211	$ 4,682	$ 4,788

Note 11 - Income Tax:

The Company recorded an income tax provision of $959 and $174 in the nine months ended September 30, 2010 and 2009, respectively. The effective tax rate was 15.0% and 3.7% for the nine months ended September 30, 2010 and 2009, respectively. The company's effective tax rate depends on various factors, such as tax legislation, the mix of domestic and international pre-tax income, research and development credits, foreign tax credits, share-based compensations and change in valuation allowance.

Based on management's evaluation of all available evidence, both positive and negative, management believes that the Company is more likely than not be able to realize approximately $1,326 of its deferred tax assets. Management has made this determination based on the ability to carryback future reversals of deductible temporary differences. Accordingly, the Company included the effect of a change in the beginning-of-the-year balance of a valuation allowance in its estimated annual effective tax rate for the fiscal year 2010. As of September 30, 2010, approximately $1,271 of tax benefit related to the change in valuation allowance was recorded in the income from continuing operations. Due to uncertainties related to future taxable income, the Company did not believe it was prudent, or more likely than not, to reverse an additional amount of valuation allowance at this time. Management will continue to monitor the situation in future periods .

The impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant tax authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. As of September 30, 2010, the Company identified and recorded unrecognized tax benefits in the amount of approximately $229, but no interest and penalties have been recorded due to the immaterial impact to financial statement. Management does not expect material changes in the balance of unrecognized tax benefits will occur within the next twelve months

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Note 12 – Joint Venture:

On April 8, 2008, Southwall IG Holdings, Inc., a wholly owned subsidiary of Southwall Technologies Inc., entered into a Joint Venture Agreement with Sound Solutions Window & Doors, LLC ("Sound Solutions"), creating SIG, which manufactures insulated glass units for the domestic market to further expand the market for the Company's Heat Mirror product. As of December 31, 2009, Southwall IG Holdings, Inc. had a 50% investment in SIG. In 2009, Southwall IG Holdings, Inc. advanced a total of $300, in the form of a promissory note, to Sound Solutions. Pursuant to the terms of the promissory note dated May 11, 2009, the principal and accrued interest was due and payable to Southwall IG Holdings, Inc. by January 1, 2010. Under terms of the note, in the event of default, the outstanding principal was to be paid in the form of a credit to the Southwall IG Holdings, Inc. capital account.

Effective January 1, 2010, Sound Solutions had not paid the principal balance of $300 and was in default of the promissory note. The $300, for which Sound Solutions had received equity consideration in SIG, was credited to Southwall IG Holdings, Inc.'s capital account in SIG; thereby increasing the Company's equity ownership to 66.3%. For the quarters ended June 30, 2010 (through May 20, 2010) and 2009, our share of SIG's net losses of approximately $108 and $200, respectively, is included in "other income (expense), net" in the condensed consolidated statements of operations. The Company incurred non-reimbursable expenses in the amount of approximately $70 and $66 in the quarters ended September 30, 2010 and 2009, respectively, related to the set up and operations of the joint venture, in accordance with the contractual terms of the joint venture agreement which is reflected in selling, general and administrative expenses in the condensed consolidated statements of operations.

On May 20, 2010 the joint venture agreement was amended allowing Southwall IG Holding, Inc. to make additional cash contributions to the joint venture. In order to acquire an additional 8.7% to obtain 75% equity ownership, the Company relinquished $256 of value allowing Sound Solutions to maintain a 25% equity interest in SIG. This transaction triggered a business combination event which resulted in the consolidation of total assets and liabilities of SIG resulting in a gain of $706, which was recorded in other income (expense) net, to adjust the equity interest in SIG to a fair value of $919 before the acquisition date.

The Company provisionally determined the assets and liabilities of SIG based on fair values at May 20, 2010 using a weighted average valuation approach. In accounting for the business combination, noncontrolling interest was assigned a fair value of $346. The Company believes the goodwill realized was the result of a number of factors, including the following: losses recognized during SIG's development stage, expected growth opportunities, and the anticipated level of investment required to achieve those opportunities. The allocation of the fair value related to valuation of assets acquired and liabilities assumed were as follows:

Goodwill	$1,488	
Trade name	300	
Customer relationships	250	
Other intangibles	180	
Net liabilities assumed	(693	)
Total	$1,525	

We do not expect the goodwill recognized to be deductible for income tax purposes.

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In September 2010, Southwall IG Holding, Inc. made contributions and acquired an additional 3% equity ownership in SIG. On October 6, 2010, Southwall IG Holding, Inc. made contributions and acquired an additional 2% equity ownership in SIG

For the quarter ended September 30, 2010, SIG revenues and loss included in the condensed income statement are $760 and ($523), respectively. For the period from May 21, 2010 through September 30, 2010, SIG revenues and loss included in the condensed income statement are $1,193 and ($644).

The unaudited pro forma financial information in the table below summarizes the combined results of the Company and SIG as though the companies were combined as of the beginning of 2009. The pro forma financial information as presented below is for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of 2009.

	Three months ended		Nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Net revenues	$ 12,198	$ 9,442	$ 35,486	$ 25,797
Net income attributable to Southwall	$ 589	$ 491	4,044	$ 3,996

Note 13 – Acquisition of Crown Operations International

On August 30, 2010, Crown International Acquisition Company, LLC, a wholly owned subsidiary of Southwall Technologies, Inc., acquired the operating assets of Crown Operations International, Ltd. ("Crown Operations"), for $3,302 in cash. Subsequent to the acquisition of Crown Operations, Crown International Acquisition Company, LLC changed its name to Crown Operations International, LLC ("COI"). Crown Operations is an interlayer converting and laminating facility. The assets purchased include a 22,000 sq. ft. manufacturing facility, situated on approximately four acres of land, and converting equipment located in Sun Prairie, Wisconsin. The Company provisionally determined the assets and liabilities of Crown Operations based on fair values at August 30, 2010 using a weighted average valuation approach. The Company believes the goodwill realized was the result of a number of factors, including the expected growth opportunities and the vertical integration of a key vendor. The allocation of the fair value related to valuation of assets acquired and liabilities assumed were as follows:

Land and building	$1,650
Equipment and other tangible personal property	726
Customer relationships	170
Unpatented technology / trade secrets	190
Other intangible assets	30
Goodwill	350
Net Working Capital	186
Total	$3,302

We expect the goodwill recognized to be deductible for income tax purposes.

For the quarter ended September 30, 2010, COI revenues and profit included in the condensed income statement are $83 and $38, respectively.

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The unaudited pro forma financial information in the table below summarizes the combined results of the Company and Crown Operations as though the companies were combined as of the beginning of 2009. The pro forma financial information as presented below is for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of 2009.

	Three months ended		Nine months ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
Net revenues	$ 12,322	$ 8,787	$ 35,005	$ 24,034
Net Income	$ 1,095	$ 1,052	5,930	$ 5,184

Note 14 – Total Equity

A summary of the changes in equity for the nine months ended September 30, 2010 and 2009 is as follows:

	Nine Months Ended September 30,					
	2010			2009		
	Southwall Stockholders' Equity	Noncontrolling Interest	Total Equity	Southwall Stockholders' Equity	Noncontrolling Interest	Total Equity
Equity, beginning of period	$ 22,343	$ -	$ 22,343	$ 16,598	$ -	$ 16,598
Fair market value of NCI of acquired entity	-	346	346	-	-	-
Acquire NCI	(18)	18	-	-	-	-
Stock-based compensation	433	-	433	294	-	294
Stock option exercise	64	-	64	42	-	42
Dividend accrual on Series A Preferred Stock	(366)	-	(366)			