INTELLIGENT SYSTEMS CORP
Form 10KSB
March 30, 2005

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

FORM 10-KSB

FOR ANNUAL AND TRANSITION REPORTS
PURSUANT TO SECTIONS 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended December 31, 2004

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 1-9330

INTELLIGENT SYSTEMS CORPORATION
(Exact name of Registrant as specified in its charter)

Georgia	**58-1964787**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4355 Shackleford Road, Norcross, Georgia	**30093**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(770) 381-2900**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**

Common Stock, $.01 par value	**American Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: None

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. þ

State registrant s revenue for its most recent fiscal year. $22,332,000

As of February 28, 2005, 4,478,971 shares of Common Stock were outstanding. The aggregate market value of the Common Stock held by non-affiliates of the registrant on February 28, 2005 was $8,843,918 (computed using the closing price of the Common Stock on February 28, 2005 as reported by the American Stock Exchange).

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the registrant s Proxy Statement for the Annual Meeting of Shareholders are incorporated by reference in Part III hereof.

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PART I

Forward-Looking Statements

In addition to historical information, this Form 10-KSB may contain forward-looking statements relating to Intelligent Systems Corporation (ISC). All statements, trend analysis and other information contained in the following discussion relative to markets for our products and trends in revenue, gross margins and anticipated expense levels, as well as other statements including words such as anticipate , believe , plan , estimate , expect , likely and intend , and similar expressions constitute forward-looking statements. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those contemplated by such forward-looking statements. A number of the factors that we believe could impact our future operations are discussed in Management s Discussion and Analysis in section Item 6 of this Form 10-KSB. ISC undertakes no obligation to update or revise its forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes in future operating results.

ITEM 1. BUSINESS

Overview

Intelligent Systems Corporation, a Georgia corporation, has operated since 1973 and its securities have been publicly traded since 1981. In this report, sometimes we use the terms company , we , ours and similar words to refer to Intelligent Systems Corporation. Our executive offices are located at 4355 Shackleford Road, Norcross, Georgia 30093 and our telephone number is (770) 381-2900. Our Internet address is www.intelsys.com. We publish our SEC-filed reports on our website as soon as reasonably practicable after we file them with or furnish them to the SEC, and shareholders may access and download these reports free of charge.

Since the early 1980 s, we have conducted our operations principally through majority owned subsidiaries or minority owned affiliates to which we devote extensive management resources. Frequent acquisitions of or investment in early stage companies in the technology industry have long been components of our overall strategy. From time to time, we may sell one of our companies or we may increase our investment in a less-than-wholly owned company. As a result, our ownership position in a given company may change from time to time, our results of operations vary considerably from quarter-to-quarter and year-to-year, and our past performance is not necessarily indicative of future results.

Our strategy has been to help entrepreneurs build valuable companies by providing operational and strategic management, practical business advice, early stage equity capital, a network of business contacts and, in some cases, an incubator program. Depending upon the needs of each company, we will undertake a variety of roles which often include day-to-day management of operations, board of director participation, financing, market planning, strategic contract negotiations, personnel and administrative roles, and similar functions. Our subsidiary and affiliate companies are in the information technology industry (principally software for business applications) although one of our subsidiary companies is in the industrial products industry. Presently, our focus is on managing our subsidiary companies and current minority investments and we do not anticipate significant new investments or acquisitions in the foreseeable future.

Financial Reporting

We consolidate the results of operations of companies in which we own a majority interest or over which we exert control. We generally account for investments by the equity method for minority owned companies (i) in which we own 20 to 50 percent and over which we do not exert control or (ii) entities that are organized as partnerships or

limited liability companies. In general, under the equity method, we report our pro rata share of the income or loss generated by each of these businesses as equity income/losses of affiliates on a quarterly basis. These equity losses and income decrease or increase, respectively, the cost basis of our investment. Privately owned corporations in which we own less than 20 percent of the equity are carried at the lower of cost or market. We do not mark up the value of privately-owned businesses even when they raise money at higher valuations. We are often actively engaged in managing strategic and operational issues with our non-consolidated companies and devote significant resources to the development of their businesses.

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Industry Segment Overview

Our consolidated companies operate in two industry segments: Information Technology Products and Services and Industrial Products. The Information Technology Products and Services segment includes our VISaer, Inc., QS Technologies, Inc. and CoreCard Software, Inc. subsidiaries and the Industrial Products segment includes ChemFree Corporation. As of December 31, 2004, we own 100 percent of our ChemFree and QS Technologies subsidiaries, 79 percent of VISaer and 87 percent of CoreCard Software.

Operations in the Information Technology Products and Services segment are involved in the design, development and marketing of application software products that are used by business customers and government agencies to manage aspects of their operations. Our software products are typically sold in competitive bids with relatively long sales and implementation cycles. We receive software license fees that vary depending upon the number of licensed users and the number of software modules licensed with total contract revenue typically ranging from $100,000 to over $1 million. We also derive service revenue from implementation, customization, training and support services. Depending on the contract terms and customer implementation and testing schedule, which are typically outside of our control, the timing of revenue recognition is not generally within our control or determinable by us with any degree of certainty in advance.

The Industrial Products segment includes the design, assembly and sale of equipment and associated supplies that are used by commercial, industrial, military and government agencies to maintain and service machinery or vehicles used in their operations. Our assembled products are shipped to resellers or direct to customer sites and do not require set-up or on-site support from us. Unit pricing varies by model but typical end-user prices are less than $2,000 per unit. Customers purchase replacement supplies from us after the sale. In some cases, we provide equipment to multi-site corporate users under leases which typically average three to four years.

Our individual operations in both segments are relatively small in size and are subject to considerable fluctuation in revenue and profitability which in turn affects our consolidated revenue and margins. For instance, sales of ChemFree products, which were slightly higher in 2004 than in 2003, represented 28 percent of consolidated revenue in 2004, but had represented 47 percent of consolidated revenue in 2003. In 2004, VISaer s revenue represented almost 52 percent of consolidated revenue, compared to 24 percent in 2003. QS Technologies revenue accounted for 12 percent and 29 percent of consolidated revenue in 2004 and 2003, respectively. CoreCard contributed an immaterial amount to consolidated revenues in 2003, but their contribution grew to eight percent in 2004. The business in our segments is not seasonal on a consolidated basis although there is generally some slowdown in ChemFree s European business in late summer. The business discussion which follows contains information on products, markets, competitors, research and development and manufacturing for our operating subsidiaries, organized by industry segment and by company. For further detailed financial information concerning our segments, see Note 15 in the accompanying Notes to Consolidated Financial Statements. For further information about trends and risks likely to impact our business, please refer to Management s Discussion and Analysis in Item 6. of this Form 10-KSB.

Industry Segment: Information Technology Products and Services

VISaer, Inc. - VISaer develops, sells and supports software for the world-wide aircraft maintenance and engineering industry. VISaer offers a fully integrated, real time software solution that helps aviation customers efficiently and cost-effectively manage the technical, commercial and operational aspects of their maintenance, repair and overhaul (MRO) operations while also meeting regulatory requirements, such as those of the Federal Aviation Administration. Headquartered in Andover, Massachusetts, VISaer also has operations in England to support product development and sales activities in Europe and a small technical and project management team in Australia. VISaer is the successor company of Visibility, Inc., a software company whose operations were sold in July 2000 to allow VISaer to concentrate on the MRO software market. VISaer s product offering includes the following major components:

technical records planning and management, MRO operations, materials management, production scheduling, commercial operations and financial management. VISaer installed its initial customers of its first Version 3 release, a fully Web-native version of its complete MRO solution, in 2003. In 2004, VISaer focused on developing the next release of its Version 3 software to establish strong reference accounts and did not allocate significant resources to new sales and marketing programs. In addition to contracts to deliver professional services and maintenance support in 2005, VISaer has additional signed contracts to purchase software licenses for its Version 3 software and has $2.6 million in short-term deferred revenue, net of related costs, at December 31, 2004 that is expected to be recognized in 2005. VISaer has also identified a pipeline of additional prospects for license sales and professional services.

During 2002 and much of 2003, the general slow-down in the economy, the terrorist attacks of September 11, 2001, hostilities involving Iraq and the outbreak of Sudden Acute Respiratory Syndrome had a significant negative impact on the commercial aviation market, initially in the domestic market and then in international markets. Some airlines delayed or canceled planned information technology projects and others experienced a decline in financial strength during the industry downturn. In the second half of 2004 and continuing in recent months, there appears to be momentum building to move forward on delayed proposals to purchase MRO software which we believe will

provide an opportunity to build our pipeline of new business opportunities. Regulatory requirements dictate that airlines manage their MRO processes carefully and there is increased pressure to improve and automate MRO record-keeping. VISaer s software products provide a comprehensive, cost-effective way to do so. We believe significant sales opportunities exist in the Asian Pacific, Latin American and Chinese markets, MRO service outsourcing companies, low-cost airlines, and small to mid-size domestic regional airlines.

VISaer markets and sells its software in both domestic and international markets. International customers represented 27 percent of VISaer revenue in 2004 but had represented a majority of VISaer sales of products and services in each of the prior two years. The percentage decline in 2004 relates to unusually high domestic sales in 2004 due to completion of a multi-year contract more than to a decline in the dollar value of international sales. The markets for VISaer products include both airline-owned maintenance and engineering shops as well as third party MRO organizations. VISaer s sales are direct to the customer with VISaer providing a turnkey solution that covers project management, software, system implementation, training, consulting and support. In most cases, sales are made in response to competitive bids and requests for proposals and have sales cycles of six to eighteen months with implementation periods of an additional six to eighteen months. VISaer provides full suite implementation services and post-sales support and maintenance activities under annual contracts, as well as customization and professional services on an as needed basis. VISaer has a number of competitors, some of whom offer MRO software as part of an Enterprise Resource Planning package and who have more financial resources, larger customer bases and greater market coverage than VISaer. Other competitors are small players focused on MRO solutions with resources similar to VISaer. VISaer competes on the basis that its software provides extensive product functionality using Web-native technology; provides low cost-of-ownership; includes integrated modules offering a complete software and service solution; and runs on industry standard technology platforms. VISaer believes that its new Version 3 Web-native software is a strong competitive offering, although any technical or quality problems that arise could delay the product s implementation and negatively impact customer acceptance and references.

QS Technologies, Inc. - QS Technologies operates mainly from its Greenville, South Carolina location, providing both health and human services and vital records software, along with maintenance and support services to its installed customer base as well as to new customers. QS Technologies products allow public health and government agencies to capture, analyze and manage client information such as immunization, maternal health, and birth and death records. The market includes local, state and federal public health agencies nationwide as well as other government agencies, hospitals and clinics. Our vital records software is typically sold to a government department that is implementing the software state-wide, compared with the market for health and human services software which includes smaller, local city and county jurisdictions as well. QS Technologies competes against a number of other software companies, many of which are small vendors like itself and some of which are larger with access to greater resources. QS Technologies competes on the basis of product functionality and value, reputation for customer service, and knowledge of market requirements acquired through more than twenty years in the market. Sales are typically made in response to competitive bids and may take six to twelve months before contracts are awarded. Demand for our products and the timing of contract awards is impacted by general economic conditions as well as customer-specific factors such as preferred technology platform, defined product specifications, state and local budgets and program priorities, over which QS Technologies has little control. Typically, QS Technologies provides its customers with post-sales service and support under annual contracts that often renew for multiple years after the initial software license fee is earned. QS Technologies has expanded its health and human services product line, marketed under the Insight name, and added a vital records (birth and death) software product and web-based capabilities. In 2003, QS Technologies benefited from an industry-wide increase in the number of new projects contracted for after several years of slowdown due to state and local budget constraints. Consequently, in 2003, QS Technologies had a record year for revenue from new license sales and from annual maintenance contracts due to an expanded installed customer base. As anticipated, in 2004, QS Technologies did not match the same level of new license revenue as it did in 2003, although service revenue continues to provide a growing, recurring contribution because new and existing customers typically sign annual maintenance and support contracts. The level of new

Requests For Proposal (RFP) activity in 2004 and into 2005 is creating a reasonable pipeline of new business opportunities although RFP s contracts awards and timelines are always subject to changes in state and federal budgets and funding.

CoreCard Software, Inc. - CoreCard Software was spun off from our former affiliate company, PaySys International, in April 2001. CoreCard designs, develops and markets software to accounts receivable businesses, banks, credit unions and retailers to manage their credit card, merchant and loan accounts. After more than seven years of product development (including prior to the spin-off), in 2003 CoreCard completed the first major installation of its CoreISSUE and CoreCOLLECT application modules, based on its proprietary CoreENGINE architecture, at a major catalog retail customer and recognized its first significant revenue in early 2004. CoreCard products allow financial institutions and commercial customers to optimize their account management systems, improve customer retention, lower operating costs and create greater market differentiation. CoreCard s feature-rich, browser-based financial software allows customers to automate, streamline and optimize business processes associated with the set-up, administration and management of credit card, merchant and loan accounts, to process transactions and to generate reports and statements for these accounts. Because CoreCard s products are designed to run on PC-based servers, rather than mini or mainframe computers, customers benefit from a lower

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overall cost-of-ownership, faster implementations and increased flexibility to respond to market conditions. CoreCard s product functionality includes embedded multilingual, multi-currency support, web-based interface, real-time processing, complex rules-based authorizations, unlimited account hierarchies, and flexible, customer-defined pricing and payment terms.

CoreCard s initial target markets include accounts receivable businesses, small and mid-size banks, and retail and private-label issuers, in the United States and in certain emerging international markets. CoreCard competes with third-party card processors, larger and more established software suppliers, and a number of software solution providers that offer more limited functional modules. CoreCard has relatively limited sales and marketing experience compared to some of its competitors and potential customers may choose to outsource their account transaction processing rather than acquire software to manage their transactions in-house, which could impact negatively the total addressable market for CoreCard. Moreover, some potential customers may be reluctant to acquire software from a company with limited customer installations and choose instead a lower risk strategy of acquiring different and perhaps older technology from more established companies. Certain of CoreCard s competitors, including processors, have significantly more financial, marketing and development resources than does CoreCard and have large, established customer bases often tied to long-term contracts. CoreCard believes it can compete successfully in its selected markets based on providing customers with a next-generation technology platform, lower overall cost-of-ownership, faster implementation cycles, greater system flexibility and more customer-driven marketing options. Like most emerging software companies, CoreCard is focusing its development, marketing and sales activities on establishing a growing base of referenceable, satisfied customers. CoreCard has certain non-compete restrictions related to the spin-off from PaySys International, the last of which expires in April 2006. However, CoreCard believes that the available worldwide market is substantial, even with this remaining restriction.

CoreCard licenses its software products typically for a one-time license fee or, depending on specific customer requirements and preferences, on a per transaction fee. It provides maintenance and support services under annual contracts, as well as professional services on an as needed basis for customization, implementation and training activities. Generally, CoreCard expects to sell its products directly to its initial customers in the domestic U.S. but may work with a small number of resellers and third parties in international markets to identify, sell and support targeted opportunities. CoreCard completed the initial functionality in its core software modules, CoreISSUE , CoreFRAUD and CoreCOLLECT in 2003, developed further enhancements in 2004, and in 2005 expects to complete and deliver CoreACQUIRE and other product enhancements to its existing products. Any delays or problems in completing, testing and delivering CoreCard s new products could adversely affect customer acceptance and references.

Industrial Products Segment

ChemFree Corporation - Our only subsidiary in the Industrial Products segment is ChemFree Corporation, one of our early incubator companies. ChemFree designs, manufactures and markets a line of parts washers under the SmartWasher® trademark. SmartWashers® use an advanced bio-remediation system that cleans automotive and machine parts without using hazardous, solvent-based chemicals. Typically, the SmartWasher® system consists of a molded plastic tub and sink, recirculating pump, heater, control panel, filter with microorganisms, and water-based degreasing solutions. Unlike traditional solvent-based systems, there are no regulated, hazardous products used or produced in the process and the SmartWasher® system is completely self-cleaning. ChemFree sells replacement fluid and filters to its customers on a regular basis after the initial parts washer sale.

ChemFree s markets include the automotive, transportation, industrial and military markets. The automotive market includes companies and governmental agencies with fleets of vehicles, individual and chain automobile service centers and auto parts suppliers, such as NAPA. The industrial market includes customers with machinery that requires routine maintenance, such as power plants and tool and equipment rental companies. Military applications

include vehicle, aircraft and weapons maintenance. ChemFree sells its products directly to high volume customers as well as through several distribution channels, including international distributors in Europe, Canada, Latin America and the Pacific Rim. ChemFree also sells under a General Services Administration schedule to government agencies. Because ChemFree sells in part through large national distributors such as NAPA and Barnes Group in the United States and exclusive distributors in certain international markets, its results could be impacted negatively if one or more of such distributors stops carrying ChemFree products. One of ChemFree s domestic distributors represented six percent and 13 percent of our consolidated revenue in 2004 and 2003, respectively, and 22 percent and 28 percent of our Industrial Products Segment revenue in 2004 and 2003, respectively. Part of ChemFree s revenue is derived from multi-year lease contracts under which ChemFree provides SmartWashers® and supplies to nationwide chains of auto repair shops, such as Firestone and Pep Boys.

ChemFree competes with larger, established companies that offer solvent-based systems, other small companies using non-hazardous systems, and hazardous waste hauling firms. Although smaller than the established solvent-based firms, ChemFree believes it is competitive based on product features, positive environmental impact, desirable health and safety features, elimination of regulatory

compliance, and price. ChemFree believes that new regulations from governmental agencies such as the Environmental Protection Agency that prohibit or restrict the use of solvent-based products, with which ChemFree s products compete, will expand overall market demand significantly if such regulations are enforced effectively by state, local and federal governments.

Customer and warranty service, typically covering a one-year period, generally consists of shipping a replacement part to the customer or returning a defective product to either ChemFree or its distributors and dealers. ChemFree subcontracts the manufacturing of major sub-assemblies built to its specifications to various manufacturers and performs final assembly and testing at its own facility. While it is possible to acquire subassemblies from multiple sources, ChemFree frequently contracts with a single source for certain components in order to benefit from lower prices and consistent quality, especially with respect to molded plastic parts which are produced using ChemFree owned molds.

Incubator Program

For more than ten years, we have operated the Intelligent Systems Incubator at our corporate facility in a suburb of Atlanta, Georgia. In exchange for a monthly facility fee, incubator companies have access to resources such as office space, conference facilities, telecommunication and network infrastructure, business advice and planning, and a network of professional services. Depending upon the experience and needs of the founding entrepreneur, incubator companies will choose to use some or all of the available resources. Income from incubator companies reduces our total facility and personnel costs.

Because we have a large facility, we have been able to offer the benefits of the incubator program to companies in which we have no ownership interest. In attracting companies to our incubator program, we compete with other sources of business assistance, facilities and financial capital that may be available to the entrepreneur. These sources include other incubator programs, corporate ventures, and shared offices such as executive suites.

Minority-Owned Partner Companies

Part of our business strategy has been to seek to own a minority interest in companies that we believe are involved in promising technologies or markets with good growth potential. From time to time, we have acquired an investment in such companies and expect to continue to do so as a regular part of our strategy. Typically, these companies are privately held, early stage companies in technology-related fields. We are often actively involved in helping the companies develop and implement their business plans. Our two largest current investments follow:

A 17 percent interest in Horizon Software International, Inc., a leading provider of software and systems to manage the food service operations of primary and secondary education, college, medical and military facilities.

A 25.5 percent interest in NKD Enterprises, LLC (dba CoreXpand), a software services company with an e-commerce application for promotional and incentive product distributors and corporate customers. CoreXpand is part of our incubator program.

Research and Development

We spent $7.6 million and $8.3 million in the years ended December 31, 2004 and 2003, respectively, on company sponsored research and development. In 2004, the Information Technology segment spent $757,000 less on software development than in 2003. In each of the last two years, of the consolidated research and development expense, approximately 50 percent relates to VISaer product development and 33 percent relates to CoreCard with the balance spent mainly for development projects at QS Technologies and, to a small extent, at ChemFree. Total R&D expenses in 2004 were lower than in 2003 mainly due to a reduced number of U.S. based personnel at CoreCard compared to

2003 coupled with a greater use of lower cost off-shore personnel for testing and certain development tasks; and at VISaer, costs were lower due to reduced need for third party contractors than were required during the early product development stages, and reassignment of some software developers to customer support and professional services activities.

VISaer released its first Version 3 software in 2003, delivered additional version releases and modules in 2004, and expects to complete a release in early 2005 that will be used as the Go-Live version for most existing and prospective customers. In 2005, CoreCard Software expects to complete additional software modules, principally CoreACQUIRE , and to develop further enhancements to its initial suite of products.

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Patents, Trademarks and Trade Secrets

Our ChemFree subsidiary has 11 U.S. patents issued and 15 patents in foreign jurisdictions issued and pending covering various aspects of the design and construction of the SmartWasher® system and the process of bioremediation used in the SmartWasher® system. ChemFree considers these patents an important component of their overall business strategy. (See Item 3 below). CoreCard has filed several patent applications covering aspects of its core software engine. It may be possible for competitors to duplicate certain aspects of these products and processes even though we regard such aspects as proprietary. We have registered with the U.S. Patent and Trademark Office and various foreign jurisdictions numerous trademarks and service marks for our products. We believe that an active trade secret, trade name, trademark, and copyright protection program is important in developing and maintaining brand recognition and protecting our subsidiaries intellectual property. Our companies presently market their products under trademarks and service marks such as SmartWasher®, OzzyJuice®, VISaer , CoreENGINE , CoreISSUE , CoreCOLLECT , Insight and others.

Personnel

As of February 28, 2005, we had 162 full-time equivalent employees in our company, including in our majority-owned companies. Our employees are not represented by a labor union, we have not had any work stoppages or strikes and we believe our employee relations are good.

Financial Information About Geographic Areas

Refer to Note 14 to the Consolidated Financial Statements for financial information in response to this item. We do not believe there are any specific risks attendant to our foreign operations that are significantly different than the general business risks discussed elsewhere in this annual report.

ITEM 2. PROPERTIES

At February 28, 2005, we have leases covering approximately 61,000 square feet in Norcross, GA, 6,100 square feet in Greenville, SC, and 12,000 square feet in Andover, MA, to house our product development, manufacturing, sales, service and administration operations, as well as a small development office in Romania. Approximately 10 percent of the space we lease in Norcross is subleased to businesses in our technology business incubator. We believe our facilities are adequate for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

In 1999, a former consultant of the ChemFree subsidiary brought suit against ChemFree and other third parties in an action styled James C. McClure vs. Zymo International, Inc., G. Robert Whiteman and ChemFree Corporation et al. challenging the ownership of certain of ChemFree s patents. ChemFree filed a suit in the United States District Court for the Northern District of Georgia in an action styled ChemFree Corporation vs. James C. McClure. During the quarter ended September 30, 2004, an agreement was reached to settle both litigation matters. ChemFree secured a full assignment of interests in all of ChemFree s patents and patent applications worldwide from the former consultant in return for periodic payments over a five year period. The payment schedule provides for four monthly payments of $25,000, beginning August 2, 2004, and 48 monthly payments of $8,333 beginning in August 2, 2005 for an aggregate consideration of $500,000 ($451,000 discounted at 6.5%). In accordance with Statement of Financial Accounting Standards No. 142, Accounting for Intangible Assets , we believe that the present value of the payment stream ($451,000) is fully recoverable at this time. Based on our current estimations, we believe the average useful life of

these patents to be 10 years, which does not exceed legal lives. In addition, from time to time we are or may become a party to a number of other legal matters arising in the ordinary course of business. It is management s opinion that none of these other matters will have a material adverse impact on our consolidated financial position or results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

We did not submit any matter to a vote of our shareholders during the fiscal quarter ended December 31, 2004.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER REPURCHASES OF EQUITY SECURITIES

Our common stock is listed and traded on The American Stock Exchange (AMEX) under the symbol INS . The following table sets forth, for the periods indicated, the range of high and low sales prices for our common stock as reported by AMEX.

Year Ended December 31,	2004		2003	
	High	Low	High	Low
1st Quarter	$ 2.80	$ 1.62	$ 1.70	$ 1.25
2nd Quarter	2.53	1.78	2.04	1.40
3rd Quarter	2.09	1.60	2.20	1.59
4th Quarter	2.52	1.91	2.01	1.55

We had 370 shareholders of record as of February 28, 2005. This number does not include beneficial owners of our common stock whose shares are held in the names of various dealers, clearing agencies, banks, brokers and other fiduciaries. The company has in the past paid cash dividends from time to time on an irregular basis but has not in the past paid regular dividends and does not expect to pay any regular dividends in the foreseeable future. Under our revolving line of credit facility, we are precluded from paying dividends without obtaining consent from the bank. See Note 5 to the Consolidated Financial Statements.

ITEM 6. MANAGEMENT S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our Consolidated Financial Statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses. We consider certain accounting policies related to revenue recognition, valuation of acquired intangibles and impairment of long-lived assets, and valuation of investments to be critical policies due to the estimation processes involved in each. For a detailed description on the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements beginning on page F-8.

Revenue Recognition - Product revenue consists of fees from software licenses and sales or leases of industrial products. Service revenue consists of fees for implementation, consulting, training, customization, reimbursable expenses, maintenance and support for software products.

We recognize revenue for industrial products when products are shipped, at which time title transfers to the customer. There are no remaining future obligations and delivery occurs upon shipment. As an alternative to selling the product, on occasion we may lease our equipment. For leased equipment, we recognize revenue monthly at the contracted monthly rate during the term of the lease.

We recognize software fees in accordance with Statement of Position (SOP) No. 97-2, Software Revenue Recognition , as amended by SOP No. 98-9, Software Revenue Recognition, With Respect to Certain Transactions . Under SOP 97-2, we recognize software license fees when the following criteria are met: (1) a signed contract is obtained; (2) delivery of the product has occurred; (3) the license fee is fixed or determinable; and (4) collectibility is probable. Additionally, license fee revenue is not recognized until there are no material uncertainties regarding customer acceptance, cancellation provisions, if any, have expired and there are no significant vendor obligations remaining. SOP No. 98-9 requires recognition of revenue using the residual method when (1) there is vendor-specific objective evidence of the fair values of all undelivered elements in a multiple-element arrangement that is not accounted for using long-term contract accounting; (2) vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement; and (3) all revenue recognition criteria in SOP No. 97-2 other than the requirement for vendor-specific objective evidence of the fair value of each delivered element of the arrangement are satisfied. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the license fee is recognized as revenue. For those contracts that contain significant production, modification and/or customization, software license fees are recognized utilizing Accounting Research Bulletin (ARB) No. 45,

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Long-term Construction Type Contracts , using the relevant guidance in SOP No. 81-1, Accounting for Performance of Construction Type and Certain Production Type Contracts .

For percentage of completion contracts, we measure the progress toward completion and recognize the software license fees based upon input measures (i.e. in the same proportion that the amount of labor hours incurred to date bears to the total estimated labor hours required for the contract). If reliable estimates cannot be determined, we follow the completed contract method. Under the completed contract method, all revenue is deferred until the customer has accepted the software and any refund rights have expired.

A number of internal and external factors could affect our estimates related to software contracts, including labor rates, utilization of resources, changes in specifications or testing requirements, and unforeseen technical problems and delays. If we do not accurately estimate the resources required or the scope of work to be performed, or we do not manage the contract properly, in future periods we may need to restate revenues, to defer revenue longer than originally anticipated or to incur additional cost which would impact our margins and reported results.

Valuation of Investments - We hold minority interests in non-publicly traded companies whose values are difficult to determine and are based on management s estimate of realizability of the carrying value of the investment. Future adverse changes in market conditions, poor operating results, lack of progress of the underlying investee company or its inability to raise capital to support the business plan could result in investment losses or an inability to recover the current carrying value of the investment. Many of the companies in which we hold non-control, minority positions are backed by venture capital, and the value of our investment may be impacted by the amount, terms and valuation of the investee s financial transactions with third party venture funds or the terms of the sale of the investee company to a third party. Our policy with respect to minority interests is to record an impairment charge when we believe an investment has experienced a decline in value that is other than temporary. For instance, this could occur if the investee company is sold for less than our pro rata carrying value or if a new round of funding is at a lower valuation than our investment was made or if the financing terms for the new investors (such as preferences on liquidation) otherwise reduce the estimated value of our investment. We do not write-up the carrying value of our investments based on favorable changes or financial transactions. At least quarterly, we review our investments to determine any impairment in their carrying value and we write-down any impaired asset at quarter-end to our best estimate of its current realizable value. Such charges could have a material adverse impact on our financial condition or results of operations and are generally not predictable or quantifiable in advance. For instance, in Note 2 to the Consolidated Financial Statements, we discuss aggregate charges totaling $639,000 in 2004 to write-off the carrying value of our investment in Ardext Technologies and $1.2 million in 2003 to reflect reductions in the carrying value of our investments in RF Solutions, Silverpop and MediZeus. Charges were recorded in the fiscal quarter corresponding to the events giving rise to management s change in estimated valuation.

Valuation of Intangibles - From time to time in the past, we have acquired companies and we may do so in the future. Occasionally, as in the case with our CoreCard Software subsidiary (as described in detail in Note 2 to the Consolidated Financial Statements), we may increase our ownership or control of an entity from a minority to a majority position, which generally is treated as an acquisition for accounting purposes. Purchase accounting for an acquisition requires use of accounting estimates and judgments to allocate the purchase price to the fair market value of the assets and liabilities purchased. Our business acquisitions may result in the allocation of a portion of the purchase price to goodwill and other intangible assets. Additionally, we may acquire an intangible asset through other means, such as occurred in August 2004, when our ChemFree subsidiary acquired intellectual property assets in settlement of long-standing legal matters, as explained in more detail in Note 8 to the Consolidated Financial Statements. We recorded the addition of $458,000 in intangible assets in 2004 related to the ChemFree intellectual property assets which are being amortized over a ten year period. We did not acquire any companies in 2004 and no write-downs with respect to goodwill or other intangibles occurred in 2004 or 2003.

The determination of the value of intangible assets requires management to make estimates and assumptions that affect the amount of future period amortization expenses and possible impairment expense that we will incur. Sometimes we use the services of a third party appraiser to provide a valuation of material intangible assets. However, often the acquired company is a small entity with limited operating history on which to base future projections and thus valuing the assets requires the use of estimates which are very subjective. Furthermore, the period over which we amortize certain intangibles may change based on future conditions and consequently we may need to adjust the intangible value and/or amortization period, which could require us to increase the amount of amortization expense we record each period or to take a non-cash charge to reduce the value of the intangible. On at least an annual basis, we review the values assigned to long-lived assets using an estimate of the undiscounted cash flows of the entity over the remaining life of the asset. Any resulting impairment could require a write-down that would have a material adverse impact on our financial condition or results of operations.

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Overview

Our consolidated subsidiaries operate in two industry segments: Information Technology Products and Services and Industrial Products. Included in the Information Technology Products and Services sector are QS Technologies, Inc. (software for public health and human services), VISaer, Inc. (software for maintenance, repair and overhaul operations in the commercial aviation industry) and CoreCard Software, Inc. (software for managing financial transactions involving credit accounts). The Industrial Products segment includes ChemFree Corporation (bio-remediating parts washers).

We derive our product revenue from sales of software licenses in our Information Technology sector and sales and leases of equipment and supplies in our Industrial Products sector. Our service revenue consists of fees for implementation, consulting, customization, training, maintenance and support for software products in our Information Technology sector. Our consolidated revenue is the aggregate of the revenue generated at our four subsidiary companies. Our revenue fluctuates from period to period and our results are not necessarily indicative of the results to be expected in future periods. Period-to-period comparisons may not be meaningful and it is difficult to predict the level of consolidated revenue on a quarterly or annual basis for a number of reasons, including the following:

A change in revenue level at one of our subsidiaries may impact consolidated revenue or be offset by an opposing change at another subsidiary.

Economic and marketplace trends may impact our subsidiaries differently or not at all and two of our software subsidiaries have very limited experience in their marketplaces which makes it difficult to identify and evaluate trends that may impact their business.

Two of our software subsidiaries, CoreCard Software and VISaer, have been involved in major new product development initiatives for the past four years and have limited experience delivering and installing their new products at customer sites, making it difficult to predict with certainty when they will recognize revenue on individual software contracts.

Our subsidiaries are relatively small in revenue size and, in the Information Technology sector, license revenue at a subsidiary in a given period may consist of a relatively small number of contracts. Consequently, even minor delays in a subsidiary s delivery under a software contract (which may be out of their control) could have a significant and unpredictable impact on the consolidated revenue that we can recognize in a given quarterly or annual period.

Acquisitions may affect our revenue and expense levels. For instance, in 2002, we acquired a controlling interest in CoreCard Software. Consequently, we consolidated the results of operations of CoreCard from the date of acquisition but not for prior periods.

Frequently we recognize consolidated operating losses on a quarterly and annual basis and are likely to do so in the future from time to time. Our operating expenses consist of the aggregate of our four subsidiaries expenses and the corporate office expenses. Our ChemFree and QS Technologies subsidiaries usually generate an operating profit on an annual basis but our early stage subsidiaries, VISaer and CoreCard, are not consistently profitable on a quarterly or annual basis, mainly due to significant research and development expense that is invested to complete their new product offerings and the deferral of revenue recognition until such products are delivered to customers. Depending upon the size and number of software licenses recognized in a particular period and the level of expenses incurred to support development and sales activities, our subsidiaries may report operating profits on an irregular basis as they build their customer base. A significant portion of our subsidiaries expense is related to personnel which is relatively fixed in the short-term and we continually evaluate and strive to balance our financial resources with the resources

required to complete products under development and support our subsidiaries customers. For these and other reasons, our operating profits or losses may vary from quarter to quarter and at the present time are generally not predictable with any degree of certainty.

We also frequently generate income or losses from non-operating sources and we may do so from time to time in the future. Occasionally we derive income from sales of holdings in affiliate and other minority-owned companies or we record a charge if we believe the value of a non-consolidated company is impaired. We also recognize on a quarterly basis our pro rata share of the income or losses of affiliate companies accounted for by the equity method. The timing and amount of gain or loss recognized as a result of a sale or the amount of equity in the income or losses of affiliates generally are not under our control and are not necessarily indicative of future results, either on a quarterly or annual basis.

In recent years, most of our cash has been generated on an irregular basis from sales of our investments in early stage technology companies. We have used a significant amount of the cash received from these sales to support the operations of our CoreCard Software and VISaer subsidiaries, although our funding in 2004 was lower than for 2003. We do not expect the same level of cash investment in the future in these two entities and presently believe that customer payments on existing and pending software contracts will be sufficient to fund VISaer s operations on an annual basis and a growing portion of CoreCard s expenses. If the business or cash flow of either subsidiary does not develop as anticipated, we would need to scale back or restructure their operations.

Results of Operations

The following discussion should be read in conjunction with the Consolidated Financial Statements and the Notes to Consolidated Financial Statements presented in this annual report.

2004 Compared to 2003

Revenue - Total revenue for the year ended December 31, 2004 was $22.3 million, an increase of 67 percent compared to the same period in 2003. Revenue from product sales increased 34 percent year-to-year from $8.5 million to $11.4 million, whereas service revenue more than doubled, from $4.9 million in 2003 to $10.9 million in 2004. Both product and service revenue were impacted positively as a result of our Visaer subsidiary s recognition of revenue related to a multi-year contract that had been deferred from prior years. This single contract with a major customer contributed $7.5 million in total revenue and $4.9 million in gross margin in the year ended December 31, 2004. It is unlikely that VISaer or any of the company s software subsidiaries will have another contract of the same size in the foreseeable future.

Product revenue includes sales of industrial products by our Industrial Products segment as well as software licenses by our Information Technology segment subsidiaries:

> Sales of industrial products by our ChemFree subsidiary were slightly higher in 2004 than in 2003, and the mix of revenue by source and product changed from year-to-year as well. ChemFree s sales of parts washers, fluid and filters to the international market increased 29 percent overall compared to the prior year reflecting increased volume of units sold in the European and Latin American markets; revenue from leased equipment in the domestic market increased 25 percent compared to the 2003 level, mainly due to a new multi-location corporate customer; and the volume of fluid and filters sold to the installed base of domestic customers increased approximately four percent in 2004 as compared to 2003. Offset against these increases was a decline in the number of machines sold through ChemFree s distribution network in the domestic U.S. market. ChemFree expects one of its expiring leases to be renewed in 2005 but if it does not, the level of revenue from this source could decline.
>
> License revenue generated by our Information Technology segment increased by $2.8 million (126 percent) in 2004 mainly due to the VISaer major customer contract described above which contributed $2.7 million in license revenue. Additionally, our CoreCard Software subsidiary generated its first significant license revenue in 2004, but this was offset by a year-to-year decline in license revenue of approximately the same amount at our QS Technologies subsidiary mainly due to a record high level of license sales in 2003 which, as expected, was not matched in 2004.

Service revenue generated by our Information Technology subsidiaries increased by $6.1 million (125 percent) in 2004 as compared to 2003. Of this amount, approximately $4.8 million was for professional services, maintenance and reimbursable travel related to the VISaer major customer contract and the balance of the increase is due to more maintenance, support and professional services revenue from a larger installed base of customers at each of our software subsidiaries.

Cost of Sales - Total cost of sales was $8.9 million in 2004, a 32 percent increase compared to 2003, on a 67 percent increase in revenue year-to-year. Cost of *product* sales in 2004 was $3.7 million, or 32 percent of total product revenue, compared to $3.3 million or 39 percent of total product revenue in 2003. The difference between years is due to the significantly greater amount of software license revenue generated in 2004, which has a lower cost of sales than do our industrial products. Software license revenue represented 45 percent and 27 percent of total product revenue in 2004 and 2003, respectively, whereas industrial products revenue represented 55 percent and 73 percent of total product revenue in 2004 and 2003, respectively. Cost of sales for industrial products remained unchanged in 2004 and

2003 at 52 percent of industrial product revenue.

Cost of *service* sales (which relates to the Information Technology subsidiaries only) represented 47 percent of service revenue or $5.2 million in 2004 compared to 69 percent of service revenue, or $3.4 million, in 2003. The decrease in cost of sales as a percentage of service revenue in 2004 is mainly due to lower costs as a percentage of sales associated with the professional services revenue recognized by VISaer, as well as more efficient utilization of professional services employees at VISaer. Partially offsetting this cost reduction was a 21 percent increase in cost of service sales at the QS Technologies subsidiary due to higher personnel expenses to support a larger installed base of customers under annual maintenance contracts and to deliver more professional services projects for new and existing customers.

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Operating Expenses - Consolidated operating expenses were nine percent lower in 2004 than in 2003, decreasing from $15.0 million in 2003 to $13.7 million in 2004. Both general and administrative expense and marketing expense declined by nine percent year-to-year, while research and development expenses declined by eight percent year-to-year. The reduction in marketing expenses is mainly due to fewer direct sales employees and their associated travel costs. The decrease in general and administrative expense reflects lower costs at each of our subsidiaries mainly due to a reduction in total number of U.S. based employees performing administrative functions, lower facility costs at VISaer, and reduced depreciation expense. Offset against these declines is an increase of $64,000 at the corporate group mainly for higher rent and audit fees. Research and development expense was $686,000 less in 2004 than in 2003 mainly due to a combination of factors, including reduction in the use of third party contractors at VISaer, the allocation of more developers expense to cost of professional services at QS Technologies, and greater use of lower cost employees at CoreCard Romania for certain testing and quality assurance functions.

Interest Expense - We did not incur a net interest expense for 2004 despite a higher average bank line of credit balance in 2004 as compared to 2003, because our interest expense of $11,000 was offset by interest income of the same amount at a subsidiary.

Investment Income - We recognized $2.5 million in net investment income in 2004 compared to net investment income of $3.0 million in 2003. Included in the investment income in 2004 is a gain of $2.7 million on distributions related to our holdings in ISC Guernsey, aggregate investment gains totaling $513,000 related to transactions involving our holdings in Cirronet, Riverside Software and RF Solutions, and a write-down of $639,000 on our holdings in Ardext Technologies. Refer to Note 2 to the Consolidated Financial Statements for more details on each of these transactions. By comparison, net investment income in 2003 is comprised mainly of a gain on the PaySys escrow stock offset by write-downs on several minority owned investments, as explained in Note 2 to the Consolidated Financial Statements.

Equity Earnings (Losses) of Affiliate Companies - We recognize our pro rata share of the earnings or losses of affiliate companies that we record on the equity method. The amount recorded is not generally predictable or indicative of future results because it is the aggregate earnings (losses) of a number of relatively small companies operating in various industries and thus aggregate earnings (losses) are subject to considerable fluctuation from quarter-to-quarter and year-to-year. In 2004, we recorded $76,000 in equity losses of five affiliate companies (Horizon Software International, Riverside Software, CoreXpand, Alliance Technology Ventures and Cirronet) for those periods in 2004 in which we accounted for each by the equity method. By comparison, in 2003, we recorded $184,000 in equity earnings of six affiliate companies (including Horizon Software International, CoreXpand, Riverside Software, MediZeus, Alliance Technology Ventures and Cirronet) for those periods in which we accounted for each by the equity method.

Other Income, net - In 2004, other income includes $382,000 in recognition of the remaining balance of deferred gain related to a VISaer product line sale in a prior period, $8,000 in currency exchange gains, and other miscellaneous expense items. In 2003, the amount includes $137,000 in recognition of deferred gain related to the VISaer product line sale, $124,000 in foreign currency exchange gains, and other miscellaneous income.

Taxes - The income tax liability of $3,000 recorded in 2004 reflects state tax liability at our QS Technologies subsidiary. We did not accrue for any other income tax liability in 2004 and we believe our deferred tax assets should be fully reserved given their character and our historical losses. In 2003, we recorded an income tax credit of $40,000 representing the net of a $104,000 refund of alternative minimum taxes paid by the VISaer subsidiary in a prior year and income tax of $64,000 related to our QS Technologies state tax liability.

Liquidity and Capital Resources

Our cash balance at December 31, 2004 was $670,000, which is $463,000 lower than at the prior year-end. During the year ended December 31, 2004, our principal sources of cash were $2.7 million from distributions related to the ISC Guernsey sale of assets, $1.1 million from the sale of our Cirronet stock, a net increase of $2.3 million in current deferred revenue related to payments by customers for software and annual maintenance contracts for which the related revenue will be recognized within twelve months and $113,000 from a lower level of inventory of industrial products. During the year, our principal use of cash was $4.0 million for operations, which was $1.4 million less than in 2003. We used $433,000 cash in 2004 to reduce accrued payroll, the majority of which was for employee bonuses earned in 2003 but paid in 2004. Further, accounts receivable increased by $1.4 million compared to December 31, 2003 reflecting the timing of ChemFree invoices for quarterly lease payments that were dated December 31, 2004 compared to a January 1 dating for the comparable invoices for the prior period and an annual maintenance billing at the QS Technologies subsidiary that was delayed from the third to the fourth quarter of 2004 due to a contract amendment.

In recent years, most of our cash has been generated on an irregular basis from sales of our investments in non-consolidated technology companies and we have used a significant amount of the cash received from these sales to support the operations of our CoreCard Software and VISaer subsidiaries. In 2004, we used $3.9 million to support these two subsidiaries, which was $2.8 million less than the $6.7 million we used in 2003. We do not expect the same level of cash investment in the future in these two subsidiaries. Based on recent trends and current projections, we presently believe that scheduled customer payments on existing and pending software contracts will be sufficient to fund substantially all of VISaer s operations on an annual basis and a growing portion of CoreCard s expenses in 2005. If the business or cash flow of either subsidiary does not develop as anticipated either due to delays in customer payments, software development, or new contract acquisitions, we would expect to scale back or restructure the respective operations to a level that could be supported by their internal cash flow with minimal cash, if any, provided by us, or to seek alternative sources of funding for the subsidiaries. Most of our consolidated expenses are related to personnel, none of whom are represented by a union or have employment contracts. Thus, while there are no current plans to do so, any action to reduce negative cash flow from operations would generally entail a reduction in numbers of employees and the payment of accrued and severance compensation which could increase cash requirements in a given quarter but reduce cash needs in future quarters. Our QS Technologies subsidiary generated sufficient cash in 2004 to offset a majority of the corporate office expenses and is expected to do so again in 2005. There are no restrictions on the transfer of cash balances between the parent and subsidiary companies.

At December 31, 2004, we have several potential near-term sources of cash to support any negative cash flow from consolidated operations, including periodic draws against our bank line of credit and additional cash distributions of between $1.8 million and $2.1 million related to the ISC Guernsey sale, as explained in more detail in Note 2 to the Consolidated Financial Statements. Sales of investments, subsidiaries or assets have generated cash on an irregular basis in the past but the amount and timing of sales of such transactions cannot be predicted with reasonable certainty at this time and presently we do not have any firm pending transactions. Our budgeted cash requirements for operations in 2005 are lower than for 2004 based on new and pending software licenses and professional services contracts at our Information Technology subsidiaries. We expect to use our bank line of credit as needed in 2005 to accommodate short-term timing differences in consolidated cash flows, as we did in 2004. We presently project that we will have sufficient accounts receivable and inventory balances throughout the year to provide the required borrowing base for such draws under our bank line of credit; however, if we fail to do so, we could experience a short-term cash shortfall unless the bank provided an exception. Furthermore, if the bank elects not to renew our line of credit at the end of the current term (September 1, 2005), we may not be able to find a replacement line of credit on acceptable terms, if at all. Certain of our software customer contracts tie cash payments to delivery dates of various software deliverables. Delays in meeting project milestones or software delivery commitments could cause customers to postpone payments and increase our need for cash during 2005. Presently, we do not believe there is a material risk to successfully performing under these contracts but if customer payments are delayed for any reason, if we do not control costs or if we encounter unforeseen technical or quality problems, then we could require more cash than planned and we would need to increase our use of our bank line of credit, scale back operations at the subsidiary or seek new financing, which could affect performance under the contracts, at least in the short term.

Beyond 2005, we expect that liquidity will continue to improve and consolidated operations will generate sufficient cash to fund their requirements with use of our credit facility to accommodate short-term needs. Other long-term sources of liquidity include potential sales of investments, subsidiaries or other assets although the timing and amount of any such transactions are uncertain and, to the extent they involve non-consolidated companies, generally not within our control.

We do not currently have any off balance sheet arrangements that are reasonably likely to have a current or future material effect on our financial condition, liquidity or results of operations.

Factors That May Affect Future Operations

Future operations in both the Information Technology and Industrial Products segments are subject to risks and uncertainties that may negatively impact our future results of operations or projected cash requirements. It is difficult to predict future quarterly and annual results with any certainty mainly because several of our subsidiaries are early stage companies with limited revenue and experience in their respective markets, all are relatively small in size and, particularly in the Information Technology sector, revenue tends to be associated with fewer and larger sales than in the Industrial Products segment. Thus any trend or delay that affects even one of our subsidiaries could have a negative impact on the company s consolidated results of operations or cash requirements on a quarterly or annual basis. In addition, the carrying value of our investments is impacted by a number of factors which are generally beyond our control since we are typically a non-control shareholder in a private company with limited liquidity.

Among the numerous factors that may affect our consolidated results of operations or financial condition are the following:

Delays in software development projects which could cause our customers to delay implementations, delay payments or cancel contracts, which would increase our costs and reduce our revenue.

Undetected software errors or poor quality control which may delay product releases, increase our costs, result in non-acceptance of our software by customers or delay revenue recognition.

Competitive pressures (including pricing, changes in customer requirements and preferences, and competitor product offerings) which may cause prospective customers to choose an alternative product solution, resulting in lower revenue and profits (or increased losses).

The inability of our CoreCard or VISaer subsidiaries to establish a base of referenceable customers for their new product offerings, resulting in lower revenue and profits (or increased losses), increased cash needs and possibly leading to restructuring or cutting back of the subsidiary s operations.

Failure of our products specifications and features to achieve market acceptance.

Delays in anticipated customer payments for any reason which would increase our cash requirements and possibly our losses.

Declines in performance, financial condition or valuation of minority-owned companies which could cause us to write-down the carrying value of our investment or postpone an anticipated liquidity event, which could negatively impact our earnings and cash.

A reversal of the improving trend in the commercial aviation industry worldwide which could impact VISaer s short-term customer purchases, thus increasing its losses and need for cash.

The relatively limited sales and marketing experience of our VISaer and CoreCard subsidiaries in their respective markets which could cause them to misinterpret or fail to adjust to a trend in the market or to underestimate the sales cycle time frame.

In the Industrial Products market, failure by ChemFree to achieve anticipated growth in the European market or to renew expiring lease contracts for domestic customers could cause lower than anticipated sales and profits and impact projected cash flow.

An insufficient number of potential CoreCard customers decide to purchase and run an in-house software system and instead choose to outsource their account transaction processing which could result in lower revenue and greater cash requirements.

Budget reductions by state and local governments for information technology products that delay award of contracts or implementations for our QS Technologies subsidiary.

An insufficient level of qualifying accounts receivable and inventories to support a borrowing base sufficient to meet any borrowing requirements under our bank line of credit.

The recurrence of some incidence such as the SARS epidemic in 2003 or the terrorist attacks of 2001 that has a negative impact on the aviation industry, resulting in delays in contract awards and customer implementations

similar to the unforeseen negative affect on cash and profits experienced by VISaer during the SARS epidemic and the aftermath of the 2001 attacks.

Other general economic and political conditions, particularly those which may cause international business and domestic government customers to delay or cancel software purchase decisions.

We have certain lease commitments, legal matters and contingent liabilities described in detail in Note 8 to the Consolidated Financial Statements. We are not aware presently of any facts or circumstances related to these that are likely to have a material negative impact on our results of operations or financial condition.

Recent Accounting Pronouncements

In December 2004, the FASB eliminated the application of the Accounting Principles Board (APB) No. 25, Accounting for Stock Issued to Employees which permitted companies to use the alternative intrinsic value method of accounting for stock based compensation. The change is effective for small business issuers for the first interim or annual reporting period that begins after December 15, 2005. SFAS No. 123, Accounting for Stock Based Compensation requires companies to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards, with limited exceptions. We have not yet determined whether the adoption of this statement after December 15, 2005 will have a material impact on our results of operations or financial condition. In the discussion of Stock Based Compensation in Note 1 to the Consolidated Financial Statements, we disclose the effect of the use of the fair-value provisions of SFAS No. 123 on historical results of operations.

In March 2004, the Emerging Issues Task Force reached a consensus on Issue No. 03-16, Accounting for Investments in Limited Liability Companies . The consensus requires an investment in a Limited Liability Company (LLC) that maintains a specific ownership account for each investor be viewed as similar to an investment in a limited partnership for the purposes of determining whether a noncontrolling investment in an LLC should be accounted for using the cost method or equity method of accounting. The consensus was effective in the

quarter beginning after June 15, 2004. The implementation of this consensus did not have a material impact on our financial position or results of operations.

ITEM 7. FINANCIAL STATEMENTS

The following consolidated financial statements and related reports of independent public accountants are included in this report and are incorporated by reference in Part II, Item 7 hereof. See Index to Financial Statements and Supplemental Schedules on page F-1 hereof.

Report of Independent Registered Public Accounting Firm
Report of Previous Independent Registered Public Accounting Firm
Consolidated Balance Sheets at December 31, 2004 and 2003
Consolidated Statements of Operations for the two years ended December 31, 2004
Consolidated Statements of Changes in Stockholders Equity and Comprehensive Income (Loss)
 for the two years ended December 31, 2004
Consolidated Statements of Cash Flow for the two years ended December 31, 2004
Notes to Consolidated Financial Statements

Financial Statements Schedule

We are including the financial statement schedule listed below in this report. We omitted all other schedules required by certain applicable accounting regulations of the Securities and Exchange Commission because the omitted schedules are not required under the related instruction or do not apply or because we have included the information required in the Consolidated Financial Statements or notes thereto. See the Index to Financial Statements and Supplemental Schedules on page F-1 hereof.

Schedule II Valuation and Qualifying Accounts and Reserves

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

On November 22, 2004, we dismissed BDO Seidman, LLP as our independent public accountants. No report of BDO Seidman, LLP on our consolidated financial statements as of and for the fiscal years ended December 31, 2003 and December 31, 2002 contained an adverse opinion or a disclaimer of opinion, or was qualified or modified as to uncertainty, audit scope, or accounting principles. During the period of BDO s appointment on July 3, 2002 through November 22, 2004, there were no disagreements with BDO Seidman, LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreement, if not resolved to the satisfaction of BDO Seidman, LLP, would have caused it to make reference to the subject matter of the disagreement in connection with its reports for such periods. Effective November 22, 2004, our Audit Committee appointed Tauber & Balser, P.C. as our new independent accountants.

ITEM 8A. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, the company carried out an evaluation, under the supervision and with the participation of the company s management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the company s disclosure controls and procedures

pursuant to Rule 13a-15(b) under the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the company s disclosure controls and the procedures are effective. There were no significant changes in the company s internal controls over financial reporting or in other factors identified in connection with this evaluation that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the company s internal control over financial reporting.

PART III

ITEM 9. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Please refer to the subsection entitled Proposal 1 The Election of One Director Nominee and Proposal 1 The Election of One Director Executive Officers in our Proxy Statement for the 2005 Annual Meeting of Shareholders for information about the individual nominated as director and about the executive officers of the company. This information is incorporated into this Item 9 by reference.

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Information regarding compliance by directors and executive officers of the company and owners of more than 10 percent of our common stock with the reporting requirements of Section 16(a) of the Securities Exchange Act of 1934, as amended, is contained under the caption Section 16(a) Beneficial Ownership Reporting Compliance in this Proxy Statement. This information is incorporated into this Item 9 by reference.

The company adopted a Code of Ethics that applies to all directors, officers, and employees. The Code of Ethics is posted on our website at www.intelsys.com. The company will disclose on its website, within the time required by the rules of the SEC, any waivers of, or amendments to, the Code of Ethics for the benefit of an executive officer.

ITEM 10. EXECUTIVE COMPENSATION

Please refer to the subsection entitled Proposal 1 The Election of One Director Executive Compensation in the Proxy Statement referred to in Item 9 for information about management compensation. This information is incorporated into this Item 10 by reference.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Please refer to the subsections entitled Voting Principal Shareholders, Directors and Certain Executive Officers and Voting Securities Authorized for Issuance Under Equity Compensation Plan in the Proxy Statement referred to in Item 9 for information about the ownership of our $0.01 par value common stock by certain persons and securities authorized for issuance under our equity compensation plans. This information is incorporated into this Item 11 by reference.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The lease on our headquarters and primary facility at 4355 Shackleford Road, Norcross, Georgia expired May 31, 2004. The former landlord was unwilling to renew this lease and had instead expressed a desire to sell the facility. On June 1, 2004, ISC Properties, LLC, an entity controlled by J. Leland Strange, a director and President and Chief Executive Officer, purchased the facility from the former landlord and leased approximately 45 percent of the facility to the company in order to allow us to stay in the present facility and to avoid the disruption and expense of a move. After careful consideration, the company s Board of Directors concluded that the lease transaction was fair to the company and in the best interests of the company and its shareholders, and approved the lease transaction between the company and ISC Properties, LLC effective June 1, 2004. Mr. Strange recused himself from deliberations concerning, and voting to approve, the lease transaction. In connection with this approval, the Board of Directors waived the conflict of interest provisions of our Code of Ethics as they apply to Mr. Strange in connection with the lease transaction. In 2004, we paid ISC Properties, LLC $229,000 in rent. We also evaluated the arrangement to determine if ISC Properties, LLC should be considered a Variable Interest Entity (VIE) within the guidance of Financial Accounting Standards Board FIN No. 46. After carefully considering the characteristics of the relationship between the company and ISC Properties, LLC, it was determined that ISC Properties, LLC did not meet the criteria of a VIE and, as a result, ISC Properties, LLC is not consolidated with the company.

In 2003, Mr. Strange participated as a common shareholder in the pro rata distribution of the escrow fund related to the sale of PaySys International, Inc. as described more fully in Note 3 to the Consolidated Financial Statements. Mr. Strange, who had owned his shares in PaySys since 1983 prior to the company s investment in PaySys in 1994, received $149,000 in the aggregate in two payments in March and June 2003, which represented his pro rata share of

the escrow funds released.

ITEM 13. EXHIBITS LIST AND REPORTS ON FORM 8-K

(a) Exhibits

We are filing the following exhibits with this report or incorporating them by reference to earlier filings. Shareholders may request a copy of any exhibit by contacting Bonnie L. Herron, Secretary, Intelligent Systems Corporation, 4355 Shackleford Road, Norcross, Georgia 30093; telephone (770) 381-2900. There is a charge of $.50 per page to cover expenses of copying and mailing.

3(i) Amended and Restated Articles of Incorporation of the Registrant dated November 14, 1991, as amended November 25, 1997. (Incorporated by reference to Exhibit 3.1 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 1991 and to Exhibit 3.1 to the Registrant s Report on Form 8-K dated November 25, 1997.)

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3(ii) Bylaws of the Registrant dated June 6, 1997. (Incorporated by reference to Exhibit 3(ii) of the Registrant s Form 10-K/A for the year ended December 31, 1997.)

4.1 Rights Agreement dated as of November 25, 1997 between the Registrant and American Stock Transfer & Trust Company as Rights Agent. (Incorporated by reference to Exhibit 4.1 of the Registrant s Report on Form 8-K dated November 25, 1997 and filed on December 16, 1997.)

4.2 Form of Rights Certificate. (Incorporated by reference to Exhibit 4.2 of the Registrant s Report on Form 8-K dated November 25, 1997 and filed on December 16, 1997.)

10.1 Lease Agreement dated June 1, 2004, between the Registrant and ISC Properties, LLC.

10.2 Management Compensation Plans and Arrangements:

(a) Intelligent Systems Corporation 2003 Stock Incentive Plan

(b) Intelligent Systems Corporation 1991 Stock Incentive Plan, amended June 6, 1997

(c) Intelligent Systems Corporation Change in Control Plan for Officers

(d) Intelligent Systems Corporation Outside Director s Retirement Plan

(e) Non-Employee Directors Stock Option Plan

Exhibit 10.2(a) is incorporated by reference to Exhibit 10.2(a) to the Registrants Form 10-K for the year ended December 31, 2003.

Exhibit 10.2(b) is incorporated by reference to Exhibit 4.1 of the Registrant s Form S-8 dated July 25, 1997.

Exhibits 10.2(c) and (d) are incorporated by reference to Exhibit 10.4 to the Registrant s Form 10-K for the year ended December 31, 1993.

Exhibit 10.2(e) is incorporated by reference to Exhibit 10.3 to the Registrant s Form 10-K for the year ended December 31, 2000.

10.3 Loan Agreement by and among Intelligent Systems Corporation and Fidelity Bank dated October 1, 2003. (Incorporated by reference to Exhibit 10.3 to the Registrant s Form 10-K for the year ended December 31, 2003.)

10.4 Security Agreement by and among Intelligent Systems Corporation and Fidelity Bank dated as of October 1, 2003. (Incorporated by reference to Exhibit 10.4 to the Registrant s Form 10-K for the year ended December 31, 2003.)

10.5 Form of Security Agreement by and among majority owned subsidiary companies of Intelligent Systems Corporation and Fidelity Bank as of October 1, 2003. (Incorporated by reference to Exhibit 10.5 to the Registrant s Form 10-K for the year ended December 31, 2003.)

10.6 Negative Pledge Agreement by and among Intelligent Systems Corporation and Fidelity Bank dated October 1, 2003. (Incorporated by reference to Exhibit 10.6 to the Registrant s Form 10-K for the year ended December 31, 2003.)

10.7 Commercial Promissory Note and Rider thereto of Intelligent Systems Corporation in favor of Fidelity Bank dated October 1, 2004. (Incorporated by reference to Exhibit 10.7 to the Registrant s Form 10-K for the year ended December 31, 2003.)

3,215

Non-regulated expenses, net

(2,253

)

(3,240

)

Income tax (expense) benefit on other income and expenses

(481

)

16

Net other income (loss)

740

(9

)

Interest expense:

Interest expense	7,077	7,803
Less: capitalized interest	(215)	(539)
Net interest expense	6,862	7,264
Net Income	$ 17,170	$ 13,510
Earnings per share		

Basic	
$	0.36
$	0.28
Diluted	
	0.36
	0.28
Weighted average shares outstanding	
Basic	
	47,804

47,729

Diluted

47,837

47,760

Dividends declared per share of common stock

$

0.1625

$

0.16000

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

Unaudited

(In thousands, except per share data)

For the six months ended		June 30, 2014		June 30, 2013
Operating revenue	$	268,931	$	265,999
Operating expenses:				
Operations:				
Water production costs		107,317		101,342
Administrative and general		48,937		48,436
Other operations		32,380		32,675
Maintenance		9,993		8,321
Depreciation and amortization		32,140		29,120
Income taxes		3,351		8,402
Property and other taxes		10,369		11,150
Total operating expenses		244,487		239,446
Net operating income		24,444		26,553
Other income and expenses:				
Non-regulated revenue		7,754		6,737
Non-regulated expenses, net		(6,372)		(5,657)
Income tax (expense) on other income and expenses		(560)		(435)
Net other income		822		645
Interest expense:				
Interest expense		14,152		15,840
Less: capitalized interest		(580)		(1,079)
Net interest expense		13,572		14,761
Net Income	$	11,694	$	12,437
Earnings per share				
Basic	$	0.24	$	0.28
Diluted		0.24		0.28
Weighted average shares outstanding				
Basic		47,780		45,004
Diluted		47,818		45,034
Dividends declared per share of common stock	$	0.3250	$	0.32000

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Unaudited

(In thousands)

For the six months ended:	June 30, 2014	June 30, 2013
Operating activities		
Net income	$ 11,694	$ 12,437
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	33,162	30,088
Changes in value of life insurance contracts	(721)	(504)
Changes in operating assets and liabilities:		
Receivables	(17,161)	(19,686)
Accounts payable	12,802	8,787
Other current assets	(4,384)	(3,889)
Other current liabilities	(16,336)	8,193
Other changes in noncurrent assets and liabilities	24,128	1,350
Net cash provided by operating activities	43,184	36,776
Investing activities:		
Utility plant expenditures	(57,047)	(66,190)
Purchase of life insurance contracts	(1,707)	(1,608)
Changes in restricted cash	313	1,079
Net cash used in investing activities	(58,441)	(66,719)
Financing activities:		
Short-term borrowings	39,400	32,615
Repayment of short-term borrowings	(5,000)	(93,275)
Proceeds from long-term debt		48
Repayment of long-term debt	(4,163)	(2,553)
Advances and contributions in aid of construction	5,950	5,006
Refunds of advances for construction	(3,203)	(3,512)
Issuance of common stock		110,688
Common stock issuance costs		(4,853)
Dividends paid	(15,527)	(14,343)
Net cash provided by financing activities	17,457	29,821
Change in cash and cash equivalents	2,200	(122)
Cash and cash equivalents at beginning of period	27,506	38,790
Cash and cash equivalents at end of period	$ 29,706	$ 38,668
Supplemental information		
Cash paid for interest (net of amounts capitalized)	$ 13,032	$ 14,383
Cash paid for income taxes		
Income tax refunds	(6,000)	
Supplemental disclosure of non-cash activities:		
Accrued payables for investments in utility plant	$ 12,244	$ 9,492
Utility plant contribution by developers	4,319	6,809

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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CALIFORNIA WATER SERVICE GROUP

Notes to Unaudited Condensed Consolidated Financial Statements

June 30, 2014

(Amounts in thousands, except share and per share amounts)

Note 1. Organization and Operations and Basis of Presentation

California Water Service Group (the Company) is a holding company that provides water utility and other related services in California, Washington, New Mexico and Hawaii through its wholly-owned subsidiaries. California Water Service Company (Cal Water), Washington Water Service Company (Washington Water), New Mexico Water Service Company (New Mexico Water), and Hawaii Water Service Company, Inc. (Hawaii Water) provide regulated utility services under the rules and regulations of their respective state s regulatory commissions (jointly referred to herein as the Commissions). CWS Utility Services and HWS Utility Services LLC provide non-regulated water utility and utility-related services.

The Company operates in one reportable segment, providing water and related utility services.

Basis of Presentation

The unaudited interim financial information has been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (SEC) and therefore do not contain all of the information and footnotes required by GAAP and the SEC for annual financial statements. The condensed consolidated financial statements should be read in conjunction with the Company s consolidated financial statements for the year ended December 31, 2013, included in its annual report on Form 10-K as filed with the SEC on February 27, 2014.

The preparation of the Company s condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenues and expenses for the periods presented. These include, but are not limited to, estimates and assumptions used in determining the Company s regulatory asset and liability balances based upon probability assessments of regulatory recovery, revenues earned but not yet billed, asset retirement obligations, allowance for doubtful accounts, pension and other employee benefit plan liabilities, and income tax-related assets and liabilities. Actual results could differ from these estimates.

In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments, consisting of normal recurring accruals that are necessary to provide a fair presentation of the results for the periods covered. The results for interim periods are not necessarily indicative of the results for any future period.

Due to the seasonal nature of the water business, the results for interim periods are not indicative of the results for a 12-month period. Revenue and income are generally higher in the warm, dry summer months when water usage and sales are greater. Revenue and income are generally lower in the winter months when cooler temperatures and rainfall curtail water usage and sales.

Note 2. Summary of Significant Accounting Policies

Revenue

Revenue generally includes monthly cycle customer billings for regulated water and wastewater services at rates authorized by regulatory commissions (plus an estimate for water used between the customer s last meter reading and the end of the accounting period) and billings to certain non-regulated customers at rates authorized by contract with government agencies.

The Company s regulated water and waste water revenue requirements are authorized by the Commissions in the states in which it operates. The revenue requirements are intended to provide the Company an opportunity to recover its operating costs and earn a reasonable return on investments.

For metered customers, Cal Water recognizes revenue from rates which are designed and authorized by the California Public Utilities Commission (CPUC). Under the Water Revenue Adjustment Mechanism (WRAM), Cal Water records the adopted level of volumetric revenues, which would include recovery of cost of service and a return on investments, as established by the CPUC for metered accounts (adopted volumetric revenues). In addition to volumetric-based revenues, the revenue requirements approved by the CPUC include service charges, flat rate charges, and other items not subject to the WRAM. The adopted volumetric revenue considers the seasonality of consumption of water based upon historical averages. The variance between adopted volumetric revenues and actual billed volumetric revenues for metered accounts is recorded as a component of revenue with an offsetting entry to a regulatory asset or liability balancing account (tracked individually for each Cal Water district) subject to certain criteria

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under the accounting for regulated operations being met. The variance amount may be positive or negative and represents amounts that will be billed or refunded to customers in the future.

Cost-recovery rates are designed to permit full recovery of certain costs. Cost-recovery rates such as the Modified Cost Balancing Account (MCBA) provides for recovery of adopted expense levels for purchased water, purchased power and pump taxes, as established by the CPUC. In addition, cost-recovery rates include recovery of cost related to water conservation programs and certain other operation expenses adopted by the CPUC. There is no markup for return or profit for cost-recovery expenses and are generally recognized when expenses are incurred. Variances (which include the effects of changes in both rate and volume for the MCBA) between adopted and actual costs are recorded as a component of revenue, as the amount of such variances will be recovered from or refunded to Cal Water customers at a later date. The variance between adopted costs and actual costs for metered accounts is recorded as a component of revenue with an offsetting entry to a regulatory asset or liability balancing account (transferred individually for each Cal Water District) subject to certain criteria under the accounting for regulated operations being met.

The balances in the WRAM and MCBA assets and liabilities accounts will fluctuate on a monthly basis depending upon the variance between adopted and actual results. The recovery or refund of the WRAM is netted against the MCBA over- or under-recovery for the corresponding district and is interest bearing at the current 90 day commercial paper rate. At the end of any calendar year, Cal Water files with the CPUC to refund or collect the balance in the accounts. Most undercollected net WRAM and MCBA receivable balances are collected over 12 or 18 months. Cal Water defers net WRAM and MCBA operating revenues and associated costs whenever the net receivable balances are estimated to be collected more than 24 months after the respective reporting periods in which it was recognized. The deferred net WRAM and MCBA revenues and associated costs were determined using forecasts of rate payer consumption trends in future reporting periods and the timing of when the CPUC will authorize Cal Water s filings to recover the undercollected balances. Deferred net WRAM and MCBA revenues and associated costs will be recognized as revenues and costs in future periods when collection is within twenty-four months of the respective reporting period.

The net WRAM and MCBA balances included in regulatory balancing account, assets, and liabilities were:

		June 30, 2014		December 31, 2013
Net short-term receivable	$	26,978	$	30,887
Net long-term receivable		26,053		15,423
Total receivable	$	53,031	$	46,310
Net short-term payable	$	5	$	1,032
Net long-term payable		439		906
Total payable	$	444	$	1,938

Flat rate customers are billed in advance at the beginning of the service period. The revenue is prorated so that the portion of revenue applicable to the current period is included in that period s revenue, with the balance recorded as unearned revenue on the balance sheets and recognized as revenue when earned in the subsequent accounting period. The unearned revenue liability was $1.4 million as of June 30, 2014 and $1.5 million as of December 31, 2013. This liability is included in accrued expenses and other liabilities on the condensed consolidated balance sheets.

Cash and Cash Equivalents

Cash equivalents include highly liquid investments with maturities of three months or less. Cash and cash equivalents was $29.7 million and $27.5 million as of June 30, 2014 and December 31, 2013, respectively. Restricted cash was presented on the condensed consolidated balance sheets as taxes, prepaid expenses and other assets and was $0.9 million and $1.2 million as of June 30, 2014 and December 31, 2013, respectively.

Accounting Standards Update

On May 28, 2014 the Financial Accounting Standards Board issued an accounting standards update (ASU) 2014-09, *Revenue from Contracts with Customers*. This update creates a single, principles based framework for revenue recognition and is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled when goods or services are transferred to customers. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016. Early adoption is not permitted. The Company is currently evaluating the impact of adopting the new revenue standard on its consolidated financial statements.

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Note 3. Stock-based Compensation

Equity Incentive Plan

The Company s equity incentive plan was originally approved by stockholders on April 27, 2005 and again on May 20, 2014. Under the equity incentive plan, the Company is authorized to issue up to 2,000,000 shares of common stock awards as defined in the Plan to employees and directors.

The Restricted Stock Awards (RSAs) granted in 2014 and 2013 to employees vest over 36 months. Director RSAs generally vest at the end of 12 months. During the first six months of 2014, the RSAs granted were valued at $23.61 per share, based upon the fair market value of the Company s common stock on the date of grant.

The table below reflects RSAs granted under the Equity Incentive Plan for the six months ended June 30, 2014:

RSA shares balance as of December 31, 2013	439,314
Additions for new grants	58,378
Reductions for cancelled grants	(5,376)
RSA shares balance as of June 30, 2014	492,316

During the six months ended June 30, 2014 and 2013, the Company also granted performance-based Restricted Stock Unit Awards (RSUs) of 37,143 shares and 50,267 shares of common stock, respectively, to officers. Each award reflects a target number of shares that may be issued to the award recipient. The 2014 and 2013 awards may be earned upon the completion of the three-year performance period ending on March 4, 2017 and March 3, 2016, respectively. Whether RSUs are earned at the end of the performance period will be determined based on the achievement of certain performance objectives set by the Board of Director Compensation Committee in connection with the issuance of the RSUs. The performance objectives are based on the Company s business plan covering the performance period. The performance objectives include achieving the budgeted return on equity, budgeted investment in utility plant, customer service standards, water quality standards, and/or safety standards. Depending on the results achieved during the three-year performance period, the actual number of shares that a grant recipient receives at the end of the performance period may range from 0% to 200% of the target shares granted, provided that the grantee is continuously employed by the Company through the vesting date. If, prior to the vesting date, employment is terminated by reason of death, disability or normal retirement, then a pro rata portion of this award will vest. RSUs are not included in diluted shares for financial reporting until earned. The 2014 and 2013 RSUs are recognized as expense ratably over the three year performance period using a fair market value of $23.61 per share and $20.62 per share, respectively, and an estimate of RSUs earned during the performance period.

The Company has recorded compensation costs for the RSAs and RSUs in operating expense in the amount of $1.0 million and $0.8 million for the six months ended June 30, 2014 and June 30, 2013, respectively.

Note 4. Equity

The Company s changes in equity for the six months ended June 30, 2014 were as follows:

		Total Stockholders Equity
Balance at December 31, 2013	$	598,756
Common stock issued		1
Share-based compensation expense		968
Common stock dividends paid		(15,527)
Net income		11,694
Balance at June 30, 2014	$	595,892

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Note 5. Net Income Per Share Calculations

The computations of basic and diluted net income per weighted average common shares are noted below. Basic net income per share is computed by dividing the net income available to common stockholders by the weighted average number of common shares outstanding during the period. RSAs are included in the weighted average common shares outstanding because the shares have all the same voting and dividend rights as issued and unrestricted common stock. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts were exercised or converted into common stock.

A total of 212,920 shares and 333,856 shares of Stock Appreciation Rights were vested and outstanding and all were dilutive as of June 30, 2014 and June 30, 2013, respectively, as shown in the table below.

	Three Months Ended June 30			
		2014		2013
Net Income available to common stockholders	$	17,170	$	13,510
Weighted average common shares outstanding, basic (in thousands)		47,804		47,729
Dilutive stock appreciation rights (treasury method) (in thousands)		33		31
Weighted average common shares outstanding, dilutive (in thousands)		47,837		47,760
Net Income per share - basic	$	0.36	$	0.28
Net Income per share - diluted	$	0.36	$	0.28

	Six Months Ended June 30			
		2014		2013
Net Income available to common stockholders	$	11,694	$	12,437
Weighted average common shares outstanding, basic (in thousands)		47,780		45,004
Dilutive stock appreciation rights (treasury method) (in thousands)		38		30
Weighted average common shares outstanding, dilutive (in thousands)		47,818		45,034
Net Income per share - basic	$	0.24	$	0.28
Net Income per share - diluted	$	0.24	$	0.28

Note 6. Pension Plan and Other Postretirement Benefits

The Company provides a qualified, defined-benefit, non-contributory pension plan for substantially all employees. The Company makes annual contributions to fund the amounts accrued for the qualified pension plan. The Company also maintains an unfunded, non-qualified, supplemental executive retirement plan. The costs of the plans are charged to expense or are capitalized in utility plant as appropriate.

The Company offers medical, dental, vision, and life insurance benefits for retirees and their spouses and dependents. Participants are required to pay a premium, which offsets a portion of the cost.

Cash payments by the Company related to pension plans and other postretirement benefit plans were $16.4 million for the six months ended June 30, 2014 and were $17.8 million during the six months ended June 30, 2013. The 2014 estimated cash contribution to the pension plans is

$26.8 million and to the other postretirement benefit plans is $9.6 million.

The following table lists components of net periodic benefit costs for the pension plans and other postretirement benefits. The data listed under pension plan includes the qualified pension plan and the non-qualified supplemental executive retirement plan. The data listed under other benefits is for all other postretirement benefits.

	Three Months Ended June 30			
	Pension Plan		Other Benefits	
	2014	2013	2014	2013
Service cost	$ 4,217	$ 4,658	$ 1,620	$ 1,695
Interest cost	4,726	4,063	1,337	1,109
Expected return on plan assets	(4,179)	(3,565)	(754)	(598)
Recognized net initial APBO (1)	N/A	N/A		2
Amortization of prior service cost	1,510	1,541	11	20
Recognized net actuarial loss	1,003	2,224	775	916
Net periodic benefit cost	$ 7,277	$ 8,921	$ 2,989	$ 3,144

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	Six Months Ended June 30			
	Pension Plan		Other Benefits	
	2014	2013	2014	2013
Service cost	$ 8,434	$ 9,316	$ 3,239	$ 3,390
Interest cost	9,453	8,126	2,674	2,218
Expected return on plan assets	(8,358)	(7,130)	(1,507)	(1,196)
Recognized net initial APBO (1)	N/A	N/A		4
Amortization of prior service cost	3,020	3,082	22	40
Recognized net actuarial loss	2,006	4,448	1,550	1,832
Net periodic benefit cost	$ 14,555	$ 17,842	$ 5,978	$ 6,288

(1) APBO - Accumulated postretirement benefit obligation

Note 7. Short-term and Long-term Borrowings

On June 29, 2011, the Company and Cal Water entered into Syndicated Credit Agreements, which provide for unsecured revolving credit facilities of up to an initial aggregate amount of $400 million. The Syndicated Credit Facilities amend, expand, and replace the Company s and its subsidiaries existing credit facilities originally entered into on October 27, 2009. The new credit facilities extended the terms until June 29, 2016, increased the Company s and Cal Water s unsecured revolving lines of credit, and lowered interest rates and fees. The Company and subsidiaries that it designates may borrow up to $100 million under the Company s revolving credit facility. Cal Water may borrow up to $300 million under its revolving credit facility; however, all borrowings need to be repaid within 12-months unless otherwise authorized by the CPUC. The proceeds from the revolving credit facilities may be used for working capital purposes, including the short-term financing of capital projects. The base loan rate may vary from LIBOR plus 72.5 basis points to LIBOR plus 95 basis points, depending on the Company s total capitalization ratio. Likewise, the unused commitment fee may vary from 8 basis points to 12.5 basis points based on the same ratio.

Both short-term unsecured credit agreements contain affirmative and negative covenants and events of default customary for credit facilities of this type including, among other things, limitations and prohibitions relating to additional indebtedness, liens, mergers, and asset sales. Also, these unsecured credit agreements contain financial covenants governing the Company and its subsidiaries consolidated total capitalization ratio and interest coverage ratio.

As of June 30, 2014 and December 31, 2013, the outstanding borrowings on the Company lines of credit were $16.2 million and $16.8 million, respectively, and were $65.0 million and $30.0 million as of June 30, 2014 and December 31, 2013 on the Cal Water lines of credit, respectively. For the six months ended June 30, 2014, the average borrowing rate was 1.20% compared to 2.30% for the same period last year.

Note 8. Income Taxes

The Company accounts for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Measurement of the deferred tax assets and liabilities is at enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date.

The Company anticipates that future rate actions by the regulatory commissions will reflect revenue requirements for the tax effects of temporary differences recognized, which have previously been passed through to customers. The regulatory commissions have granted the Company rate increases to reflect the normalization of the tax benefits of the federal accelerated methods and available Investment Tax Credits (ITCs) for all assets placed in service after 1980. ITCs are deferred and amortized over the lives of the related properties for book purposes.

During 2012, the Company filed an application for a change in tax accounting method with the IRS to implement tangible property regulations specifically in regards to repairs and maintenance deductions. On September 13, 2013, the U.S. Department of the Treasury and Internal Revenue Service (IRS) issued the final and re-proposed tangible property regulations for repairs and maintenance deductions with an effective date of January 1, 2014. These tax regulations allowed the Company to deduct a

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significant amount of linear asset costs previously capitalized for book and tax purposes. The Company intends to file a tax accounting method change with its 2013 tax return for the repair and maintenance of linear assets within the guidance of the tangible property regulations. During the second quarter of 2014 the Company recorded additional repairs deductions of $52.3 million for federal and $64.0 million for state. The Company s total federal net operating loss (NOL) was $67.1 million and state net operating loss NOL was $106.0 million as of December 31, 2013. The NOL carry-forward amounts are more likely than not to be recovered and therefore require no valuation allowance. The NOL carry-forward does not begin to expire until 2033.

As of June 30, 2014 the Company had unrecognized tax benefits of approximately $7.2 million. Included in the balance of unrecognized tax benefits is approximately $1.6 million of tax benefits that, if recognized, would result in an adjustment to the Company s effective tax rate. The Company does not expect its unrecognized tax benefits to change significantly within the next twelve months.

The State of Hawaii Department of Taxation is presently auditing the Company s 2011 and 2012 Hawaii state income tax returns. The State of California Board of Equalization is presently auditing the Company s 2010, 2011, and 2012 sales and use tax filings. It is uncertain when the state audits will be completed. The Company believes that the final resolution of the state audits will not have a material impact on its financial condition or results of operations.

Note 9. Regulatory Assets and Liabilities

During 2011, the CPUC issued a decision regarding the $34.2 million of litigation proceeds previously received by Cal Water during 2008 which is being used to replace infrastructure damaged by the gasoline additive Methyl tert-butyl ether (MTBE). The decision requires use of these proceeds for costs incurred as a result of MTBE contamination with any related benefits to be provided to Cal Water customers. Such usage includes transfer of the amount to contributions in aid of construction (CIAC) for remediation or replacement project costs once complete. Usage of the proceeds is reported to the CPUC through an Advice Letter or General Rate Case filing. As of December 31, 2013, $28.3 million of the proceeds was recorded as CIAC and $0.9 million was spent on MTBE legal services. The remaining balance of $5.0 million is recorded as other long-term liabilities.

During 2011, Cal Water added balancing accounts for its pension plans and conservation program. Both balancing account effective dates were January 1, 2011. The pension plan s balancing account is a two-way balancing account that tracks the differences between actual expenses and adopted rate recovery which will result in either a regulatory asset or liability. The conservation program is a one-way balancing account that tracks the differences between actual expenses and adopted rate recovery which may result in a regulatory liability if actual conservation expenses are less than adopted over the three year period ending December 31, 2013. As of June 30, 2014 and December 31, 2013, the pension balancing account was a regulatory asset of $1.0 million and $3.0 million, respectively. The conservation balancing account was a regulatory liability of $6.8 million as of June 30, 2014 and $6.3 million as of December 31, 2013.

Note 10. Commitments and Contingencies

Commitments

The Company has significant commitments to lease certain office spaces and water systems and to purchase water from water wholesalers. These commitments are described in Form 10-K for the year ended December 31, 2013. As of June 30, 2014, there were no significant changes from December 31, 2013.

Contingencies

Groundwater Contamination

The Company has undertaken litigation against third parties to recover past and future costs related to ground water contamination in the Company s service areas. The cost of litigation is expensed as incurred and any settlement is first offset against such costs. The Commission s general policy requires all proceeds from contamination litigation to be used first to pay transactional expenses, then to make ratepayers whole for water treatment costs to comply with the Commission s water quality standards. The Commission allows for a risk-based consideration of contamination proceeds which exceed the costs of the remediation described above and may result in some sharing of proceeds with the shareholder, determined on a case by case basis. The Commission has authorized various memorandum accounts that allow the Company to track significant litigation costs to request recovery of these costs in future filings and uses of proceeds to comply with Commission s general policy.

Other Legal Matters

From time to time, the Company is involved in various disputes and litigation matters that arise in the ordinary course of business. The status of each significant matter is reviewed and assessed for potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount of the range of loss can be estimated, a liability is accrued for the estimated loss in accordance with the accounting standards for contingencies. Legal proceedings are subject to uncertainties, and the outcomes are difficult to predict. Because of such uncertainties, accruals are based on the best information available at the time. While the outcome of these disputes and litigation matters cannot be predicted with any certainty, management does not believe when taking into account existing reserves the ultimate resolution of these matters will materially affect the Company s financial position, results of operations, or cash flows. The Company recognized a liability of $2.5 million and $1.3 million for all known legal matters as of June 30, 2014 and December 31, 2013, respectively. The cost of litigation is expensed as incurred and any settlement is first offset against such costs. Any settlement in excess of the cost to litigate is accounted for on a case by case basis, dependant on the nature of the settlement.

Note 11. Fair Value of Financial Assets and Liabilities

The accounting guidance for fair value measurements and disclosures provides a single definition of fair value and requires certain disclosures about assets and liabilities measured at fair value. A hierarchal framework for disclosing the observability of the inputs utilized in measuring assets and liabilities at fair value is established by this guidance. The three levels in the hierarchy are as follows:

Level 1 - Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. The types of assets and liabilities included in Level 1 are highly liquid and actively traded instruments with quoted prices.

Level 2 - Pricing inputs are other than quoted prices in active markets, but are either directly or indirectly observable as of the reporting date. The types of assets and liabilities included in Level 2 are typically either comparable to actively traded securities or contracts, or priced with discounted cash flow or option pricing models using highly observable inputs.

Level 3 - Significant inputs to pricing have little or no observability as of the reporting date. The types of assets and liabilities included in Level 3 are those valued with models requiring significant management judgment or estimation.

Specific valuation methods include the following:

Cash equivalents, accounts receivable and accounts payable carrying amounts approximated the fair value because of the short-term maturity of the instruments.

Long-term debt fair values were estimated using the published quoted market price, if available, or the discounted cash flow analysis, based on the current rates available using a risk-free rate (a U.S. Treasury securities yield curve) plus a risk premium of 1.19%.

Advances for construction fair values were estimated using broker quotes from companies that frequently purchase these investments.

	June 30, 2014				
		Fair Value			
	Cost	**Level 1**	**Level 2**	**Level 3**	**Total**
Long -term debt, including current maturities	$ 429,884		$ 526,155		$ 526,155
Advances for construction	181,443		74,365		74,365
Total	$ 611,327	$	$ 600,520	$	$ 600,520

	December 31, 2013				
		Fair Value			
	Cost	**Level 1**	**Level 2**	**Level 3**	**Total**
Long -term debt, including current maturities	$ 434,050	$	$ 511,146	$	$ 511,146
Advances for construction	183,393		73,389		73,389
Total	$ 617,443		$ 584,535	$	$ 584,535

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Note 12. Subsequent Event

On July 21, 2014, the California Public Utilities Commission (CPUC) issued a proposed decision authorizing rate increases in all regulated operating districts in California effective January 1, 2014. The proposed decision authorizes an increase of $45.3 million or 9.2% in rates for 2014, $10.1 million or 1.9% in rates for 2015 and $10.0 million or 1.8% in rates for 2016 which includes completion of the Company s authorized capital projects. The authorized increase in rates for 2015 and 2016 is subject to the CPUC s escalation procedures. The proposed decision authorizes Cal Water to invest $448.9 million in districts throughout California over the three-year period from January 1, 2013 through December 31, 2015 in order to provide a safe and reliable water supply to its customers. Included in the $448.9 million in water system infrastructure improvements is $125.8 million that would be recovered through the CPUC s advice letter procedure upon completion of qualified projects.

Note 13. Condensed Consolidating Financial Statements

On April 17, 2009, Cal Water issued $100 million aggregate principal amount of 5.875% First Mortgage Bonds due 2019, and on November 17, 2010, Cal Water issued $100 million aggregate principal amount of 5.500% First Mortgage Bonds due 2040, all of which are fully and unconditionally guaranteed by the Company. As a result of these guarantee arrangements, we are required to present the following condensed consolidating financial information.

The following tables present the condensed consolidating balance sheets as of June 30, 2014 and December 31, 2013, the condensed consolidating statements of income for the three months ended June 30, 2014 and 2013, the condensed consolidating statements of income for the six months ended June 30, 2014 and 2013 and the condensed consolidating statements of cash flows for the six months ended June, 2014 and 2013 of (i) California Water Service Group, the guarantor of the first mortgage bonds and the parent company; (ii) California Water Service Company, the issuer of the first mortgage bonds and a 100% owned consolidated subsidiary of California Water Service Group; and (iii) the other 100% owned non-guarantor consolidated subsidiaries of California Water Service Group.

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING BALANCE SHEET

As of June 30, 2014

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
ASSETS					
Utility plant:					
Utility plant	$ 1,318	$ 2,087,926	$ 187,732	$ (7,197)	$ 2,269,779
Less accumulated depreciation and amortization	(263)	(691,815)	(39,857)	1,669	(730,266)
Net utility plant	1,055	1,396,111	147,875	(5,528)	1,539,513
Current assets:					
Cash and cash equivalents	731	27,646	1,329		29,706
Receivables and unbilled revenue		95,053	8,933	(850)	103,136
Receivables from affiliates	19,848	4,663	0	(24,511)	
Other current assets	213	16,614	1,139		17,966
Total current assets	20,792	143,976	11,401	(25,361)	150,808
Other assets:					
Regulatory assets		261,408	2,837		264,245
Investments in affiliates	564,224			(564,224)	
Long-term affiliate notes receivable	25,766			(25,766)	
Other assets	830	47,866	7,127	(205)	55,618
Total other assets	590,820	309,274	9,964	(590,195)	319,863
	$ 612,667	$ 1,849,361	$ 169,240	$ (621,084)	$ 2,010,184
CAPITALIZATION AND LIABILITIES					
Capitalization:					
Common stockholders equity	$ 595,892	$ 497,991	$ 71,630	$ (569,621)	$ 595,892
Affiliate long-term debt			25,766	(25,766)	
Long-term debt, less current maturities		422,229	1,105		423,334
Total capitalization	595,892	920,220	98,501	(595,387)	1,019,226
Current liabilities:					
Current maturities of long-term debt		6,155	395		6,550
Short-term borrowings	16,215	65,000			81,215
Payables to affiliates		1,087	23,424	(24,511)	
Accounts payable		67,773	3,133		70,906
Accrued expenses and other liabilities	871	60,343	3,007	(818)	63,403
Total current liabilities	17,086	200,358	29,959	(25,329)	222,074
Unamortized investment tax credits		2,106			2,106
Deferred income taxes, net	(311)	177,790	3,845	(368)	180,956
Pension and postretirement benefits other than pensions		145,426			145,426
Regulatory and other liabilities		81,221	8,913		90,134
Advances for construction		180,879	564		181,443
Contributions in aid of construction		141,361	27,458		168,819
	$ 612,667	$ 1,849,361	$ 169,240	$ (621,084)	$ 2,010,184

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING BALANCE SHEET

As of December 31, 2013

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
ASSETS					
Utility plant:					
Utility plant	$ 1,318	$ 2,034,935	$ 184,272	$ (7,197)	$ 2,213,328
Less accumulated depreciation and amortization	(164)	(661,780)	(37,168)	1,615	(697,497)
Net utility plant	1,154	1,373,155	147,104	(5,582)	1,515,831
Current assets:					
Cash and cash equivalents	5,280	20,790	1,436		27,506
Receivables and unbilled revenue	(756)	90,008	8,931	(94)	98,089
Receivables from affiliates	16,747	5,755		(22,502)	
Other current assets		13,011	884		13,895
Total current assets	21,271	129,564	11,251	(22,596)	139,490
Other assets:					
Regulatory assets		248,938	2,743		251,681
Investments in affiliates	565,347			(565,347)	
Long-term affiliate notes receivable	26,255			(26,255)	
Other assets	1,120	44,827	7,111	(205)	52,853
Total other assets	592,722	293,765	9,854	(591,807)	304,534
	$ 615,147	$ 1,796,484	$ 168,209	$ (619,985)	$ 1,959,855
CAPITALIZATION AND LIABILITIES					
Capitalization:					
Common stockholders equity	$ 598,756	$ 500,290	$ 70,548	$ (570,838)	$ 598,756
Affiliate long-term debt			26,255	(26,255)	
Long-term debt, less current maturities		424,854	1,288		426,142
Total capitalization	598,756	925,144	98,091	(597,093)	1,024,898
Current liabilities:					
Current maturities of long-term debt		6,137	1,771		7,908
Short-term borrowings	16,815	30,000			46,815
Payables to affiliates	48		22,454	(22,502)	
Accounts payable		51,764	3,323		55,087
Accrued expenses and other liabilities	107	55,346	1,321		56,774
Total current liabilities	16,970	143,247	28,869	(22,502)	166,584
Unamortized investment tax credits		2,106			2,106
Deferred income taxes, net	(579)	179,870	4,344	(390)	183,245
Pension and postretirement benefits other than pensions		145,451			145,451
Regulatory and other liabilities		77,627	8,828		86,455
Advances for construction		182,776	617		183,393
Contributions in aid of construction		140,263	27,460		167,723
	$ 615,147	$ 1,796,484	$ 168,209	$ (619,985)	$ 1,959,855

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the three months ended June 30, 2014

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating revenue	$	$ 150,340	$ 8,076	$	$ 158,416
Operating expenses:					
Operations:					
Water production costs		59,514	2,401		61,915
Administrative and general	33	21,090	2,673		23,796
Other		14,363	1,767	(126)	16,004
Maintenance		4,833	155		4,988
Depreciation and amortization	57	14,961	1,095	(26)	16,087
Income tax (benefit) expense	(55)	7,429	(421)	237	7,190
Taxes other than income taxes		4,493	651		5,144
Total operating expenses	35	126,683	8,321	85	135,124
Net operating (loss) income	(35)	23,657	(245)	(85)	23,292
Other Income and Expenses:					
Non-regulated revenue	450	3,208	370	(554)	3,474
Non-regulated expenses, net		(2,109)	(144)		(2,253)
Income tax (expense) on other income and expense	(184)	(447)	(76)	226	(481)
Net other income	266	652	150	(328)	740
Interest:					
Interest expense	46	6,984	476	(429)	7,077
Less: capitalized interest		(197)	(18)		(215)
Net interest expense	46	6,787	458	(429)	6,862
Equity earnings of subsidiaries	16,985			(16,985)	
Net income (loss)	$ 17,170	$ 17,522	$ (553)	$ (16,969)	$ 17,170

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the three months ended June 30, 2013

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating revenue	$	$ 146,730	$ 7,825	$	$ 154,555
Operating expenses:					
Operations:					
Water production costs		57,102	2,543		59,645
Administrative and general		20,460	2,695		23,155
Other		15,418	1,737	(125)	17,030
Maintenance		4,029	159		4,188
Depreciation and amortization	28	13,697	794	(28)	14,491
Income tax (benefit) expense	(93)	9,813	(542)	370	9,548
Taxes other than income taxes		5,015	700		5,715
Total operating (income) expenses	(65)	125,534	8,086	217	133,772
Net operating income (loss)	65	21,196	(261)	(217)	20,783
Other Income and Expenses:					
Non-regulated revenue	597	3,005	408	(795)	3,215
Non-regulated expenses, net		(2,873)	(367)		(3,240)
Income tax (expense) on other income and expense	(244)	(54)	(45)	359	16
Net other income (expense)	353	78	(4)	(436)	(9)
Interest:					
Interest expense	199	7,631	642	(669)	7,803
Less: capitalized interest		(405)	(134)		(539)
Net interest expense	199	7,226	508	(669)	7,264
Equity earnings of subsidiaries	13,291			(13,291)	
Net income (loss)	$ 13,510	$ 14,048	$ (773)	$ (13,275)	$ 13,510

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the six months ended June 30, 2014

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating revenue	$	$ 254,089	$ 14,842	$	$ 268,931
Operating expenses:					
Operations:					
Water production costs		102,882	4,435		107,317
Administrative and general	33	43,862	5,042		48,937
Other		29,025	3,607	(252)	32,380
Maintenance		9,656	337		9,993
Depreciation and amortization	100	29,915	2,178	(53)	32,140
Income tax (benefit) expense	(105)	4,081	(1,079)	454	3,351
Taxes other than income taxes		9,143	1,226		10,369
Total operating expenses	28	228,564	15,746	149	244,487
Net operating (loss) income	(28)	25,525	(904)	(149)	24,444
Other Income and Expenses:					
Non-regulated revenue	917	7,237	747	(1,147)	7,754
Non-regulated expenses, net		(5,748)	(624)		(6,372)
Income tax (expense) on other income and expense	(374)	(606)	(12)	432	(560)
Net other income	543	883	111	(715)	822
Interest:					
Interest expense	125	13,944	979	(896)	14,152
Less: capitalized interest		(538)	(42)		(580)
Net interest expense	125	13,406	937	(896)	13,572
Equity earnings of subsidiaries	11,304			(11,304)	
Net income (loss)	$ 11,694	$ 13,002	$ (1,730)	$ (11,272)	$ 11,694

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF INCOME

For the six months ended June 30, 2013

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating revenue	$	$ 251,161	$ 14,838	$	$ 265,999
Operating expenses:					
Operations:					
Water production costs		96,543	4,799		101,342
Administrative and general		43,069	5,367		48,436
Other		29,607	3,320	(252)	32,675
Maintenance		7,994	327		8,321
Depreciation and amortization	28	27,454	1,694	(56)	29,120
Income tax (benefit) expense	(229)	9,086	(1,171)	716	8,402
Taxes other than income taxes		9,869	1,281		11,150
Total operating (income) expenses	(201)	223,622	15,617	408	239,446
Net operating income (loss)	201	27,539	(779)	(408)	26,553
Other Income and Expenses:					
Non-regulated revenue	1,167	6,187	940	(1,557)	6,737
Non-regulated expenses, net		(4,793)	(864)		(5,657)
Income tax (expense) on other income and expense	(476)	(568)	(84)	693	(435)
Net other income (expenses)	691	826	(8)	(864)	645
Interest:					
Interest expense	533	15,358	1,254	(1,305)	15,840
Less: capitalized interest		(784)	(295)		(1,079)
Net interest expense	533	14,574	959	(1,305)	14,761
Equity earnings of subsidiaries	12,078			(12,078)	
Net income (loss)	$ 12,437	$ 13,791	$ (1,746)	$ (12,045)	$ 12,437

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

For the six months ended June 30, 2014

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating activities:					
Net income (loss)	$ 11,694	$ 13,002	$ (1,730)	$ (11,272)	$ 11,694
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:					
Equity earnings of subsidiaries	(11,304)			11,304	
Dividends received from affiliates	15,527			(15,527)	
Depreciation and amortization	100	30,852	2,263	(53)	33,162
Changes in value of life insurance contracts		(721)			(721)
Other changes in noncurrent assets and liabilities	1,570	23,088	(551)	21	24,128
Changes in operating assets and liabilities:	(249)	(26,137)	1,307		(25,079)
Net cash provided by operating activities	17,338	40,084	1,289	(15,527)	43,184
Investing activities:					
Utility plant expenditures		(53,437)	(3,610)		(57,047)
Changes in affiliate advances	(6,175)	1,092		5,083	
Proceeds from affiliates long-term debt	462			(462)	
Purchase of life insurance contracts		(1,707)			(1,707)
Changes in restricted cash		313			313
Net cash (used in) investing activities	(5,713)	(53,739)	(3,610)	4,621	(58,441)
Financing Activities:					
Short-term borrowings	4,400	35,000			39,400
Repayment of short-term borrowings	(5,000)				(5,000)
Changes in affiliate advances	(47)	1,087	4,043	(5,083)	
Repayment of affiliates long-term borrowings			(462)	462	
Repayment of long-term debt		(2,607)	(1,556)		(4,163)
Advances and contributions in aid for construction		5,427	523		5,950
Refunds of advances for construction		(3,158)	(45)		(3,203)
Dividends paid to non-affiliates	(15,527)				(15,527)
Dividends paid to affiliates		(15,238)	(289)	15,527	
Net cash (used in) provided by financing activities	(16,174)	20,511	2,214	10,906	17,457
Change in cash and cash equivalents	(4,549)	6,856	(107)		2,200
Cash and cash equivalents at beginning of period	5,280	20,790	1,436		27,506
Cash and cash equivalents at end of period	$ 731	$ 27,646	$ 1,329	$	$ 29,706

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CALIFORNIA WATER SERVICE GROUP

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

For the six months ended June 30, 2013

(In thousands)

	Parent Company	Cal Water	All Other Subsidiaries	Consolidating Adjustments	Consolidated
Operating activities:					
Net income (loss)	$ 12,437	$ 13,791	$ (1,746)	$ (12,045)	$ 12,437
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:					
Equity earnings of subsidiaries	(12,078)			12,078	
Dividends received from affiliates	14,343			(14,343)	
Depreciation and amortization		28,350	1,794	(56)	30,088
Change in value of life insurance contracts		(504)			(504)
Other changes in noncurrent assets and liabilities	108	883	336	23	1,350
Changes in operating assets and liabilities	(514)	(7,765)	1,684		(6,595)
Net cash provided by operating activities	14,296	34,755	2,068	(14,343)	36,776
Investing activities:					
Utility plant expenditures		(57,764)	(8,426)		(66,190)
Investment in affiliates	(35,000)			35,000	
Net changes in affiliate advances	(7,294)	(324)	742	6,876	
Repayment of affiliates long-term debt	605	7,796		(8,401)	
Purchase of life insurance		(1,608)			(1,608)
Changes in restricted cash and other changes, net		1,079			1,079
Net cash (used in) investing activities	(41,689)	(50,821)	(7,684)	33,475	(66,719)
Financing Activities:					
Short-term borrowings	12,615	20,000			32,615
Repayment of short-term borrowings	(68,275)	(25,000)			(93,275)
Proceeds from long-term debt			48		48
Repayment of long-term debt		(2,230)	(323)		(2,553)
Net changes in affiliate advances	758	(892)	7,010	(6,876)	
Repayment of affiliates long-term debt	(7,796)		(605)	8,401	
Advances and contributions in aid for construction		4,989	17		5,006
Refunds of advances for construction		(3,467)	(45)		(3,512)
Dividends paid to non-affiliates	(14,343)				(14,343)
Dividends paid to affiliates		(12,889)	(1,454)	14,343	
Issuance of common stock, net	105,835				105,835
Investment from affiliates		35,000		(35,000)	
Net cash provided by financing activities	28,794	15,511	4,648	(19,132)	29,821
Change in cash and cash equivalents	1,401	(555)	(968)		(122)
Cash and cash equivalents at beginning of period	1,470	34,609	2,711		38,790
Cash and cash equivalents at end of period	$ 2,871	$ 34,054	$ 1,743	$	$ 38,668

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Item 2

MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(Dollar amounts in thousands, except where otherwise noted and per share amounts)

FORWARD LOOKING STATEMENTS

This quarterly report, including all documents incorporated by reference, contains forward-looking statements within the meaning established by the Private Securities Litigation Reform Act of 1995 (Act). Forward-looking statements in this quarterly report are based on currently available information, expectations, estimates, assumptions and projections, and our management s beliefs, assumptions, judgments and expectations about us, the water utility industry and general economic conditions. These statements are not statements of historical fact. When used in our documents, statements that are not historical in nature, including words like expects, intends, plans, believes, may, estimates, assumes, anticipates, projects, predicts, forecasts, should, seeks, or variations of these words or similar expressions are intended to identify forward-looking statements. The forward-looking statements are not guarantees of future performance. They are based on numerous assumptions that we believe are reasonable, but they are open to a wide range of uncertainties and business risks. Consequently, actual results may vary materially from what is contained in a forward-looking statement.

Factors which may cause actual results to be different than those expected or anticipated include, but are not limited to:

- governmental and regulatory commissions decisions, including decisions on proper disposition of property;
- changes in regulatory commissions policies and procedures;
- the timeliness of regulatory commissions actions concerning rate relief;
- changes in the capital markets and access to sufficient capital on satisfactory terms;
- new legislation;

- changes in California Department of Public Health water quality standards;
- changes in environmental compliance and water quality requirements;
- changes in accounting valuations and estimates;
- changes in accounting treatment for regulated companies, including adoption of International Financial Reporting Standards, if required;
- electric power interruptions;
- increases in suppliers prices and the availability of supplies including water and power;
- fluctuations in interest rates;
- litigation that may result in damages or costs not recoverable from third parties;
- acquisitions and the ability to successfully integrate acquired companies;
- the ability to successfully implement business plans;
- civil disturbances or terrorist threats or acts, or apprehension about the possible future occurrences of acts of this type;
- the involvement of the United States in war or other hostilities;
- our ability to attract and retain qualified employees;

- labor relations matters as we negotiate with the unions;

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- federal health care law changes could result in increases to Company health care costs and additional income tax expenses in future years;
- changes in federal and state income tax regulations and treatment of such by regulatory commissions;
- implementation of new information technology systems;
- changes in operations that result in an impairment to acquisition goodwill;
- restrictive covenants in or changes to the credit ratings on current or future debt that could increase financing costs or affect the ability to borrow, make payments on debt, or pay dividends;
- our general economic conditions, including changes in customer growth patterns and the Company s ability to collect billed revenue from customers;
- changes in customer water use patterns and the effects of conservation;
- the impact of weather and climate on water sales and operating results;
- the ability to satisfy requirements related to the Sarbanes-Oxley and Dodd-Frank Acts and other regulations on internal controls; and
- the risks set forth in Risk Factors included elsewhere in this quarterly report.

In light of these risks, uncertainties and assumptions, investors are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date of this quarterly report or as of the date of any document incorporated by reference in this report, as applicable. When considering forward-looking statements, investors should keep in mind the cautionary statements in this quarterly report and the documents incorporated by reference. We are not under any obligation, and we expressly disclaim any obligation, to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise.

CRITICAL ACCOUNTING POLICIES

We maintain our accounting records in accordance with accounting principles generally accepted in the United States of America (GAAP) and as directed by the Commissions to which our operations are subject. The process of preparing financial statements in accordance with GAAP requires the use of estimates on the part of management. The estimates used by management are based on historic experience and an understanding of current facts and circumstances. Management believes that the following accounting policies are critical because they involve a higher degree of complexity and judgment, and can have a material impact on our results of operations, financial condition, and cash flows of the business. These policies and their key characteristics are discussed in detail in the 2013 Form 10-K. They include:

- revenue recognition and the water revenue adjustment mechanism;
- modified cost balancing accounts;
- expense balancing and memorandum accounts;
- regulatory utility accounting;
- income taxes;
- pension benefits;
- workers compensation and other claims;
- goodwill accounting and evaluation for impairment; and
- contingencies.

For the six-month period ended June 30, 2014, there were no changes in the methodology for computing critical accounting estimates, no additional accounting estimates met the standards for critical accounting policies, and there were no material changes to the important assumptions underlying the critical accounting estimates.

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RESULTS OF SECOND QUARTER 2014 OPERATIONS COMPARED TO

SECOND QUARTER 2013 OPERATIONS

Amounts in thousands except share data

Overview

Net income for the three month period ended June 30, 2014 was $17.2 million or $0.36 per diluted common share compared to net income of $13.5 million or $0.28 per diluted common share for the three month period ended June 30, 2013. Net income increased $3.7 million during the second quarter of 2014 compared to the second quarter of 2013. The increase was due to a $2.5 million one time tax benefit, an increase in estimated unbilled revenue, and a decrease in net interest expense which was partially offset by operating expense increases. The increase in the unbilled revenue estimate resulted in an increase in pre-tax income of $4.3 million for the three month period ended June 30, 2014 and was driven by higher customer consumption at the end of the quarter. Unbilled revenue does not affect the WRAM calculation or balance. The operating cost increases were driven by depreciation expense increases for plant placed in service during 2013, mains and well maintenance cost increases, an increase in uninsured losses, and wage increases which were effective January 1, 2014. Net other income, net of income taxes, increased $0.7 million, mostly due to a higher unrealized gain on our benefit plan insurance investments during the second quarter of 2014 compared to the second quarter of 2013.

Operating Revenue

Operating revenue increased $3.9 million or 2.5% to $158.4 million in the second quarter of 2014. The factors that impacted the operating revenue for the second quarter of 2014 as compared to 2013 are as follows:

Net effect of WRAM	$	8,601
Pension balancing account		(1,724)
Conservation balancing account		739
Net change due to usage and other		(3,845)
Rate increases		1,085
Deferral of net WRAM and MCBA revenue		(995)
Net operating revenue increase	$	3,861

The net effect of WRAM in the above table was the revenue changes recognized by the WRAM and MCBA. The WRAM is impacted by changes in consumption patterns from our historical trends as well as an increase in conservation efforts. The MCBA, which records the differences in production costs from the adopted costs, is recorded as an adjustment to revenue as it represents pass through costs which are billed to customers. The MCBA is impacted by changes in total production quantities, the production mix of the source of water, the price paid for purchased water and power, and the amount of pump taxes paid. The net change during the three months ended June 30, 2014 compared to the three months ended June 30, 2013 resulted in an increase to revenue of $8.6 million due to a decrease in consumption in 2014 which increased the WRAM and MCBA adjustment because actual consumption was farther from the adopted values in 2014 compared to 2013.

The pension balancing account in the above table refers to the difference between actual expenses and adopted rate recovery. The decrease of $1.7 million is due to lower actual pension expenses as compared to adopted rate recovery in 2014.

The net change in usage and other in the above table was the difference between actual metered customer consumption during the three months ended June 30, 2014 and the three months ended June 30, 2013. The $3.8 million usage and other revenue decrease was due to a decrease in customer consumption during the second quarter of 2014 compared to 2013. This was partially offset by a $4.3 million increase in accrued unbilled operating revenue which is not a component of the WRAM. The quarterly changes in the accrued unbilled operating revenue usually vary year over year. These changes are usually most variable in the first and third quarters due to weather conditions and have not had a significant impact on annual revenue in past years.

The deferral of net WRAM and MCBA revenue in the table above occurs whenever a district net receivable balance is estimated to be collected more than 24 months after the respective reporting period in which it was recognized. The deferrals are reversed when district net receivable balances are estimated to be collected within 24-months. The $1.0 million net revenue decrease during the second quarter of 2014 as compared to the second quarter of 2013 was mostly due to a larger deferral of net WRAM and MCBA revenues during the second quarter of 2014 as compared to the second quarter of 2013. The deferral in 2014 has increased because of a decrease in actual consumption relative to adopted consumption, which has caused an increase in the net receivables that are expected to be collected more than 24 months after the respective reporting period in which it was recognized.

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The components of the rate increases are as follows:

Purchased water offset increases	$	1,009
General rate case (GRC) increases		76
Total increase in rates	$	1,085

Total Operating Expenses

Total operating expenses were $135.1 million for the second quarter of 2014, versus $133.8 million for the same period in 2013, a 1% increase.

Water production expense consists of purchased water, purchased power, and pump taxes. It represents the largest component of total operating expenses, accounting for approximately 46% of total operating expenses in the second quarter of 2014. Water production expenses increased 4% compared to the same period last year mostly due to purchased water price increases and an increase in customer usage.

Sources of water as a percent of total water production are listed in the following table:

	Three Months Ended June 30	
	2014	**2013**
Well production	51%	47%
Purchased	46%	48%
Surface	3%	5%
Total	100%	100%

The components of water production costs are shown in the table below:

	Three Months Ended June 30					
		2014		**2013**		**Change**
Purchased water	$	49,150	$	47,883	$	1,267
Purchased power		9,133		8,778		355
Pump taxes		3,632		2,984		648
Total	$	61,915	$	59,645	$	2,270

Purchased water costs increased due to price increases from water wholesalers. Total water production, measured in acre feet, decreased by 2% during the second quarter of 2014 as compared to the second quarter of 2013.

Administrative and general expense and other operations expense decreased 1% to $39.8 million during the second quarter of 2014 as compared to the second quarter of 2013 mostly due to a decrease in conservation plan program expenses due to the success of prior years conservation efforts, a decrease in pension benefit expenses which was partially offset by an increase in uninsured losses, and employee wage increases. Wage increases became effective January 1, 2014. At June 30, 2014, there were 1,128 employees and at June 30, 2013, there were 1,127 employees.

Maintenance expense increased by 19% to $5.0 million in the second quarter of 2014 compared to $4.2 million in the second quarter of 2013, due to an increase in groundwater treatment facilities, transmission and distribution mains, pumping equipment, and well repair costs.

Depreciation and amortization expense increased $1.6 million, or 11%, mostly due to 2013 capital additions.

Federal and state income tax expense for operating expenses decreased $2.4 million in the second quarter of 2014 as compared to the second quarter of 2013 because of a $2.5 million one time tax benefit during the second quarter of 2014. Federal and state income taxes charged to other income and expenses increased $0.5 million in the second quarter of 2014 mostly due to an increase in unrealized gains on our benefit plan insurance investments. We expect the effective tax rate to be between 37% and 41% for fiscal year 2014.

Property and other taxes decreased $0.6 million during the second quarter of 2014 as compared to the second quarter of 2013 due to a reduction in our assessed property values effective July 1, 2013.

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Other Income and Expenses

Net other income increased $0.7 million in the second quarter of 2014 mostly due to an increase in unrealized gains on our benefit plan insurance investments. The unrealized gain on our benefit plan insurance investments increased $0.6 million during the second quarter of 2014 compared to the same period last year.

Interest Expense

Net interest expense, net of interest capitalized, decreased $0.4 million, or 6%, to $6.9 million for the second quarter of 2014 compared to the same period last year. The decrease was mostly due to $40.0 million of first mortgage bonds maturing during the fourth quarter of 2013 which was partially offset by an increase in short term borrowings and a decrease in capitalized interest charged to construction projects.

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RESULTS OF THE SIX MONTHS ENDED JUNE 30, 2014 OPERATIONS COMPARED TO

THE SIX MONTHS ENDED JUNE 30, 2013 OPERATIONS

Amounts in thousands except share data

Overview

Net income for the six month period ended June 30, 2014 was $11.7 million or $0.24 per diluted common share compared to a net income of $12.4 million or $0.28 per diluted common share for the six month period ended June 30, 2013. Net income decreased $0.7 million during the first six months of 2014 compared to the first six months of 2013 due to operating cost increases which was partially offset by a $2.5 million one time tax benefit, an increase in the estimated unbilled revenue, and decrease in net interest expense. The increase in the estimated unbilled revenue resulted in an increase in pre-tax income of $1.7 million for the six month period ended June 30, 2014 and was driven by higher customer consumption at the end of the quarter. Unbilled revenue does not affect the WRAM calculation or balance. The operating cost increases were driven by depreciation expense increases for plant placed in service during 2013, mains and well maintenance cost increases, an increase in uninsured losses, and wage and health care cost increases. Net other income, net of income taxes, increased $0.2 million, mostly due to a higher unrealized gain on our benefit plan insurance investments during the first six months of 2014 compared to the first six months of 2013.

Operating Revenue

Operating revenue increased $2.9 million or 1% to $268.9 million during the first six months of 2014. The factors that impacted the operating revenue during the first six months of 2014 as compared to the first six months of 2013 are as follows:

Net effect of WRAM	$	3,946
Pension balancing account		(3,374)
Conservation balancing account		(203)
Net change due to usage and other		(458)
Rate increases		2,955
Deferral of net WRAM and MCBA revenue		66
Net operating revenue increase	$	2,932

The net effect of WRAM in the above table was the revenue changes recognized by the WRAM and MCBA. The WRAM is impacted by changes in consumption patterns from our historical trends as well as an increase in conservation efforts. The MCBA, which records the differences in production costs from the adopted costs, is recorded as an adjustment to revenue as it represents pass through costs which are billed to customers. The MCBA is impacted by changes in total production quantities, the production mix of the source of water, the price paid for purchased water and power, and the amount of pump taxes paid. The net change during the six months ended June 30, 2014 compared to the six months ended June 30, 2013 resulted in an increase to revenue of $3.9 million due to an increase in water production costs due to wholesaler water rate increases.

The pension balancing account in the above table refers to the difference between actual expenses and adopted rate recovery. The decrease of $3.4 million is due to lower actual pension expenses as compared to adopted rate recovery in 2014.

The net change in usage and other in the above table was the difference between actual metered customer consumption during the six months ended June 30, 2014 and the six months ended June 30, 2013. The $0.5 million usage and other revenue decrease was due to a decrease in flat rate customer revenue during the six months ended 2014 compared to the six months ended June 2013 as the Company has continued to work to convert flat rate customer to metered customers. This was partially offset by an increase in accrued unbilled operating revenue which is not a component of the WRAM. The changes in the accrued unbilled operating revenue usually vary year over year. These changes are usually most variable in the first and third quarters due to weather conditions and have not had a significant impact on annual revenue in past years.

The deferral of net WRAM and MCBA revenue in the table above occurs whenever a district net receivable balance is estimated to be collected more than 24 months after the respective reporting period in which it was recognized. The deferrals are reversed when district net receivable balances are estimated to be collected within 24-months. The $0.1 million net revenue increase during the six months ended 2014 as compared to the six months ended 2013 was mostly due to similar actual consumption relative to adopted consumption for the periods

The components of the rate increases are as follows:

Purchased water offset increases	$	2,789
General rate case (GRC) increases		166
Total increase in rates	$	2,955

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Total Operating Expenses

Total operating expenses were $244.5 million for the first six months of 2014, compared to $239.4 million for the same period in 2013, a 2% increase.

Water production expense consists of purchased water, purchased power, and pump taxes. It represents the largest component of total operating expenses, accounting for approximately 44% of total operating expenses during the first six months 2014. Water production expenses increased 6% compared to the same period last year mostly due to purchased water price increases and an increase in customer usage.

Sources of water as a percent of total water production are listed in the following table:

	Six Months Ended June 30	
	2014	**2013**
Well production	49%	46%
Purchased	48%	49%
Surface	3%	5%
Total	100%	100%

The components of water production costs are shown in the table below:

	Six Months Ended June 30					
	2014		**2013**		**Change**	
Purchased water	$	86,428	$	82,729	$	3,699
Purchased power		14,706		13,629		1,077
Pump taxes		6,183		4,984		1,199
Total	$	107,317	$	101,342	$	5,975

Purchased water costs increased due to price increases from water wholesalers. Total water production, measured in acre feet, increased by 1% during the first six months of 2014 as compared to the first six months of 2013.

Administrative and general expense and other operations expense increased $0.2 million to $81.3 million during the first six months of 2014 as compared to the first six months of 2013 mostly due to increases in employee wages and health care costs and uninsured losses which was partially offset by a decrease in employee pension benefit costs and a decrease in conservation plan program expenses due to the success of prior years conservation efforts. Wage increases became effective January 1, 2014.

Maintenance expense increased by 20% to $10.0 million during the first six months of 2014 compared to $8.3 million during the first six months of 2013, due to an increase in groundwater treatment facilities, transmission and distribution mains, pumping equipment, and well repair costs.

Depreciation and amortization expense increased $3.0 million, or 10%, mostly due to 2013 capital additions.

Federal and state income tax expense for operating expenses decreased $5.1 million during the first six months of 2014 because of a $2.5 million one time tax benefit and a decrease in pre-tax income during the first six months of 2014 as compared to the first six months of 2013. Federal and state income taxes charged to other income and expenses increased $0.1 million during the first six months of 2014 mostly due to an increase in unrealized gains on our benefit plan insurance investments. We expect the effective tax rate to be between 37% and 41% for fiscal year 2014.

Property and other taxes decreased $0.8 million during the first six months of 2014 as compared to the first six months of 2013 due to a reduction in our assessed property values, effective July 1, 2013.

Other Income and Expenses

Net other income increased $0.2 million during the first six months of 2014 due to an increase in unrealized gains on our benefit plan insurance investments. The unrealized gain on our benefit plan insurance investments increased $0.2 million during the first six months of 2014 compared to the same period last year.

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Interest Expense

Net interest expense, net of interest capitalized, decreased $1.2 million, or 8%, to $13.6 million for the six month period ended June 30, 2014 compared to the same period in 2013. The decrease was mostly due to $40.0 million of first mortgage bonds maturing during the fourth quarter of 2013 which was partially offset by an increase in short term borrowings and a decrease in capitalized interest charged to construction projects.

REGULATORY MATTERS

Rates and Regulation

The state regulatory commissions have plenary powers setting rates and operating standards. As such, state commission decisions significantly impact the Company s revenues, earnings, and cash flows. The amounts discussed herein are generally annual amounts, unless specifically stated, and the financial impact to recorded revenue is expected to occur over a 12-month period from the effective date of the decision. In California, water utilities are required to make several different types of filings. Most filings result in rate changes that remain in place until the next General Rate Case (GRC). As explained below, surcharges and surcredits to recover balancing and memorandum accounts as well as general rate case interim rate relief are temporary rate changes, which have specific time frames for recovery.

GRCs, escalation rate increase filings, and offset filings change rates to amounts that will remain in effect until the next GRC. The CPUC follows a rate case plan, which requires Cal Water to file a GRC for each of its regulated operating districts every three years. In a GRC proceeding, the CPUC not only considers the utility s rate setting requests, but may also consider other issues that affect the utility s rates and operations. The CPUC is generally required to issue its GRC decision prior to the first day of the test year or authorize interim rates. In accordance with the rate case plan, the Commission issued a decision on Cal Water s 2009 general rate case filing in the fourth quarter of 2010 with rates effective on January 1, 2011. In accordance with the CPUC s rate case plan for Class A water utilities Cal Water filed a GRC on July 5, 2012, which is applicable to all of its California Districts. Any rate change as a result of that filing will be effective as of January 1, 2014.

Between GRC filings utilities may file escalation rate increases, which allow the utility to recover cost increases, primarily from inflation and incremental investment, during the second and third years of the rate case cycle. However, escalation rate increases are subject to a weather-normalized earnings test on a district-by-district basis. Under the earnings test, the CPUC may reduce the escalation rate increase if, in the most recent 12-month period, this earnings test reflects earnings in excess of what was authorized for that district.

In addition, California water utilities are entitled to make offset filings. Offset filings may be filed to adjust revenues for construction projects authorized in GRCs when the plant is placed in service (referred to as ratebase offets), or for rate changes charged to the Company for purchased water, purchased power, and pump taxes (referred to as offsettable expenses). Such rate changes approved in offset filings remain in effect until the next GRC is approved.

In pursuit of the CPUC s water conservation goals, the CPUC decoupled Cal Water s revenue requirement from customer consumption levels in 2008 by authorizing WRAM/MCBA for each ratemaking area. The WRAM/MCBA ensure that Cal Water recovers all of the quantity revenues

authorized by the CPUC, and no more, regardless of customer consumption. This removes the Company s historical disincentive against the promotion of lower water usage among customers. Through an annual advice letter filing, Cal Water recovers any uncollected quantity revenue amounts authorized, or refunds over-collected quantity revenues, via surcharges and surcredits. The advice letters are filed between February and April of each year and address the net WRAM/MCBA balances collected for the previous calendar year. Most WRAM/MCBA balances have been revenue under- collections that are amortized through surcharges for a period of 12 or 18 months. The WRAM/MCBA amounts are cumulative, so if they are not amortized in a given calendar year, the balance will be carried forward and included with the following year balance.

2014 Regulatory Activity

California GRC filing

On July 5, 2012, Cal Water filed a GRC application seeking rate increases in all regulated operating districts in California beginning January 1, 2014. The GRC application requested an increase of $92.7 million or 19.4% in rates for 2014, $17.2 million or 3.0% in rates for 2015 and $16.9 million or 2.9% in rates for 2016. In addition to the CPUC s Office of Ratepayer Advocates

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(ORA), (formerly the Division of Ratepayer Advocates), several other entities representing various districts intervened in the case to become active parties. In early 2013, six parties submitted testimony in response to Cal Water s application, and Cal Water submitted rebuttal testimony. Settlement negotiations began in May 2013, and on October 30, 2013, Cal Water entered into a settlement agreement with all parties who were active in the case.

On December 19, 2013, the assigned Administrative Law Judge granted Cal Water s request to continue applying existing rates on and after January 1, 2014 as interim rates and is allowing Cal Water to track the difference between interim rates and the new rates eventually adopted by the Commission in a memorandum account. Once the Commission issues a final order and new rates are implemented, the memorandum account balance will be collected and amortized through customer surcharges. On July 21, 2014, the California Public Utilities Commission issued its proposed decision authorizing Cal Water to increase rates by $45.3 million or 9.2% in 2014, $10.1 million or 1.9% in 2015 and $10.0 million or 1.8% in 2016. Also, the proposed decision authorizes Cal Water to invest $448.9 million in districts throughout California over the three-year period from January 1, 2013 through December 31, 2015 in order to provide a safe and reliable water supply to its customers. Included in the $448.9 million in water system infrastructure improvements is $125.8 million that would be recovered through the Commission s advice letter procedure upon completion of qualified projects which we estimate would provide an additional $19.0 million in revenue. The Company expects the CPUC to finalize the proposed decision in the third quarter of 2014.

Federal Income Tax Bonus Depreciation

In 2011, Cal Water filed for and received approval to track the benefits from federal income tax accelerated depreciation in a memorandum account due to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Additional federal income tax deductions for assets placed in service after September 8, 2010, and before December 31, 2011, were $0.1 million for 2010 and $12.2 million for 2011. The memorandum account may result in a surcredit because of the impact to Cal Water s revenue requirement for changes to working cash estimates, reductions to federal income tax qualified U.S. production activities deductions (QPAD), and changes to contributions-in-aid-of-construction. As of June 30, 2014 and December 31, 2013, the estimated surcredit range is between $1.5 million and $2.0 million. The CPUC will determine the disposition of amounts recorded in the memorandum account in Cal Water s next GRC proceeding.

Selma Groundwater Surcharges

In January 2014, Cal Water and the City of Selma jointly filed an application to apply groundwater surcharges to customers in the Selma District. The surcharges would be used by the City of Selma and the Consolidated Irrigation District for groundwater recharge projects in the Upper Kings River Basin, which is in overdraft. If the CPUC approves the application, groundwater surcharges would be applied to customer bills, and phased in over 8 years, to eventually collect approximately $0.8 million a year for remittance to the City of Selma. The Office of Ratepayer Advocates has submitted testimony opposing the application, and Cal Water and the City of Selma have submitted rebuttal testimony. An evidentiary hearing was held in July, 2014.

WRAM/MCBA filings

In March 2014, Cal Water filed three advice letters to true up the revenue under-collections in the 2013 annual WRAMs/MCBAs of its regulated districts. A total under- collection of $34.9 million is being recovered from customers in the form of 12, 18 or 20+ month surcharges (balances

that are relative to the district s annual revenues are recovered over longer time periods).

Expense Offset filings

Expense offsets are dollar-for-dollar increases in revenue to match increased expenses, and therefore do not affect net operating income. Cal Water did not file any expense offsets in the second quarter of 2014.

Ratebase Offset filings

For construction projects that are authorized in GRCs as advice letter projects, companies are allowed to file rate base offsets to increase revenues after the plant is placed into service. Cal Water did not file any Ratebase offsets in the second quarter of 2014.

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Regulatory Activity Other States

2011 Pukalani (Hawaii) GRC Filing

In August 2011, Hawaii Water filed a general rate case for Pukalani. On January 15, 2014, Hawaii Water received a Decision and Order for the general rate case for the Pukalani wastewater system approving $0.59 million in additional annual revenues. Hawaii Water reached a comprehensive and conceptual settlement with the Consumer Advocate. This decision approved an increase of $0.28 million in 2014, another increase of $0.15 million in 2015, and another increase of $0.15 million in 2016. Each increase is separated by one year. The new rates for 2014 were implemented in February.

2012 Waikoloa (Hawaii) GRC Filings

In August 2012, Hawaii Water filed general rate cases for the Waikoloa Village Water, Waikoloa Village Wastewater and Waikoloa Resort Utilities requesting $6.3 million in additional annual revenues. The cases are being processed at this time on separate schedules. Hawaii Water and the Consumer Advocate reached settlements on the rate filings for Waikoloa Village Water, Wastewater, and Resort Utilities which would increase annual revenues by $2.7 million if adopted by the Hawaii Public Utilities Commission. On July 16, 2014, the Hawaii Public Utilities Commission approved Waikaloa Resort Utilities, Inc. general rate case authorizing annual revenue increase of $2.0 million.

LIQUIDITY

Cash flow from Operations

Cash flow from operations for the first six months of 2014 was $43.2 million compared to $36.8 million for the same period of 2013. Cash generated by operations varies during the year due to customer billings, timing of contributions to our benefit plans, and timing of estimated tax payments.

During the first six months of 2014 we made contributions of $16.4 million to our pension and retiree health care plans compared to contributions of $17.8 million made during the first six months of 2013. The 2014 estimated cash contribution to the pension plans is $26.8 million and to the other postretirement benefit plans is $9.6 million.

During the first six months of 2014 we received a $6.0 million refund for 2013 calendar year federal and state income tax payments. No federal and state income refunds were received during the prior year.

The water business is seasonal. Billed revenue is lower in the cool, wet winter months when less water is used compared to the warm, dry summer months when water use is highest. This seasonality results in the possible need for short-term borrowings under the bank lines of credit in the event cash is not available to cover operating and capital costs during the winter period. The increase in cash flows during the summer allows short-term borrowings to be paid down. Customer water usage can be lower than normal in years when more than normal precipitation falls in our service areas or temperatures are lower than normal, especially in the summer months. The reduction in water usage reduces cash flows from operations and increases the need for short-term bank borrowings. In addition, short-term borrowings are used to finance capital expenditures until long-term financing is arranged.

Investing Activities

During the first the first six months of 2014 and 2013, we used $57.0 million and $66.2 million, respectively, of cash for both company-funded and developer-funded capital expenditures. For 2014, our capital budget is approximately $110 to $130 million. Annual expenditures fluctuate each year due to the availability of construction resources and our ability to obtain construction permits in a timely manner.

Financing Activities

Net cash provided by financing activities was $17.5 million during the first six months of 2014 compared to $29.8 million for the same period of 2013.

During the first six months of 2014, we borrowed $39.4 million and paid down $5.0 million on our unsecured revolving credit facilities.

On March 26, 2013, we sold 5,750,000 shares of its common stock in an underwritten public offering for cash proceeds of approximately $105.6 million, net of underwriting discounts and commissions and offering expenses. The net proceeds from the sale of common stock were added to our general funds to be used for general corporate purposes. In April 2013, we used a portion of the net proceeds from the offering to repay outstanding borrowings on the Company and Cal Water lines of credit of $68.3 million and $25.0 million, respectively.

The undercollected net WRAM and MCBA receivable balances were $53.0 million as of June 30, 2014 and $46.3 million as of December 31, 2013, respectively. The undercollected balances were primarily financed by Cal Water using short-term and long-term financing arrangements to meet operational cash requirements. Interest on the undercollected balances, the interest recoverable from ratepayers, is limited to the current 90-day commercial paper rates which is significantly lower than Cal Water s short and long-term financing rates.

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Short-Term and Long-Term Financing

Short-term liquidity is provided by our unsecured revolving credit facilities, which were amended and replaced on June 29, 2011, and internally generated funds. Long-term financing is accomplished through the use of both debt and equity. On September 23, 2010, the CPUC authorized Cal Water to issue $350 million of debt and common stock to finance capital projects and operations.

During the first six months of 2014, we utilized cash generated operations and borrowings on the unsecured revolving credit facilities. We have not issued Company common stock or first mortgage bonds in 2014. In future periods, management anticipates funding our capital needs through a relatively balanced approach between long term debt and equity.

As of June 30, 2014, there were short-term borrowings of $81.2 million outstanding on the unsecured revolving credit facilities compared to $46.8 million as of December 31, 2013. The increase in short-term borrowings during the first six months of 2014 was to fund capital expenditures and general operations.

Given our ability to access our lines of credit on a daily basis, cash balances are managed to levels required for daily cash needs and excess cash is invested in short-term or cash equivalent instruments. Minimal operating levels of cash are maintained for Washington Water, New Mexico Water, and Hawaii Water.

Both short-term credit agreements contain affirmative and negative covenants and events of default customary for credit facilities of this type including, among other things, limitations and prohibitions relating to additional indebtedness, liens, mergers, and asset sales. Also, these unsecured credit agreements contain financial covenants governing the Company and its subsidiaries   consolidated total capitalization ratio not to exceed 66.7% and an interest coverage ratio of three or more. As of June 30, 2014, we are in compliance with all of the covenant requirements and are eligible to use the full amount of our credit facilities.

Bond principal and other long-term debt payments were $4.2 million during the first six months of 2014 compared to $2.6 million during the first six months of 2013.

Long-term financing, which includes senior notes, other debt securities, and common stock, has typically been used to replace short-term borrowings and fund capital expenditures. Internally generated funds, after making dividend payments, provide positive cash flow, but have not been at a level to meet the needs of our capital expenditure requirements. Management expects this trend to continue given our capital expenditures plan for the next five years. Some capital expenditures are funded by payments received from developers for contributions in aid of construction or advances for construction. Funds received for contributions in aid of construction are non-refundable, whereas funds classified as advances in construction are refundable. Management believes long-term financing is available to meet our cash flow needs through issuances in both debt and equity instruments.

Dividends

During the first six months of 2014, our quarterly common stock dividend payments were $0.1625 per share compared to quarterly common stock dividend payments of $0.160 per common share during first six months of 2013. The second quarter dividend payment was our 277th consecutive quarterly dividend. Annualized, the 2014 dividend rate is $0.65 per common share, compared to $0.64 in 2013. For the full year 2013, the payout ratio was 63% of net income. On a long-term basis, our goal is to achieve a dividend payout ratio of 60% of net income accomplished through future earnings growth.

At its July 30, 2014 meeting, the Board declared the third quarter dividend of $0.1625 per share payable on August 22, 2014, to stockholders of record on August 11, 2014. This was our 278th consecutive quarterly dividend.

2014 Financing Plan

We intend to fund our capital needs in future periods through a relatively balanced approach between long-term debt and equity. The Company and Cal Water have a three-year syndicated unsecured revolving line of credit of $100 million and $300 million, respectively for short-term borrowings. As of June 30, 2014, the Company s availability on these unsecured revolving lines of credit was $319 million.

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Book Value and Stockholders of Record

Book value per common share was $12.47 at June 30, 2014 compared to $12.54 at December 31, 2013. There were approximately 2,219 stockholders of record for our common stock as of July 24, 2014.

Utility Plant Expenditures

During the first six months of 2014, capital expenditures totaled $57.0 million for company-funded and developer-funded projects. The planned 2014 company-funded capital expenditure budget is approximately $110 to $130 million. The actual amount may vary from the budget number due to timing of actual payments related to current year and prior year projects. We do not control third-party-funded capital expenditures and therefore are unable to estimate the amount of such projects for 2014.

At June 30, 2014, construction work in progress was $116.8 million compared to $152.7 million at June 30, 2013. Work in progress includes projects that are under construction but not yet complete and placed in service.

WATER SUPPLY

Our source of supply varies among our operating districts. Certain districts obtain all of their supply from wells; some districts purchase all of their supply from wholesale suppliers; and other districts obtain supply from a combination of wells and wholesale suppliers. A small portion of supply comes from surface sources and is processed through Company-owned water treatment plants. To the best of management s knowledge, we are meeting water quality, environmental, and other regulatory standards for all company-owned systems.

California s normal weather pattern yields little precipitation between mid-spring and mid-fall. The Washington Water service areas receive precipitation in all seasons, with the heaviest amounts during the winter. New Mexico Water s rainfall is heaviest in the summer monsoon season. Hawaii Water receives precipitation throughout the year, with the largest amounts in the winter months. Water usage in all service areas is highest during the warm and dry summers and declines in the cool winter months. Rain and snow during the winter months replenish underground water aquifers and fill reservoirs, providing the water supply for subsequent delivery to customers. As of July 1, 2014, the State of California snowpack water content and rainfall accumulation during the 2013 2014 water year is 59% of normal (per the California Department of Water Resources, Northern Sierra Precipitation Accumulation report). Precipitation in California during the first six months of 2014 was below normal. Management believes that supply pumped from underground aquifers and purchased from wholesale suppliers will be adequate to meet customer demand during 2014 and beyond. Long-term water supply plans are developed for each of our districts to help assure an adequate water supply under various operating and supply conditions. Some districts have unique challenges in meeting water quality standards, but management believes that supplies will meet current standards using current treatment processes.

CONTRACTUAL OBLIGATIONS

During the first six months of 2014, there were no material changes in contractual obligations outside the normal course of business.

Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We do not hold, trade in or issue derivative financial instruments and therefore are not exposed to risks these instruments present. Our market risk to interest rate exposure is limited because the cost of long-term financing and short-term bank borrowings, including interest costs, is covered in consumer water rates as approved by the commissions. We do not have foreign operations; therefore, we do not have a foreign currency exchange risk. Our business is sensitive to commodity prices and is most affected by changes in purchased water and purchased power costs.

Historically, the CPUC s balancing account or offsetable expense procedures allowed for increases in purchased water and purchased power costs to be passed on to consumers. Traditionally, a significant percentage of our net income and cash flows comes from California regulated operations; therefore the CPUC s actions have a significant impact on our business. See Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies -Expense Balancing and Memorandum Accounts and Regulatory Matters .

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Item 4.

CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(c) under the Exchange Act) that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow for timely decisions regarding required disclosure.

In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Accordingly, our disclosure controls and procedures have been designed to provide reasonable assurance of achieving their objectives.

Our management, with the participation of our CEO and our CFO, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2014. Based on that evaluation, we concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

(b) Changes to Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

On May 14, 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued an updated version of its Internal Control-Integrated Framework (2013 Framework). Originally issued in 1992 (1992 Framework), the framework helps organizations design, implement and evaluate the effectiveness of internal control concepts and simplify their use and application. The 1992 Framework remains available during the transition period, which extends to December 15, 2014, after which time COSO will consider it as superseded by the 2013 Framework. As of June 30, 2014, the Company continues to utilize the 1992 Framework during the transition to the 2013 Framework by the end of 2014.

PART II OTHER INFORMATION

Item 1.

LEGAL PROCEEDINGS

From time to time, the Company has been named as a co-defendant in asbestos-related lawsuits. Several of these cases against the Company have been dismissed without prejudice. In other cases the Company s contractors and insurance policy carriers have settled the cases with no effect on the Company s financial statements. As such, the Company does not currently believe there is any potential loss that is probable to occur related to these matters and therefore no accrual has been recorded.

From time to time, the Company is involved in various disputes and litigation matters that arise in the ordinary course of business. The status of each significant matter is reviewed and assessed for potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount of the range of loss can be estimated, a liability is accrued for the estimated loss in accordance with the accounting standards for contingencies. Legal proceedings are subject to uncertainties, and the outcomes are difficult to predict. Because of such uncertainties, accruals are based on the best information available at the time. While the outcome of these disputes and litigation matters cannot be predicted with any certainty, management does not believe when taking into account existing reserves the ultimate resolution of these matters will materially affect the Company s financial position, results of operations, or cash flows. In the future, we may be involved in disputes and litigation related to a wide range of matters, including employment, construction, environmental issues and operations. Litigation can be time consuming and expensive and could divert management s time and attention from our business. In addition, if we are subject to additional lawsuits or disputes, we might incur significant legal costs and it is uncertain whether we would be able to recover the legal costs from ratepayers or other third parties.

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Item 1A.

RISK FACTORS

There have been no material changes to the Company s risk factors set forth in Part I, Item 1A of the Company s Annual Report on Form 10-K for the year-ended December 31, 2013, filed with the SEC on February 27, 2014.

Item 6.

EXHIBITS

Exhibit	**Description**
31.1	Chief Executive Officer certification of financial statements pursuant to Section 302 of the Sarbanes- Oxley Act of 2002
31.2	Chief Financial Officer certification of financial statements pursuant to Section 302 of the Sarbanes- Oxley Act of 2002
32	Chief Executive Officer and Chief Financial Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes- Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

Pursuant to the requirement of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	CALIFORNIA WATER SERVICE GROUP Registrant	
July 31, 2014	By:	/s/ Thomas F. Smegal III Thomas F. Smegal III Vice President, Chief Financial Officer and Treasurer

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