

ECHELON CORP  
Form 10-Q  
November 04, 2009  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

(Mark one)

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

000-29748

(Commission file number)

**ECHELON CORPORATION**

(Exact name of registrant as specified in its charter)

Edgar Filing: ECHELON CORP - Form 10-Q

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**77-0203595**  
(IRS Employer

Identification Number)

**550 Meridian Avenue**

**San Jose, CA 95126**

(Address of principal executive office and zip code)

**(408) 938-5200**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (do not check if a smaller reporting company) Smaller reporting company

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

As of October 31, 2009, 40,985,772 shares of the registrant's common stock were outstanding.

**Table of Contents****ECHELON CORPORATION****FORM 10-Q****FOR THE QUARTER ENDED SEPTEMBER 30, 2009****INDEX**

	<b>Page</b>
<b><u>Part I. FINANCIAL INFORMATION</u></b>	
Item 1. <u>Unaudited Condensed Consolidated Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets as of September 30, 2009 and December 31, 2008</u>	3
<u>Condensed Consolidated Statements of Operations for the three months and nine months ended September 30, 2009 and September 30, 2008</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2009 and September 30, 2008</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	42
Item 4. <u>Controls and Procedures</u>	42
<b><u>Part II. OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	44
Item 1A. <u>Risk Factors</u>	44
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	44
Item 6. <u>Exhibits</u>	45
<b><u>SIGNATURE</u></b>	45
<b><u>EXHIBIT INDEX</u></b>	46

**FORWARD-LOOKING INFORMATION**

*This report contains forward-looking statements within the meaning of the U.S. federal securities laws that involve risks and uncertainties. Certain statements contained in this report are not purely historical including, without limitation, statements regarding our expectations, beliefs, intentions, anticipations, commitments or strategies regarding the future that are forward-looking. These statements include those discussed in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, including Critical Accounting Estimates, Results of Operations, Off-Balance-Sheet Arrangements and Other Critical Contractual Obligations, Liquidity and Capital Resources, and Recently Issued Accounting Standards, and elsewhere in this report.*

*In this report, the words may, could, would, might, will, should, plan, forecast, anticipate, believe, expect, intend, estimate, predict, potential, continue, future, moving toward or the negative of these terms or other similar expressions also identify forward-looking statements. Our actual results could differ materially from those forward-looking statements contained in this report as a result of a number of risk factors including, but not limited to, those set forth in the section entitled Factors That May Affect Future Results of Operations and elsewhere in this report. You should carefully consider these risks, in addition to the other information in this report and in our other filings with the SEC. All forward-looking statements and reasons why results may differ included in this report are made as of the date of this report, and we assume no obligation to update any such forward-looking statement or reason why such results might differ.*

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
ECHELON CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands)****(Unaudited)**

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 6,489	\$ 37,669
Short-term investments	69,946	49,647
Accounts receivable, net <sup>(1)</sup>	14,737	23,480
Inventories	19,761	16,513
Deferred cost of goods sold	2,319	2,482
Other current assets	3,170	4,707
<b>Total current assets</b>	<b>116,422</b>	<b>134,498</b>
Property and equipment, net	36,761	40,574
Goodwill	8,554	8,417
Other long-term assets	1,088	2,028
<b>Total assets</b>	<b>\$ 162,825</b>	<b>\$ 185,517</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 6,578	\$ 10,675
Accrued liabilities	4,340	5,053
Current portion lease financing obligations	1,553	1,439
Deferred revenues	7,835	8,520
<b>Total current liabilities</b>	<b>20,306</b>	<b>25,687</b>
<b>LONG-TERM LIABILITIES:</b>		
Lease financing obligations, net of current portion	24,202	25,350
Other long-term liabilities	1,748	1,909
<b>Total long-term liabilities</b>	<b>25,950</b>	<b>27,259</b>
<b>STOCKHOLDERS EQUITY:</b>		
Common stock	441	437
Additional paid-in capital	325,371	313,549

Edgar Filing: ECHELON CORP - Form 10-Q

Treasury stock	(28,130)	(28,130)
Accumulated other comprehensive income	1,262	784
Accumulated deficit	(182,375)	(154,069)
<b>Total stockholders' equity</b>	<b>116,569</b>	<b>132,571</b>
Total liabilities and stockholders' equity	\$ 162,825	\$ 185,517

<sup>(1)</sup> Includes related party amounts of \$630 as of September 30, 2009 and \$4,970 as of December 31, 2008. See Note 11 for additional information on related party transactions.

*See accompanying notes to condensed consolidated financial statements.*

**Table of Contents**

**ECHELON CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
<b>Revenues:</b>				
Product	\$ 22,965	\$ 28,875	\$ 62,190	\$ 95,008
Service	710	625	2,314	2,244
Total revenues <sup>(2)</sup>	23,675	29,500	64,504	97,252
<b>Cost of revenues:</b>				
Cost of product <sup>(1)</sup>	12,838	15,715	34,737	56,998
Cost of service <sup>(1)</sup>	547	592	1,796	1,980
Total cost of revenues	13,385	16,307	36,533	58,978
Gross profit	10,290	13,193	27,971	38,274
<b>Operating expenses:</b>				
Product development <sup>(1)</sup>	8,850	9,713	26,583	28,151
Sales and marketing <sup>(1)</sup>	5,279	5,653	16,656	17,820
General and administrative <sup>(1)</sup>	3,717	3,761	11,590	12,997
Total operating expenses	17,846	19,127	54,829	58,968
Loss from operations	(7,556)	(5,934)	(26,858)	(20,694)
Interest and other income (expense), net	(91)	1,141	(158)	2,319
Interest expense on lease financing obligations	(415)	(435)	(1,259)	(974)
Loss before provision for income taxes	(8,062)	(5,228)	(28,275)	(19,349)
Income tax expense	155	136	31	230
Net loss	\$ (8,217)	\$ (5,364)	\$ (28,306)	\$ (19,579)
<b>Net loss per share:</b>				
Basic	\$ (0.20)	\$ (0.13)	\$ (0.70)	\$ (0.48)
Diluted	\$ (0.20)	\$ (0.13)	\$ (0.70)	\$ (0.48)
<b>Shares used in computing net loss per share:</b>				
Basic	40,759	40,554	40,643	40,704
Diluted	40,759	40,554	40,643	40,704

Edgar Filing: ECHELON CORP - Form 10-Q

(1) Amounts include stock-based compensation costs as follows:

Cost of product	\$ 457	\$ 450	\$ 1,137	\$ 1,203
Cost of service	43	56	136	150
Product development	1,500	1,754	4,277	4,455
Sales and marketing	817	750	2,474	2,193
General and administrative	849	617	2,725	2,735
Total	\$ 3,666	\$ 3,627	\$ 10,749	\$ 10,736

(2) Includes related party amounts of \$1,167 and \$5,469 for the three months ended September 30, 2009 and 2008, respectively, and \$4,158 and \$8,384 for the nine months ended September 30, 2009 and 2008, respectively. See Note 11 for additional information on related party transactions.

*See accompanying notes to condensed consolidated financial statements.*

**Table of Contents****ECHELON CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
<b>CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:</b>		
Net loss	\$ (28,306)	\$ (19,579)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,805	5,834
Reduction of allowance for doubtful accounts	(17)	(16)
Loss on disposal of fixed assets	16	9
Reduction of accrued investment income	12	645
Stock-based compensation	10,749	10,736
Change in operating assets and liabilities:		
Accounts receivable	8,766	16,931
Inventories	(3,243)	(2,923)
Deferred cost of goods sold	96	(467)
Other current assets	1,562	(3,472)
Accounts payable	(3,773)	(5,019)
Accrued liabilities	(934)	1,232
Deferred revenues	(687)	(1,852)
Deferred rent	(29)	(22)
Net cash provided by (used in) operating activities	(10,983)	2,037
<b>CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:</b>		
Purchases of available-for-sale short-term investments	(99,783)	(45,411)
Proceeds from maturities and sales of available-for-sale short-term investments	79,424	61,030
Change in other long-term assets	1,027	(40)
Capital expenditures	(1,291)	(3,474)
Net cash provided by (used in) investing activities	(20,623)	12,105
<b>CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:</b>		
Principal payments of lease financing obligations	(1,079)	(1,451)
Proceeds from exercise of stock options	1,829	2,047
Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options	(699)	(1,358)
Repurchase of common stock under stock repurchase program		(8,871)
Net cash provided by (used in) financing activities	51	(9,633)
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH</b>	<b>375</b>	<b>(541)</b>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>(31,180)</b>	<b>3,968</b>



Edgar Filing: ECHELON CORP - Form 10-Q

CASH AND CASH EQUIVALENTS:		
Beginning of period	37,669	76,062
End of period	\$ 6,489	\$ 80,030
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest on lease financing obligations	\$ 1,253	\$ 1,025
Cash paid for income taxes	\$ 30	\$ 482
Noncash investing and financing information    Increase in property and equipment and related lease financing obligation due to lease extension	\$	\$ 12,526

*See accompanying notes to condensed consolidated financial statements.*

---

**Table of Contents**

**ECHELON CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Summary of Significant Accounting Policies**

***Basis of Presentation***

The condensed consolidated financial statements include the accounts of Echelon Corporation (the Company), a Delaware corporation, and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2008 included in its Annual Report on Form 10-K.

The Company has evaluated subsequent events through November 4, 2009, the date which these financial statements were available to be issued.

***Risks and Uncertainties***

The Company's operations and performance depend significantly on worldwide economic conditions and their impact on purchases of the Company's products as well as the ability of suppliers to provide the Company with products and services in a timely manner. The impact of any of the matters described below could have an adverse affect on the Company's business, results of operations and financial condition.

The Company's sales are currently concentrated with a relatively small group of customers, as approximately 56% of net revenues for the three and nine months ended September 30, 2009, was derived from seven customers. Customers in any of the Company's target market sectors may experience unexpected reductions in demand for their products and reduce their purchase orders from the Company, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. In addition, if any of these customers were unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to the Company.

The Company utilizes third-party contract electronic manufacturers to manufacture, assemble, and test its products. As a result of current credit market conditions, if any of these third-parties were unable to obtain the necessary capital to operate their business, they may be unable to provide the Company with timely services or to make timely deliveries of products.

Due to the continuing current worldwide economic crisis, coupled with the fact that the Company's NES customers may request products that have been customized to meet their requirements, the Company has limited visibility into ultimate product demand, which makes sales forecasting more difficult. As a result, anticipated demand may not materialize, which could subject the Company to increased levels of excess and obsolete inventories.

***Use of Estimates***

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions, and estimates that affect amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Significant estimates and judgments are used for revenue recognition, stock-based compensation, allowance for doubtful accounts, inventory valuation, allowance for warranty costs, and other loss contingencies. In order to determine the carrying values of assets and liabilities that are not readily apparent from other sources, the Company bases its estimates and assumptions on current facts, historical experience, and various other factors that it believes to be reasonable under the circumstances. Actual results experienced

by the Company may differ materially from management's estimates.

---

**Table of Contents**

**ECHELON CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

***Revenue Recognition***

The Company's revenues are derived from the sale and license of its products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to its customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Service revenues consist of product technical support (including software post-contract support services), training, and custom software development services.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectability is probable, and there are no post-delivery obligations. For non-distributor hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For hardware sales made to the Company's distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer. For software licenses, these criteria are generally met upon shipment to the final end-user. Service revenue is recognized as the training services are performed, or ratably over the term of the support period.

Revenue earned on software arrangements involving multiple elements is allocated to each element based upon the relative fair values of the elements. The Company uses the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date. In these instances, the amount of revenue deferred at the time of sale is based on vendor specific objective evidence ( VSOE ) of the fair value for each undelivered element. If VSOE of fair value does not exist for each undelivered element, all revenue attributable to the multi-element arrangement is deferred until sufficient VSOE of fair value exists for each undelivered element or all elements have been delivered.

The Company currently sells a limited number of its LONWORKS® Infrastructure products that are considered multiple element arrangements. Revenue for the software license element is recognized at the time of delivery of the applicable product to the end-user. The only undelivered element at the time of sale consists of post-contract customer support ( PCS ). The VSOE for this PCS is based on prices paid by the Company's customers for stand-alone purchases of PCS. Revenue for the PCS element is deferred and recognized ratably over the PCS service period. The costs of providing these PCS services are expensed when incurred.

In most instances involving large-scale deployments, the Company's Networked Energy Services ( NES ) system products are sold as part of multiple element arrangements, which may include electricity meters and data concentrators (collectively, the Hardware ); NES system software, for which a royalty is charged on a per-meter basis; PCS for the NES system software; and extended warranties for the Hardware. These arrangements may require the Company to deliver Hardware over an extended period of time. When the multiple element arrangement includes NES system software, the Company defers the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, the Company recognizes revenues for the Hardware and NES system software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. The Company has established VSOE for the PCS on the NES system software, as well as for extended warranties on its NES Hardware products, based on stated renewal rates. These revenues are recognized ratably over the associated service period, which generally commences upon the later of the delivery of all software, or the customer's acceptance of any given Hardware shipment.

In arrangements which include significant customization or modification of software, the Company recognizes revenue using the percentage-of-completion method if the Company believes it is able to make reasonably dependable estimates of the extent of progress toward completion. The Company measures progress toward completion using an input method based on the ratio of costs incurred, principally labor, to date to total estimated costs of the project. These estimates are assessed continually during the term of the contract, and revisions are reflected when the changed conditions become known. Revenues from these types of arrangements are included in service revenues in the condensed consolidated statement of operations.

## Edgar Filing: ECHELON CORP - Form 10-Q

The Company accounts for the rights of return, price protection, rebates, and other sales incentives as a reduction in revenue. With the exception of sales to distributors, the Company's customers are generally not entitled to return products for a refund. For sales to distributors, due to contractual rights of return and other factors that impact our ability to make a reasonable estimate of future returns and other sales incentives, revenues are not recognized until the distributor has shipped the Company's product to the end customer.

---

**Table of Contents**

**ECHELON CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

***Deferred Revenue and Deferred Cost of Goods Sold***

Deferred revenue and deferred cost of goods sold result from transactions where the Company has shipped product or performed services for which all revenue recognition criteria have not yet been met. Deferred cost of goods sold related to deferred product revenues includes direct product costs and applied overhead. Deferred cost of goods sold related to deferred service revenues includes direct labor costs and applied overhead. Once all revenue recognition criteria have been met, the deferred revenues and associated cost of goods sold are recognized.

***Recently Issued Accounting Standards***

With the exception of the items discussed below, there have been no recent accounting pronouncements or changes in accounting pronouncements during the three and nine months ended September 30, 2009, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the year ended December 31, 2008, that are of significance, or potential significance, to the Company.

During the quarter ended September 30, 2009, the Company adopted the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification (the Codification ). The Codification became the single source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in accordance with GAAP. All guidance included in the Codification will be considered authoritative at that time, even guidance that comes from what is currently deemed to be a non-authoritative section of a standard. Under the Codification, all non-grandfathered, non-SEC accounting literature not included in the Codification is considered non-authoritative. There was no impact to the Company s financial position, results of operations, or cash flows as result of adoption of the Codification.

In May 2009, the Company adopted FASB authoritative guidance on subsequent event accounting, which established general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The new guidance require the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether the date represents the date the financial statements were issued or were available to be issued. The adoption of these guidelines did not have a material impact on the Company s financial position, results of operations, or cash flows.

On April 1, 2009 the Company adopted FASB authoritative guidance related to the determination of fair value when the volume and level of activity for an asset or liability has significantly decreased, the identification of transactions that are not orderly, the recognition and presentation of other-than-temporary impairments, and the disclosure of the fair value of financial instruments on an interim basis. The adoption of the guidance did not have a material impact on the Company s financial position, results of operations, or cash flows.

On January 1, 2009, the Company adopted FASB authoritative guidance for nonfinancial assets and nonfinancial liabilities to be measured at fair value on a non-recurring basis. These nonfinancial items include goodwill and other long-lived assets measured at fair value for purposes of conducting impairment tests. The adoption of the guidance did not have a material impact on the Company s financial position, results of operations, or cash flows.

In October 2009, the FASB issued amended authoritative guidance for separating and allocating revenue to certain arrangements with multiple deliverables. The new guidance changes the level of evidence of standalone selling price required to separate deliverables by allowing a vendor to make its best estimate of the standalone selling price of deliverables when vendor-specific objective evidence (VSOE) or third-party evidence (TPE) of selling price is not available. The new guidance also eliminates the residual method and requires a vendor to allocate revenue to each unit of accounting based on the relative selling price of each deliverable. For the Company, this guidance is effective for all new or materially modified arrangements within the scope of the guidance entered into on or after January 1, 2011, with earlier adoption permitted. If the Company elects early adoption on a prospective basis, and the period of adoption is not the beginning of a fiscal year, the requirements are applied retrospectively to the beginning of the fiscal year. Full retrospective application of the new guidance is also optional. The Company is currently assessing its implementation of this new guidance, and expects that its application could have a material impact on its financial statements.

## Edgar Filing: ECHELON CORP - Form 10-Q

In October 2009, the FASB issued authoritative guidance which amends the scope of existing software revenue recognition accounting. Tangible products containing software components and non-software components that function together to deliver the product's essential functionality would be scoped out of the accounting guidance on software and accounted for based on other

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

appropriate revenue recognition guidance. For the Company, this guidance is effective at the same time the Company adopts the new authoritative guidance for multiple element arrangements referred to above. The Company is currently assessing its implementation of this new guidance, and expects that its application could have a material impact on its financial statements.

**2. Financial Instruments**

The Company's financial instruments consist of cash equivalents, short-term investments, accounts receivable, accounts payable, and lease financing obligations. The carrying value of the Company's financial instruments approximates fair value. Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of investments, which are classified as either cash equivalents or short-term, and trade receivables. With respect to its investments, the Company has an investment policy that limits the amount of credit exposure to any one financial institution and restricts placement of the Company's investments to financial institutions independently evaluated as highly creditworthy. With respect to its trade receivables, the Company performs ongoing credit evaluations of each of its customers' financial condition. For a customer whose credit worthiness does not meet the Company's minimum criteria, the Company may require partial or full payment prior to shipment. Alternatively, prior to shipment, customers may be required to provide the Company with an irrevocable letter of credit or arrange for some other form of coverage to mitigate the risk of uncollectibility, such as a bank guarantee. Additionally, the Company establishes an allowance for doubtful accounts and sales return allowances based upon factors surrounding the credit risk of specific customers, historical trends, and other available information.

On a recurring basis, the Company measures certain of its financial assets, namely its cash equivalents and available-for-sale investments, at fair value. The Company does not have any financial liabilities measured at fair value on a recurring basis. The fair value of the Company's financial assets measured at fair value on a recurring basis was determined using the following inputs at September 30, 2009 (in thousands):

	Fair Value Measurements at Reporting Date Using Significant			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds <sup>(1)</sup>	\$ 3,603	\$ 3,603	\$	\$
Fixed income available-for-sale securities <sup>(2)</sup>	69,946		69,946	
<b>Total</b>	<b>\$ 73,549</b>	<b>\$ 3,603</b>	<b>\$ 69,946</b>	<b>\$</b>

The fair value of the Company's financial assets measured at fair value on a recurring basis was determined using the following inputs at December 31, 2008 (in thousands):

	Fair Value Measurements at Reporting Date Using Significant			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)



Edgar Filing: ECHELON CORP - Form 10-Q

Money market funds <sup>(1)</sup>	\$ 2,399	\$ 2,399	\$	\$
Fixed income available-for-sale securities <sup>(2)</sup>	82,641		82,641	
<b>Total</b>	<b>\$ 85,040</b>	<b>\$ 2,399</b>	<b>\$ 82,641</b>	<b>\$</b>

<sup>(1)</sup> Included in cash and cash equivalents in the Company's condensed consolidated balance sheets

<sup>(2)</sup> Included in either cash and cash equivalents or short-term investments in the Company's condensed consolidated balance sheets

All of the \$69.9 million of fixed income available-for-sale securities at September 30, 2009 are classified as short-term investments. Of the \$82.6 million of fixed income available-for-sale securities at December 31, 2008, approximately \$33.0 million are classified as cash equivalents, while the remaining \$49.6 million are classified as short-term investments. Cash equivalents consist of either investments with remaining maturities of three months or less at the date of purchase, or money market funds for which the carrying amount is a reasonable estimate of fair value.

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

As of September 30, 2009, the Company's available-for-sale short-term investments had contractual maturities from three to twelve months and an average remaining term to maturity of four months. As of September 30, 2009, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses of the Company's short-term investments by major security type were as follows (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. corporate commercial paper	\$ 8,997	\$ 8,997	\$	\$
U.S. government and agency securities	60,922	60,949	27	
<b>Total investments in debt securities</b>	<b>\$ 69,919</b>	<b>\$ 69,946</b>	<b>\$ 27</b>	<b>\$</b>

For investments in debt securities with unrealized losses, the Company considers whether any of the impairment is due to credit losses. Any unrealized losses due to credit losses are recognized in earnings. Unrealized losses due to other factors are recorded in other comprehensive income (loss) unless the Company intends to sell the investment prior to recovery of its amortized cost or it is more likely than not that the Company will be required to sell the investment before recovery. As of September 30, 2009, none of the Company's investments had any material unrealized losses.

**3. Earnings Per Share**

The following is a reconciliation of the numerators and denominators of the basic and diluted net loss per share computations for the three months and nine months ended September 30, 2009 and September 30, 2008 (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
<b>Net loss (Numerator):</b>				
Net loss, basic & diluted	\$ (8,217)	\$ (5,364)	\$ (28,306)	\$ (19,579)
<b>Shares (Denominator):</b>				
Weighted average common shares outstanding	40,759	40,554	40,643	40,704
Shares used in basic computation	40,759	40,554	40,643	40,704
Common shares issuable upon exercise of stock options (treasury stock method)				
Shares used in diluted computation	40,759	40,554	40,643	40,704
<b>Net loss per share:</b>				
Basic	\$ (0.20)	\$ (0.13)	\$ (0.70)	\$ (0.48)
Diluted	\$ (0.20)	\$ (0.13)	\$ (0.70)	\$ (0.48)

For the three and nine months ended September 30, 2009 and 2008, the diluted net loss per share calculation is equivalent to the basic net loss per share calculation as there were no potentially dilutive stock options due to the Company's net loss position. The number of stock options, stock appreciation rights, and restricted stock units excluded from this calculation for the three and nine months ended September 30, 2009 and 2008 was 7,413,512 and 8,260,816, respectively.

#### **4. Stockholders' Equity and Employee Stock Option Plans**

##### *Common Stock*

In April 2008, the Company's board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company's common stock. During the quarter and nine months ended September 30, 2009, the Company did not repurchase any shares under the repurchase program. Since inception, the Company has repurchased a total of 750,000 shares under the program at a cost of \$8.9 million. As of September 30, 2009, 2,250,000 shares were available for repurchase. The stock repurchase program will expire in April 2011.

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Comprehensive Loss**

Comprehensive loss for the Company consists of net loss plus the effect of unrealized holding gains or losses on investments classified as available-for-sale and foreign currency translation adjustments. Comprehensive loss for the three and nine months ended September 30, 2009 and 2008 is as follows (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Net loss	\$ (8,217)	\$ (5,364)	\$ (28,306)	\$ (19,579)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustment	265	(1,111)	526	(605)
Unrealized holding gain (loss) on available-for-sale securities	1	92	(48)	(18)
<b>Comprehensive loss</b>	<b>\$ (7,951)</b>	<b>\$ (6,383)</b>	<b>\$ (27,828)</b>	<b>\$ (20,202)</b>

**Stock Award Activity**

The total intrinsic value of options exercised during the three and nine months ended September 30, 2009 was approximately \$630,000 and \$839,000, respectively. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the awards.

The total fair value of performance shares vested and released during the three and nine months ended September 30, 2009 was approximately \$1.4 million and \$2.2 million, respectively. The fair value is calculated by multiplying the fair market value of the Company's stock on the vesting date by the number of shares vested.

**Equity Compensation Expense for Share Awards with Financial-Based Performance Vesting Requirements**

As of September 30, 2009, there were 244,087 non-vested share awards (with a grant date fair value of approximately \$2.0 million) that were subject to certain financial-based performance requirements that must be achieved before vesting can occur. Of these 244,087 non-vested share awards, 31,250 (that were issued in October 2006 with a grant date fair value of approximately \$263,000) contain financial-based performance conditions that must be achieved by October 2010; 87,898 (that were issued in February 2007 with a grant date fair value of approximately \$778,000) contain financial-based performance conditions that must be achieved by February 2010; and the remaining 124,939 share awards (that were issued in May 2009 with a grant date fair value of approximately \$933,000) contain financial-based performance conditions that must be achieved by May 2014.

Through September 30, 2009, cumulative compensation expense of \$232,000 and \$174,000 associated with the 31,250 share awards granted in October 2006 and the 124,939 share awards granted in May 2009, respectively, has been recognized because the Company believes it is probable that the associated financial performance requirements will be achieved. If such requirements are not met, no compensation cost will be recognized and any recognized compensation cost will be reversed. No compensation expense has been recognized associated with the remaining 87,898 share awards granted in February 2007 as management does not currently expect the financial performance requirements for these awards will be met. During the quarter ended March 31, 2009, previously recognized compensation expense of \$503,000 associated with these 87,898 share awards was reversed.



**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****5. Significant Customers**

The Company markets its products and services throughout the world to original equipment manufacturers (OEMs) and systems integrators in the building, industrial, transportation, utility/home, and other automation markets. During the three and nine months ended September 30, 2009 and 2008, the Company had seven customers that accounted for a majority of its revenues: EBV Elektronik GmbH (EBV), the Company's primary distributor of its LonWorks® Infrastructure products in Europe; Enel S.p.A. (Enel), an Italian utility company (including Enel's third party meter manufacturers); Duke Energy Corporation (Duke), a U.S. utility company; and Eltel Networks A/S (Eltel), Telvent Energia y Medioambiente SA (Telvent), Limited Liability Company Engineering Center ENERGOAUDITCONTROL (EAC), and ES Elektrosandberg AB (ES), value added resellers of the Company's NES products. For the three and nine months ended September 30, 2009 and 2008, the percentage of the Company's revenues attributable to sales made to these customers was as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Eltel	33.9%	3.6%	26.6%	1.4%
EBV	13.7%	18.5%	16.9%	16.9%
Enel	4.5%	18.2%	5.7%	8.2%
ES	2.0%	3.6%	2.1%	18.3%
Telvent	0.8%	1.0%	1.6%	10.9%
Duke	0.6%	10.2%	0.7%	5.6%
EAC	0.1%	7.2%	2.0%	7.7%
Total	55.6%	62.3%	55.6%	69.0%

Of the percentage of sales made to EBV, approximately 0.4% and 0.7% for the three and nine months ended September 30, 2009, respectively, and approximately 0.4% for both the three and nine months ended September 30, 2008, related to sales of components the Company sold to EBV, which EBV in turn sold to one of Enel's third party meter manufacturers. Elsewhere in this document, those sales are reported as Enel Project revenues. The Company's contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2009. Please refer to Note 11, Related Parties, for additional information regarding the Company's agreements with Enel.

**6. Commitments and Contingencies****Legal Actions**

In April 2009, the Company received notice that the receiver for two companies that filed for the Italian law equivalent of bankruptcy protection in May 2004, Finmek Manufacturing SpA and Finmek Access SpA (collectively, the Finmek Companies), had filed a lawsuit under an Italian claw back law in Padua, Italy against the Company, seeking the return of approximately \$16.7 million in ordinary course of business payments received by the Company in payment for components sold by the Company to the Finmek Companies prior to the bankruptcy filing. The Finmek Companies were among Enel's third party meters manufacturers, and from time to time through January 2004, the Company sold components to the Finmek Companies that were incorporated into the electricity meters that were manufactured by the Finmek Companies and sold to Enel SpA for the Enel Project. The Company believes that the Italian claw back law is not applicable to its transactions with the Finmek Companies, and the claims of the Finmek Companies' receiver are without merit.

From time to time, in the ordinary course of business, the Company may be subject to other legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment,

## Edgar Filing: ECHELON CORP - Form 10-Q

and other matters. In accordance with generally accepted accounting principles, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While the Company believes it has adequately provided for such contingencies as of September 30, 2009, the amounts of which were immaterial, it is possible that the Company's results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

### *Line of Credit*

The Company maintains a \$10.0 million line of credit with its primary bank. As of September 30, 2009, the Company's primary bank has issued, against the line of credit, a standby letter of credit totaling \$37,000. Other than causing to have issued standby letters of credit, the Company has never drawn against the line of credit, nor have amounts ever been drawn against standby letters of credit issued by the bank.

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****7. Inventories**

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and manufacturing overhead. When required, provisions are made to reduce excess and obsolete inventories to their estimated net realizable value. Inventories consist of the following (in thousands):

	September 30, 2009	December 31, 2008
Purchased materials	\$ 4,672	\$ 6,844
Work-in-process	33	89
Finished goods	15,056	9,580
	\$ 19,761	\$ 16,513

**8. Accrued Liabilities**

Accrued liabilities consist of the following (in thousands):

	September 30, 2009	December 31, 2008
Accrued payroll and related costs	\$ 2,613	\$ 2,666
Warranty reserve	1,138	849
Accrued taxes	177	70
Customer deposits		643
Other accrued liabilities	412	825
	\$ 4,340	\$ 5,053

**9. Segment Disclosure**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company's chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer and his direct reports.

The Company operates in one principal industry segment, its reportable segment: the design, manufacture and sale of products for the controls network industry, and markets its products primarily to the building automation, industrial automation, transportation, and utility/home automation markets. The Company's products provide the infrastructure and support required to implement and deploy open, interoperable, control network solutions. For the electric utility industry, the Company has developed an advanced metering infrastructure system called the Networked Energy Services (NES) system. The NES system provides a two-way information and control path between the utility and its customer, which enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. All of the Company's products either incorporate or



## Edgar Filing: ECHELON CORP - Form 10-Q

operate with the Neuron<sup>®</sup> Chip and/or the LonWorks protocol. The Company also provides a range of services to its customers that consist of technical support, training courses covering its LonWorks network technology and products, and custom software development. In total, the Company offers a wide ranging set of products and services that together constitute the LonWorks system. Any given customer purchases a small subset of such products and services that are appropriate for that customer's application.

The Company operates in three main geographic areas: the Americas; Europe, Middle East and Africa ( EMEA ); and Asia Pacific/ Japan ( APJ ). Each geographic area provides products and services to the Company's customers located in the respective region. The Company's long-lived assets include property and equipment, goodwill, loans to certain key employees, purchased technology, and deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of September 30, 2009 and December 31, 2008, long-lived assets of approximately \$42.7 million and \$47.5 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements.

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The Company has three primary product lines: NES, LonWorks Infrastructure (LWI), and products and services sold to Enel. Summary revenue information by product line for the three and nine months ended September 30, 2009 and 2008 is as follows (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
NES	\$ 11,506	\$ 9,370	\$ 27,243	\$ 46,510
LWI	11,002	14,660	33,103	42,358
Enel	1,167	5,470	4,158	8,384
Total	\$ 23,675	\$ 29,500	\$ 64,504	\$ 97,252

In North America, the Company sells its products primarily through a direct sales organization and select third-party electronics representatives. Outside North America, the Company sells its products through direct sales organizations in EMEA and APJ, value-added resellers, and local distributors. Revenues are attributed to geographic areas based on the country where the customer is domiciled. Summary revenue information by geography for the three and nine months ended September 30, 2009 and 2008 is as follows (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Americas	\$ 4,251	\$ 8,606	\$ 12,897	\$ 20,879
EMEA	16,811	17,565	44,283	68,165
APJ	2,613	3,329	7,324	8,208
Total	\$ 23,675	\$ 29,500	\$ 64,504	\$ 97,252

For information regarding the Company's major customers, please refer to Note 5, Significant Customers.

**10. Income Taxes**

The provision for income taxes for the three months ended September 30, 2009 and 2008 was \$155,000 and \$136,000, respectively. The provision for income taxes for the nine months ended September 30, 2009 and 2008 was \$31,000 and \$230,000, respectively. The difference between the statutory rate and the Company's effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits.

As of September 30, 2009 and December 31, 2008, the Company had gross unrecognized tax benefits of approximately \$5.1 million and \$4.7 million, respectively, of which \$913,000 and \$1.0 million, respectively, if recognized, would impact the effective tax rate on income from continuing operations. The Company's policy is to recognize interest and/or penalties related to unrecognized tax benefits in income tax expense. As of September 30, 2009 and December 31, 2008, the Company had \$256,000 and \$310,000, respectively, accrued for interest and penalties.

**11. Related Parties**

## Edgar Filing: ECHELON CORP - Form 10-Q

The law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, the Company's Chairman and Chief Executive Officer, M. Kenneth Oshman, uses his private plane or charter aircraft for company business for himself and any employees that accompany him. In August 2008, the Company's Board of Directors approved a reimbursement arrangement whereby the Company will reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. During the three and nine months ended September 30, 2009, the Company recognized a total of approximately \$38,000 and \$169,000, respectively, in expenses pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the Condensed Consolidated Statements of Operations. The Audit Committee of the Company's Board of Directors regularly reviews these reimbursements.

**Table of Contents**

**ECHELON CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

In June 2000, the Company entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock. Under the terms of the stock purchase agreement, Enel has the right to nominate a member of the Company's board of directors. A representative of Enel is not presently serving on the Company's board.

At the same time as the Company entered into the stock purchase agreement with Enel, it also entered into a Research and Development and Technological Cooperation Agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, the Company cooperated with Enel to integrate LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. The Company completed the sale of its components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, the Company supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, the Company entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers may purchase additional electronic components and finished goods from Echelon. Under the software enhancement agreement, the Company provides software enhancements to Enel for use in its Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

For the three months ended September 30, 2009 and 2008, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$1.2 million and \$5.5 million, respectively. For the nine months ended September 30, 2009 and 2008, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$4.2 million and \$8.4 million, respectively. As of September 30, 2009, and December 31, 2008, \$630,000 and \$5.0 million, respectively, of the Company's total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business. These statements may be identified by the use of words such as we believe, expect, anticipate, intend, plan, goal, continues, may, and similar expressions. In addition, forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the Factors That May Affect Future Results Of Operations section. Our actual results may differ materially.*

**OVERVIEW**

Echelon Corporation was incorporated in California in February 1988 and reincorporated in Delaware in January 1989. We are based in San Jose, California, and maintain offices in ten foreign countries throughout Europe and Asia. We develop, market, and sell system and network infrastructure products that enable everyday devices — such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves — to be made smart and inter-connected. Working together, products and systems equipped with our technology can monitor and save energy, lower costs, improve productivity, and enhance service, quality, safety and convenience. We offer these hardware and software products and related services to OEMs and systems integrators in the building, industrial, transportation, utility/home, and other automation markets.

For the last several years, we have been investing heavily in the development of hardware and software products for the advanced metering infrastructure, or AMI, market. These AMI products are used by the electric utility industry in their distribution and metering systems, and are components of what is commonly referred to as the smart grid. To date, we have generated revenues of approximately \$166.7 million from these investments. We refer to this revenue as networked energy services, or NES, revenue. We sell certain of our products to Enel and certain suppliers of Enel for use in Enel's Contatore Elettronico electricity meter management project in Italy. We refer to Echelon's revenue derived from sales to Enel and Enel's designated manufacturers as Enel Project revenue. We refer to all other revenue as LONWORKS Infrastructure, or LWI, revenue. We also provide a variety of technical training courses related to our products and the underlying technology. Some of our customers also rely on us to provide customer support on a per-incident or term contract basis.

We have a history of losses and although we achieved profitability in past fiscal periods, we incurred a loss for the three and nine months ended September 30, 2009 as well as for the years ended December 31, 2008, 2007, and 2006.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. Note 1, Significant Accounting Policies of Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2008, which we filed with the Securities and Exchange Commission in March 2009, describes the significant accounting policies and methods used in the preparation of our consolidated financial statements. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our stock-based compensation, allowance for doubtful accounts, inventory valuation, allowance for warranty costs, and other commitments and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

---

## Table of Contents

We believe the following critical accounting policies and estimates relate to those policies that are most important to the presentation of our consolidated financial statements and require the most difficult, subjective and complex judgments.

**Revenue Recognition.** Our revenues are derived from the sale and license of our products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to our customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Service revenues consist of product technical support (including software post-contract support services), training, and custom software development services.

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectibility is probable, and there are no post-delivery obligations. For non-distributor hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For hardware sales made to our distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer. For software licenses, these criteria are generally met upon shipment to the final end-user.

In most instances involving large-scale deployments, our NES system products are sold as part of multiple element arrangements. These arrangements may include electricity meters and data concentrators (collectively, the Hardware); NES system software, for which a royalty is charged on a per-meter basis; post-contract customer support (PCS) for the NES system software; and extended warranties for the Hardware. These arrangements may require us to deliver Hardware over an extended period of time. When the multiple element arrangement includes NES system software, we defer the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, we recognize revenues for the Hardware and NES system software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators are disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators have occurred. We have established vendor specific objective evidence for the PCS on the NES system software, as well as for extended warranties on our NES Hardware products, based on stated renewal rates. These revenues are recognized ratably over the associated service period, which generally commences upon the later of the delivery of all software or the customer's acceptance of any given Hardware shipment.

We account for the rights of return, price protection, rebates, and other sales incentives offered to distributors of our products as a reduction in revenue. With the exception of sales to distributors, the Company's customers are generally not entitled to return products for a refund. For sales to distributors, due to contractual rights of return and other factors that impact our ability to make a reasonable estimate of future returns and other sales incentives, revenues are not recognized until the distributor has shipped our product to the end customer.

**Stock-Based Compensation.** Under generally accepted accounting principles in the United States, stock-based compensation cost is measured at the grant date based on the estimated fair value of the award and is recognized as expense ratably over the requisite service period, which is the vesting period.

We currently use the Black-Scholes-Merton (BSM) option-pricing model to estimate the fair value of stock options. The estimation of fair value of share-based payment awards on the date of grant using the BSM option-pricing model is affected by the fair market value of our stock on the date of grant, as well as a number of highly complex and subjective variables. These variables include the expected term of the option, the expected volatility of our stock price over the expected term of the option, risk-free interest rates, and expected dividends.

For options and stock-appreciation rights (SARs) granted prior to January 1, 2008, the expected term has been calculated using the simplified method as permitted under the Securities and Exchange Commission Staff Accounting Bulletin No. 107. Under the simplified method, the expected term is calculated by taking the average of the vesting term and the contractual term of the option. For options and SARs granted subsequent to December 31, 2007, the expected term has been calculated by applying a Monte Carlo simulation model that incorporates Echelon's historical data on post-vest exercise activity and employee termination behavior. The expected volatility is based on both the historical volatility of the our common stock over the most recent period commensurate with the expected life of the option as well as on implied volatility calculated from the market traded options on our company's stock. We base the risk-free interest rate that we use in the BSM option-pricing model on U.S. Treasury issues in effect at the time of equity compensation grant that have remaining terms similar to the expected term of the option. We have never paid cash dividends on our common stock, and do not anticipate paying cash dividends in the foreseeable future. Therefore, we use an expected dividend yield of zero in the BSM option-pricing model.

## **Table of Contents**

Current accounting rules also require us to record compensation expense for stock-based compensation net of estimated forfeitures, and to revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All share-based payment awards are amortized using the accelerated multiple option method over their requisite service period, which is generally the vesting period.

Certain of the stock-based compensation awards we issue vest upon the achievement of specific financial-based performance requirements. We are required to estimate whether or not it is probable that these financial-based performance requirements will be met, and, in some cases, when they will be met. These estimates of future financial performance are based on the best information available at the time of grant, and each quarterly period thereafter until the awards are either earned or forfeited. During the quarter ended March 31, 2009, our management concluded that it was unlikely that the financial performance requirements for certain of these awards would be met, and accordingly, we reversed previously recognized compensation expense of \$503,000 associated with these awards. As of September 30, 2009, our management continues to believe it is unlikely that the financial performance requirements for these awards will be met. Any changes we make to our estimates of future financial performance could have a material impact on the amount and timing of compensation expense associated with these awards.

There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and may materially affect the estimated fair value of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods, and assumptions. The BSM option-pricing model was developed for use in estimating the fair value of traded options that have no vesting or hedging restrictions and that are fully transferable, characteristics that are not present in our equity compensation grants.

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods, or if we decide to use a different option-pricing model, stock-based compensation expense in those future periods may differ significantly from what we have recorded in the current period and could materially affect our operating results.

**Allowance for Doubtful Accounts.** We typically sell our products and services to customers with net 30-day payment terms. In certain instances, payment terms may extend to as much as approximately net 90 days. For a customer whose credit worthiness does not meet our minimum criteria, we may require partial or full payment prior to shipment. Alternatively, customers may be required to provide us with an irrevocable letter of credit prior to shipment.

We evaluate the collectibility of our accounts receivable based on a combination of factors. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected. These determinations are made based on several sources of information, including, but not limited to, a specific customer's payment history, recent discussions we have had with the customer, updated financial information for the customer, and publicly available news related to that customer. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, the current business environment, the credit worthiness of our overall customer base, changes in our customers' payment patterns, and our historical experience. If the financial condition of our customers were to deteriorate, or if general economic conditions continue to worsen, additional allowances may be required in the future, which could materially impact our results of operations and financial condition. Our allowance for doubtful accounts was \$306,000 as of September 30, 2009, and \$323,000 as of December 31, 2008.

**Inventory Valuation.** At each balance sheet date, we evaluate our ending inventories for excess quantities and obsolescence. In general, the evaluation for excess quantities includes analyses of historical sales levels by product and projections of future demand. Inventories on hand in excess of one year's forecasted demand are generally deemed to be excess.

## Table of Contents

In performing the excess inventory analysis, management considers factors that are unique to each of our NES and LWI product lines. For our NES products, the analysis requires us to consider that NES customers procure specific meter types that meet their requirements. In other words, any given customer may require a meter that is custom to their specifications. Accordingly, management must make significant judgments not only as to which customers will buy how many meters (and associated data concentrators), but also which meter type(s) each customer will buy. In making these judgments, management uses the best sales forecast information available at the time. However, because future sales volumes for any given customer opportunity have the potential to vary significantly, actual results could be materially different from original estimates. This could increase our exposure to excess inventory for which we would need to record a reserve, thereby resulting in a potentially material negative impact to our operating results.

For most of our LWI products, our customers generally buy from a portfolio of off-the-shelf or standard products. In addition, whereas for our NES customers our revenues are attributable to a relatively few customers buying substantial quantities of any given product, our LWI revenues are composed of a larger volume of smaller dollar transactions. Accordingly, while any single LWI customer's demand for a given product may fluctuate from quarter to quarter, the fact that there are so many LWI customers buying a standard product tends to average out increases or decreases in any individual customer's demand. This has historically resulted in a relatively stable future demand forecast for our LWI products, which, absent outside forces such as worsening general economic conditions, management evaluates in determining its requirement for an excess inventory reserve.

In addition to providing a reserve for excess inventories, we do not value inventories that we consider obsolete. We consider a product to be obsolete when one of several factors exists. These factors include, but are not limited to, our decision to discontinue selling an existing product, the product has been re-designed and we are unable to rework our existing inventory to update it to the new version, or our competitors introduce new products that make our products obsolete.

We adjust remaining inventory balances to approximate the lower of our cost or market value. If future demand or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales in the period the revision is made.

**Warranty Reserves.** We evaluate our reserve for warranty costs based on a combination of factors. In circumstances where we are aware of a specific warranty related problem, for example a product recall, we reserve an estimate of the total out-of-pocket costs we expect to incur to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. When evaluating the need for any additional reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical warranty-related return rates, historical costs of repair, and knowledge of new products introduced. If any of these factors were to change materially in the future, we may be required to increase our warranty reserve, which could have a material negative impact on our results of operations and our financial condition. Our reserve for warranty costs was \$1.1 million as of September 30, 2009, and \$849,000 as of December 31, 2008.



**Table of Contents****RESULTS OF OPERATIONS**

The following table reflects the percentage of total revenues represented by each item in our Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2009 and 2008:

	Three Months Ended September 30, 2009		September 30, 2008	
Revenues:				
Product	97.0%	97.9%	96.4%	97.7%
Service	3.0	2.1	3.6	2.3
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
Cost of product	54.2	53.3	53.8	58.6
Cost of service	2.3	2.0	2.8	2.0
Total cost of revenues	56.5	55.3	56.6	60.6
Gross profit	43.5	44.7	43.4	39.4
Operating expenses:				
Product development	37.4	32.9	41.2	29.0
Sales and marketing	22.3	19.2	25.8	18.3
General and administrative	15.7	12.7	18.0	13.4
Total operating expenses	75.4	64.8	85.0	60.7
Loss from operations	(31.9)	(20.1)	(41.6)	(21.3)
Interest and other income (expense), net	(0.4)	3.9	(0.2)	2.4
Interest expense on lease financing obligations	(1.8)	(1.5)	(2.0)	(1.0)
Loss before provision for income taxes	(34.1)	(17.7)	(43.8)	(19.9)
Income tax expense	0.6	0.5	0.1	0.2
Net loss	(34.7)%	(18.2)%	(43.9)%	(20.1)%

**Revenues***Total Revenues*

<i>(Dollars in thousands)</i>	Three Months Ended September 30, 2009		2009 over 2008 \$ Change	
	2009	2008	2009 over 2008 \$	2009 over 2008 %
Total revenues	\$ 23,675	\$ 29,500	\$ (5,825)	(19.7)%
	Nine Months Ended September 30,		2009 over 2008 \$	
				2009 over 2008 %

Edgar Filing: ECHELON CORP - Form 10-Q

*(Dollars in thousands)*

	2009	2008	Change	Change
Total revenues	\$ 64,504	\$ 97,252	\$ (32,748)	(33.7)%

The \$5.8 million decrease in total revenues for the quarter ended September 30, 2009 as compared to the same period in 2008 was primarily the result of a \$4.3 million decrease in Enel Project revenues and a \$3.7 million decrease in LWI revenues, partially offset by a \$2.1 million increase in NES revenues. The \$32.7 million decrease in total revenues for the nine months ended September 30, 2009 as compared to the same period in 2008 was primarily the result of a \$19.3 million decrease in NES revenues, a \$9.3 million decrease in LWI revenues, and a \$4.2 million decrease in Enel Project revenues.

**Table of Contents***NES revenues*

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>		<b>2009 over</b>	
	<b>September 30, 2009</b>	<b>2008</b>	<b>2009 \$ Change</b>	<b>2009 over 2008 % Change</b>
NES revenues	\$ 11,506	\$9,370	\$ 2,136	22.8%

<i>(Dollars in thousands)</i>	<b>Nine Months Ended</b>		<b>2009 over</b>	
	<b>September 30, 2009</b>	<b>2008</b>	<b>2009 \$ Change</b>	<b>2009 over 2008 % Change</b>
NES revenues	\$ 27,243	\$46,510	\$ (19,267)	(41.4)%

NES revenues generated during the three and nine month periods ended September 30, 2009 and 2008 were primarily related to large scale deployments of our NES system products. As of September 30, 2009 and 2008, approximately \$3.0 million and \$8.1 million, respectively, of NES revenue was deferred. Deferred revenues are generally recognized in future periods once all of the required criteria for revenue recognition have been met. The \$2.1 million increase in NES revenues during the three months ended September 30, 2009 as compared to the same period in 2008 was due to an increase in the amount of NES products shipped to and accepted by our NES customers during the period. The \$19.3 million decrease during the nine months ended September 30, 2009, as compared to the same period in 2008, was due to an overall reduction in the level of large-scale deployments of our NES system products during the comparable periods.

Our ability to recognize revenue on shipments of our NES products depends on several factors, including, but not limited to, delivery to the customer of all of the software called for in any given agreement, the impact on delivery dates of any modifications to existing shipment schedules included in the contracts that have been awarded to us thus far, and certain contractual provisions, such as customer acceptance. In addition, the complex revenue recognition rules relating to products such as our NES system will likely require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period. For example, once all other revenue recognition criteria have been met, we recognize revenues for the meters (and related NES system software royalties) and data concentrators based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. In some instances, the reasons for these deferrals may not be fully under our control, which could result in the actual timing of revenue being significantly different than we currently anticipate.

We also expect that some foreign utilities will require us to price our NES system in the respective utility's local currency, which will expose us to foreign currency risk. For the nine months ended September 30, 2009, the portion of our NES revenues conducted in currencies other than the U.S. dollar, principally the European Euro, was about \$28,000, or 0.1%. For the nine months ended September 30, 2008, the portion of our NES revenues conducted in currencies other than the U.S. dollar, principally the European Euro and the Australian dollar, was about \$194,000, or 0.4%. To date, we have not hedged any of these foreign currency risks. In most cases, in the event of a significant contract award that requires us to price our NES products in the customer's local currency, we intend to hedge this foreign currency risk so long as we can secure forward currency contracts that are reasonably priced and that are consistent with the scheduled deliveries for that project.

In addition, we will face foreign currency exposures from the time we submit our foreign currency denominated bid until the award of a contract by the utility (the bid to award term). This bid to award term can often exceed several months. If a utility awards us a contract that gives the utility the right to exercise options for additional supply in the future, we would also be exposed to foreign currency risk until such time as these options, if any, were exercised. We may decide that it is too expensive to hedge the foreign currency risks during the bid to award term or for any unexercised options. Any resulting adverse foreign currency fluctuations could significantly harm our revenues, results of operations, and financial condition.

**Table of Contents***LWI revenues*

<i>(Dollars in thousands)</i>	Three Months Ended September 30,		2009 over 2008 \$	2009 over 2008 %
	2009	2008	Change	Change
LWI revenues	\$ 11,002	\$ 14,660	\$ (3,658)	(25.0)%

<i>(Dollars in thousands)</i>	Nine Months Ended September 30,		2009 over 2008 \$	2009 over 2008 %
	2009	2008	Change	Change
LWI revenues	\$ 33,103	\$ 42,358	\$ (9,255)	(21.8)%

Our LWI revenues are primarily comprised of sales of our hardware and software products, and to a lesser extent, revenues we generate from our customer support and training offerings. Both the \$3.7 million and \$9.3 million decreases during the three and nine month periods ended September 30, 2009, as compared to the same periods in 2008, were primarily due to decreases in LWI revenues in the EMEA, and to a lesser extent, in the Americas region. We believe these decreases were the result of the generally depressed state of economic conditions in these regions. Within the LWI family of products, the quarterly and nine month decreases were primarily attributable to decreases in sales of our power line transceiver and other control and connectivity products.

Our future LWI revenues will continue to be subject to fluctuations in the exchange rates between the U.S. dollar and the foreign currencies in which we sell our LWI products and services. In general, if the dollar were to weaken against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would increase. Conversely, if the dollar were to strengthen against these currencies, our revenues from those foreign currency sales, when translated into U.S. dollars, would decrease. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in these currencies and the magnitude of the exchange rate fluctuation from period to period. The portion of our LWI revenues conducted in currencies other than the U.S. dollar, principally the Japanese Yen, was about 6.8% for the nine months ended September 30, 2009 and 5.2% for the same period in 2008. We do not currently expect that, in the near future, the amount of our LWI revenues conducted in these foreign currencies will fluctuate significantly from prior year levels. Given the historical and expected future level of sales made in foreign currencies, we have not nor do we currently plan to hedge against these currency rate fluctuations. However, if the portion of our revenues conducted in foreign currencies was to grow significantly, we would re-evaluate these exposures and, if necessary, enter into hedging arrangements to help minimize these risks.

*Enel Project revenues*

<i>(Dollars in thousands)</i>	Three Months Ended September 30,		2009 over 2008 \$	2009 over 2008 %
	2009	2008	Change	Change
Enel Project revenues	\$ 1,167	\$ 5,470	\$ (4,303)	(78.7)%

<i>(Dollars in thousands)</i>	Nine Months Ended September 30,		2009 over 2008 \$	2009 over 2008 %
	2009	2008	Change	Change
Enel Project revenues	\$ 4,158	\$ 8,384	\$ (4,226)	(50.4)%

In October 2006, we entered into two new agreements with Enel, a development and supply agreement and a software enhancement agreement. Under the development and supply agreement, Enel is purchasing additional metering kit and data concentrator products from us. Under the software enhancement agreement, we are providing software enhancements to Enel for use in its Contatore Elettronico system. Enel Project revenue recognized during the three and nine month periods ended September 30, 2009 and 2008 related primarily to shipments under the new development and supply agreement, and to a lesser extent, from revenues attributable to the software enhancement agreement. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

We sell our products to Enel and its designated manufacturers in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency risks.



**Table of Contents***EBV revenues*

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>		<b>2009 over</b>	
	<b>September 30, 2009</b>	<b>September 30, 2008</b>	<b>2008 \$ Change</b>	<b>2008 % Change</b>
EBV revenues	\$ 3,158	\$ 5,343	\$ (2,185)	(40.9)%

<i>(Dollars in thousands)</i>	<b>Nine Months Ended</b>		<b>2009 over</b>	
	<b>September 30, 2009</b>	<b>September 30, 2008</b>	<b>2008 \$ Change</b>	<b>2008 % Change</b>
EBV revenues	\$ 10,417	\$ 15,967	\$ (5,550)	(34.8)%

Sales to EBV, our largest distributor and the primary independent distributor of our products in Europe, accounted for 13.3% of our total revenues for three months ended September 30, 2009, and 18.1% of our total revenues for the same period in 2008; and 16.1% of our total revenues for the nine months ended September 30, 2009 and 16.4% of our total revenues for the same period in 2008. The primary factor contributing to the \$2.2 million decrease between the two quarters and the \$5.6 million decrease between the two nine month periods was a decrease in sales of our power line transceiver and other control and connectivity products. We believe these decreases were the result of the generally depressed state of economic conditions in the areas where EBV sells our products.

We currently sell our products to EBV in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency exchange rate risks. However, EBV has the right, on notice to our company, to require that we sell our products to them in Euros.

Our contract with EBV, which has been in effect since 1997 and to date has been renewed annually thereafter, expires in December 2009. If our agreement with EBV is not renewed, or is renewed on terms that are less favorable to us, our revenues could decrease and our results of operations and financial condition could be harmed.

*Product revenues*

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>		<b>2009 over</b>	
	<b>September 30, 2009</b>	<b>September 30, 2008</b>	<b>2008 \$ Change</b>	<b>2008 % Change</b>
Product revenues	\$ 22,965	\$ 28,875	\$ (5,910)	(20.5)%

<i>(Dollars in thousands)</i>	<b>Nine Months Ended</b>		<b>2009 over</b>	
	<b>September 30, 2009</b>	<b>September 30, 2008</b>	<b>2008 \$ Change</b>	<b>2008 % Change</b>
Product revenues	\$ 62,190	\$ 95,008	\$ (32,818)	(34.5)%

The \$5.9 million decrease in product revenues for the quarter ended September 30, 2009 as compared to the same period in 2008 was primarily the result of a \$4.4 million decrease in Enel project product revenues and a \$3.7 million decrease in LWI product revenues, partially offset by a \$2.2 million increase in NES product revenues. The \$32.8 million decrease in product revenues for the nine months ended September 30, 2009 as compared to the same period in 2008 was primarily the result of a \$19.6 million decrease in NES product revenues, a \$9.1 million decrease in LWI product revenues, and a \$4.1 million decrease in Enel project product revenues.

*Service revenues*

<b>Three Months Ended</b>	<b>2009 over</b>	
	<b>September 30, 2008 \$</b>	<b>2009 over 2008 %</b>

Edgar Filing: ECHELON CORP - Form 10-Q

<i>(Dollars in thousands)</i>	2009	2008	Change	Change
Service revenues	\$ 710	\$ 625	\$ 85	13.6%

  

<i>(Dollars in thousands)</i>	Nine Months Ended September 30,		2009 over 2008 \$	2009 over 2008 %
	2009	2008	Change	Change
Service revenues	\$ 2,314	\$ 2,244	\$ 70	3.1%

The \$85,000 increase in service revenues for the quarter ended September 30, 2009 as compared to the same period in 2008 was primarily the result of a \$135,000 increase in custom software development services provided to Enel, partially offset by modest reductions in NES support and LWI service revenues. The \$70,000 increase in service revenues for the nine months ended September 30, 2009 as compared to the same period in 2008 was primarily the result of a \$286,000 increase in NES support revenues, partially offset by a \$139,000 reduction in LWI service revenues and a \$77,000 decrease in custom software development services provided to Enel.

**Table of Contents****Gross Profit and Gross Margin**

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>		<b>2009 over</b>	
	<b>September 30,</b>		<b>2008 \$</b>	<b>2009 over</b>
	<b>2009</b>	<b>2008</b>		
Gross Profit	\$ 10,290	\$ 13,193	\$ (2,903)	(22.0)%
Gross Margin	43.5%	44.7%		(1.2)

<i>(Dollars in thousands)</i>	<b>Nine Months Ended</b>		<b>2009 over</b>	
	<b>September 30,</b>		<b>2008 \$</b>	<b>2009 over</b>
	<b>2009</b>	<b>2008</b>		
Gross Profit	\$ 27,971	\$ 38,274	\$ (10,303)	(26.9)%
Gross Margin	43.4%	39.4%		4.0

Gross profit is equal to revenues less cost of goods sold. Cost of goods sold for product revenues includes direct costs associated with the purchase of components, subassemblies, and finished goods, as well as indirect costs such as allocated labor and overhead; costs associated with the packaging, preparation, and shipment of products; and charges related to warranty and excess and obsolete inventory reserves. Cost of goods sold for service revenues consists of employee-related costs such as salaries and benefits as well as other direct and indirect costs incurred in providing training, customer support, and custom software development services. Gross margin is equal to gross profit divided by revenues.

Both the 1.2 percentage point decrease and the 4.0 percentage point increase in gross margin during the three and nine month periods ended September 30, 2009 as compared to the same periods in 2008 were due primarily to the mix of revenues reported. During the three and nine months ended September 30, 2009, approximately 48.6% and 42.2%, respectively, of our revenues were attributable to sales of our NES system products and services, 46.5% and 51.3%, respectively, of our revenues were attributable to sales of our LWI products and services, and the remaining 4.9% and 6.5%, respectively, were attributable to the Enel project. During the three and nine months ended September 30, 2008, approximately 31.8% and 47.8%, respectively, of our revenues were attributable to sales of our NES system products, 49.7% and 43.6%, respectively, of our revenues were attributable to sales of our LWI products and services, and the remaining 18.5% and 8.6%, respectively, were attributable to the Enel project. In general, gross margins generated from sales of our NES system products are lower than those generated from both sales of our LWI products and services as well as sales made under the Enel Project. As a result, when NES revenues are higher as a percentage of overall revenues, as they were during the three months ended September 30, 2009, overall gross margins will be lower. Conversely, when NES revenues comprise a lower percentage of overall revenues, as they did during the nine months ended September 30, 2009, overall gross margins will be higher. Also contributing to the quarter-over-quarter fluctuations in gross margins was the impact of improved gross margins in our NES product line, which resulted from a higher percentage of our NES revenues being attributable to sales of the more recent, cost reduced versions of our NES products.

Gross margins during the three and nine months ended September 30, 2009 as compared to the same periods in 2008 were also impacted by reduced revenues. As discussed above, a portion of our cost of goods sold relates to indirect costs. Some of these costs do not increase or decrease in conjunction with revenue levels, but rather remain relatively constant from quarter to quarter. As a result, when revenues decrease, as they did in the three and nine months ended September 30, 2009 as compared to the same period in 2008, gross margins are negatively impacted.

Our future gross margins will continue to be affected by several factors, including, but not limited to: overall revenue levels; changes in the mix of products sold; periodic charges related to excess and obsolete inventories, warranty expenses; introductions of cost reduced versions of our NES and LWI products; changes in the average selling prices of the products we sell; purchase price variances; and fluctuations in the level of indirect overhead spending that is capitalized in inventory. In addition, the impact of foreign exchange rate fluctuations may affect our gross margins in the future. We currently outsource the manufacturing of most of our products requiring assembly to contract electronic manufacturers (CEMs) located primarily in China. To the extent the dollar were to weaken against the Chinese currency, or other currencies used by our CEMs, our costs for the products they manufacture could rise, which would negatively affect our gross margins. Lastly, many of our products, particularly our NES products, contain significant amounts of certain commodities, such as copper and cobalt. Recently, prices for these commodities have been volatile, which in turn have caused fluctuations in the prices we pay for the products in which they are incorporated.



**Table of Contents****Operating Expenses***Product Development*

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>		<b>2009 over</b>	
	<b>September 30,</b>	<b>September 30,</b>	<b>2008 \$</b>	<b>2009 over</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>2008 %</b>
Product Development	\$ 8,850	\$ 9,713	\$ (863)	(8.9)%

<i>(Dollars in thousands)</i>	<b>Nine Months Ended</b>		<b>2009 over</b>	<b>2009 over</b>
	<b>September 30,</b>	<b>September 30,</b>	<b>2008 \$</b>	<b>2008 %</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>Change</b>
Product Development	\$ 26,583	\$ 28,151	\$ (1,568)	(5.6)%

Product development expenses consist primarily of payroll and related expenses for development personnel, fees paid to third party consultants, facility costs, equipment and supplies, depreciation and amortization, and other costs associated with the development of new technologies and products.

The \$863,000 decrease in product development expense for the quarter ended September 30, 2009 as compared to the same period in 2008 was primarily due to a \$376,000 decrease in compensation expenses for our product development personnel, which was primarily the result of a structured salary reduction program we implemented in May 2009 for our U.S. based personnel as well as reduced equity compensation expense. Also contributing to the quarter-over-quarter decrease were lower facility costs of \$142,000, reductions in equipment and supplies used in the development process of \$116,000, fees paid to third party service providers of \$97,000, and other miscellaneous spending reductions of \$132,000.

The \$1.6 million decrease in product development expense for the nine months ended September 30, 2009 as compared to the same period in 2008 was primarily due to a \$420,000 reduction in equipment and supply expenses, a \$356,000 decrease in compensation expenses, reduced facility costs of \$351,000, a \$307,000 reduction in fees paid to third party service providers, and other miscellaneous spending reductions of \$134,000.

*Sales and Marketing*

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>		<b>2009 over</b>	<b>2009 over</b>
	<b>September 30,</b>	<b>September 30,</b>	<b>2008 \$</b>	<b>2008 %</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>Change</b>
Sales and Marketing	\$ 5,279	\$ 5,653	\$ (374)	(6.6)%

<i>(Dollars in thousands)</i>	<b>Nine Months Ended</b>		<b>2009 over</b>	<b>2009 over</b>
	<b>September 30,</b>	<b>September 30,</b>	<b>2008 \$</b>	<b>2008 %</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>Change</b>
Sales and Marketing	\$ 16,656	\$ 17,820	\$ (1,164)	(6.5)%

Sales and marketing expenses consist primarily of payroll and related expenses for sales and marketing personnel, including commissions to sales personnel, travel and entertainment, facilities costs, advertising and product promotion, and other costs associated with our sales and support offices.

The \$374,000 decrease in sales and marketing expenses for the quarter ended September 30, 2009 as compared to the same period in 2008 was primarily due to a \$161,000 decrease in compensation expenses for our sales and marketing personnel, a \$66,000 reduction in facility costs, a \$53,000 reduction in fees paid to third party service providers, and miscellaneous other spending reductions of \$94,000. The \$1.2 million decrease in sales and marketing expenses for the nine months ended September 30, 2009 as compared to the same period in 2008 was primarily due to a \$319,000 decrease in advertising and product promotion costs, a \$268,000 reduction in travel and entertainment expenses, a \$190,000 decrease in facility costs, a \$138,000 reduction in fees paid to third party service providers, an \$89,000 decrease in compensation expenses, and miscellaneous other spending reductions of \$160,000.

## Edgar Filing: ECHELON CORP - Form 10-Q

Also contributing to the decreases between the three and nine month periods was the impact of foreign currency exchange rate fluctuations between the U.S. dollar and the local currencies in several of the foreign countries in which we operate, including the Euro, the British Pound Sterling, and the Japanese Yen. Approximately \$57,000 of the \$374,000 decrease between the two quarterly periods, and \$498,000 of the \$1.2 million decrease between the two nine month periods, was the result of these foreign currency exchange rate fluctuations.

**Table of Contents**

Our future sales and marketing expenses will continue to be affected by fluctuations in exchange rates between the U.S. dollar and the foreign currencies where we operate. If the United States dollar were to weaken against these currencies, our sales and marketing expenses would increase. Conversely, if the dollar were to strengthen against these currencies, it would have a favorable impact on our sales and marketing expenses.

*General and Administrative*

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>		<b>2009 over</b>	
	<b>September 30,</b>		<b>2008 \$</b>	<b>2009 over</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>2008 %</b>
General and Administrative	\$ 3,717	\$ 3,761	\$ (44)	(1.2)%

<i>(Dollars in thousands)</i>	<b>Nine Months Ended</b>		<b>2009 over</b>	
	<b>September 30,</b>		<b>2008 \$</b>	<b>2009 over</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>2008 %</b>
General and Administrative	\$ 11,590	\$ 12,997	\$ (1,407)	(10.8)%

General and administrative expenses consist primarily of payroll and related expenses for executive, finance, and administrative personnel, professional fees for legal and accounting services rendered to the company, facility costs, insurance, and other general corporate expenses.

The \$44,000 decrease in general and administrative expenses during the quarter ended September 30, 2009 as compared to the same period in 2008 was primarily related to a \$128,000 reduction travel and entertainment expenses, a \$71,000 reduction in salaries and wages for our general and administrative personnel, and miscellaneous other spending reductions of \$77,000, partially offset by a \$232,000 increase in non-cash equity compensation expenses. The \$1.4 million decrease in general and administrative expenses during the nine months ended September 30, 2009 as compared to the same period in 2008 was primarily related to a \$666,000 reduction in expenses related to our independent accountants and other third party service providers, a \$459,000 reduction in facility costs, a \$235,000 reduction in compensation and other employee related expenses, and miscellaneous other spending reductions of \$47,000.

**Interest and Other Income, Net**

<i>(Dollars in thousands)</i>	<b>Three Months Ended</b>		<b>2009 over</b>	
	<b>September 30,</b>		<b>2008 \$</b>	<b>2009 over</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>2008 %</b>
Interest and Other Income (Expense), Net	\$ (91)	\$ 1,141	\$ (1,232)	(108.0)%

<i>(Dollars in thousands)</i>	<b>Nine Months</b>		<b>2009 over</b>	
	<b>Ended September 30,</b>		<b>2008 \$</b>	<b>2009 over</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>2008 %</b>
Interest and Other Income (Expense), Net	\$ (158)	\$ 2,319	\$ (2,477)	(106.8)%

Interest and other income, net primarily reflects interest income earned by our company on cash and short-term investment balances as well as foreign exchange translation gains and losses related to short-term intercompany balances.

The \$1.2 million and \$2.5 million decreases in interest and other income, net during the three and nine month periods ended September 30, 2009 as compared to the same periods in 2008 were primarily attributable to a \$482,000 and \$1.7 million, respectively, decrease in interest income. The reduction in interest income is primarily the result of a reduction in our average invested cash balance between the periods coupled with reductions in the weighted average yield on our investment portfolio.

Also contributing to the \$1.2 million and \$2.5 million declines in interest and other income, net between the two three and nine month periods were increases of \$736,000 and \$701,000, respectively, in foreign currency translation losses. We account for foreign currency translation gains and losses associated with our short-term intercompany balances by reflecting these amounts as either other income or loss in our consolidated statements of operations. During periods when the U.S. dollar strengthens in value against these foreign currencies, the associated translation gains favorably impact other income. Conversely, when the U.S. dollar weakens, as it did during the third quarter of 2009, the resulting

translation losses negatively impact other income.

**Table of Contents****Interest Expense on Lease Financing Obligations**

<i>(Dollars in thousands)</i>	<b>Three Months Ended September 30,</b>		<b>2009 over 2008 \$</b>	<b>2009 over 2008 %</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>Change</b>
Interest Expense on Lease Financing Obligations	\$ 415	\$ 435	\$ (20)	(4.6)%

  

<i>(Dollars in thousands)</i>	<b>Nine Months Ended September 30,</b>		<b>2009 over 2008 \$</b>	<b>2009 over 2008 %</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>Change</b>
Interest Expense on Lease Financing Obligations	\$ 1,259	\$ 974	\$ 285	29.3%

The monthly rent payments we make to our lessor under the lease agreements for our San Jose headquarters site are recorded in our financial statements partially as land lease expense, with the remainder being allocated to principal and interest on the financing liability. Interest expense on lease financing obligations reflects the portion of our monthly lease payments that is allocated to interest expense.

The \$285,000 increase in interest expense on lease financing obligations during the nine months ended September 30, 2009 as compared to the same period in 2008 was the result of the June 2008 building lease extension. The extension had the effect of increasing the amount of our monthly payment attributable to interest expense. As with any amortizing fixed rate loan, payments made earlier in the term of the loan are comprised primarily of interest expense with little being allocated to principal repayment. Payments made later in the term of the loan, however, have an increasing proportion of principal repayment, with less being attributable to interest expense. Accordingly, as we continue to make payments in accordance with our lease obligation, we expect a higher proportion of these future payments will be allocated to principal repayment and less will be allocated to interest expense.

**Provision for Income Taxes**

<i>(Dollars in thousands)</i>	<b>Three Months Ended September 30,</b>		<b>2009 over 2008 \$</b>	<b>2009 over 2008 %</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>Change</b>
Income Tax Expense	\$ 155	\$ 136	\$ 19	14.0%

  

<i>(Dollars in thousands)</i>	<b>Nine Months Ended September 30,</b>		<b>2009 over 2008 \$</b>	<b>2009 over 2008 %</b>
	<b>2009</b>	<b>2008</b>	<b>Change</b>	<b>Change</b>
Income Tax Expense	\$ 31	\$ 230	\$ (199)	(86.5)%

Income tax expense for the quarters ended September 30, 2009 and 2008 was \$155,000 and \$136,000, respectively. Income tax expense for the nine month periods ended September 30, 2009 and 2008 was \$31,000 and \$230,000, respectively. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits.

**OFF-BALANCE-SHEET ARRANGEMENTS AND OTHER CONTRACTUAL OBLIGATIONS**

**Off-Balance-Sheet Arrangements.** We have not entered into any transactions with unconsolidated entities whereby we have financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose our company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to us.

**Lease Commitments.** In December 1999, we entered into a lease agreement with a real estate developer for our existing corporate headquarters in San Jose, California. In October 2000, we entered into a second lease agreement with the same real estate developer for an additional building at our headquarters site. These leases were scheduled to expire in 2011 and 2013, respectively.

## Edgar Filing: ECHELON CORP - Form 10-Q

Effective June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately \$48.9 million. Both

**Table of Contents**

leases permit us to exercise an option to extend the respective lease for two sequential five-year terms. In addition, the amended leases eliminated our requirement to provide the landlord with security deposits totaling \$6.2 million, which we had previously satisfied by causing to have issued standby letters of credit ( LOCs ). As of June 30, 2008, the previously issued LOCs had been returned to the bank that issued them and were cancelled.

In addition, we lease facilities under operating leases for our sales, marketing, distribution, and product development personnel located elsewhere within the United States and in ten foreign countries throughout Europe and Asia, including a land lease for accounting purposes associated with our corporate headquarters facilities in San Jose, California. These operating leases expire on various dates through 2020, and in some instances are cancelable with advance notice. Lastly, we also lease certain equipment and, for some of our sales personnel, automobiles. These operating leases are generally less than five years in duration.

**Purchase Commitments.** We utilize several contract manufacturers who manufacture and test our products requiring assembly. These contract manufacturers acquire components and build product based on demand information supplied by us in the form of purchase orders and demand forecasts. These purchase orders and demand forecasts generally cover periods that range from one to six months, and in some cases, up to one year. We also obtain individual components for our products from a wide variety of individual suppliers. We generally acquire these components through the issuance of purchase orders, and in some cases through demand forecasts, both of which cover periods ranging from one to nine months.

We also utilize purchase orders when procuring capital equipment, supplies, and services necessary for our day-to-day operations. These purchase orders generally cover periods ranging up to twelve months, but in some instances cover a longer duration.

**Indemnifications.** In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant. However, we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that could enable us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

**Royalties.** We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which is recorded under our cost of products revenue in our condensed consolidated statements of operations, was approximately \$99,000 during the quarter ended September 30, 2009, and \$127,000 for the same period in 2008, and \$291,000 for the nine months ended September 30, 2009, and \$400,000 for the same period in 2008.

We will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of our products. While we are currently unable to estimate the maximum amount of these future royalties, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

**Taxes.** We conduct our operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on Echelon's operations in that particular location. While we strive to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with generally accepted accounting principles, we make a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and we believe that, as of September 30, 2009, we have adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

**Table of Contents**

**Legal Actions.** In April 2009, we received notice that the receiver for two companies that filed for the Italian law equivalent of bankruptcy protection in May 2004, Finmek Manufacturing SpA and Finmek Access SpA (collectively, the Finmek Companies), has filed a lawsuit under an Italian claw back law in Padua, Italy against us, seeking the return of approximately \$16.7 million in ordinary course of business payments received by us in payment for components we sold to the Finmek Companies prior to the bankruptcy filing. The Finmek Companies were among Enel's third party meters manufacturers, and from time to time through January 2004, we sold components to the Finmek Companies that were incorporated into the electricity meters that were manufactured by the Finmek Companies and sold to Enel SpA for the Enel Project. We believe that the Italian claw back law is not applicable to our transactions with the Finmek Companies, and the claims of the Finmek Companies' receiver are without merit.

From time to time, in the ordinary course of business, we may be subject to other legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While we believe we have adequately provided for such contingencies as of September 30, 2009, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

**LIQUIDITY AND CAPITAL RESOURCES**

Since our inception, we have financed our operations and met our capital expenditure requirements primarily from the sale of preferred stock and common stock, although during the years 2002 through 2004, we were also able to finance our operations through operating cash flow. From inception through September 30, 2009, we raised \$293.3 million from the sale of preferred stock and common stock, including the exercise of stock options and warrants from our employees and directors.

In March and August 2004, March 2006, and February 2007, our board of directors approved a stock repurchase program, which authorized us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. We repurchased a total of 2,204,184 shares under the program at a cost of \$16.1 million. This stock repurchase program expired in March 2008.

In April 2008, our board of directors approved a new stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. There were no repurchases under this stock repurchase program during the quarter and nine months ended September 30, 2009. Since inception, we have repurchased a total of 750,000 shares under this program at a cost of \$8.9 million. As of September 30, 2009, 2,250,000 shares were available for repurchase. This stock repurchase program will expire in April 2011.

The following table presents selected financial information as of September 30, 2009, and for each of the last three fiscal years (dollars in thousands):

	September 30,		December 31,	
	2009	2008	2007	2006
Cash, cash equivalents, and short-term investments	\$ 76,435	\$ 87,316	\$ 107,190	\$ 124,157
Trade accounts receivable, net	14,737	23,480	33,469	13,918
Working capital	96,116	108,811	126,711	129,521
Stockholders' equity	116,569	132,571	153,211	153,663

As of September 30, 2009, we had \$76.4 million in cash, cash equivalents, and short-term investments, a decrease of \$10.9 million as compared to December 31, 2008. Historically, our primary source of cash, other than stock sales, has been receipts from revenue, and to a lesser extent, proceeds from the exercise of stock options and warrants by our employees and directors. Our primary uses of cash have been cost of product revenue, payroll (salaries, commissions, bonuses, and benefits), general operating expenses (costs associated with our offices such as rent, utilities, and maintenance; fees paid to third party service providers such as consultants, accountants, and attorneys; travel and entertainment; equipment and supplies; advertising; and other miscellaneous expenses), acquisitions, capital expenditures, and purchases under our stock repurchase programs.



**Table of Contents**

**Cash flows from operating activities.** Cash flows from operating activities have historically been driven by net income (loss) levels, adjustments for non-cash charges such as stock-based compensation, depreciation, amortization, and in-process research and development charges, as well as fluctuations in operating asset and liability balances. Net cash used in operating activities was \$11.0 million for the nine months ended September 30, 2009, an increase in cash outflows of approximately \$13.0 million as compared to the same period in 2008. During the nine months ended September 30, 2009, net cash used in operating activities was primarily the result of our net loss of \$28.3 million, partially offset by stock-based compensation expenses of \$10.7 million, depreciation and amortization expense of \$4.8 million, and changes in our operating assets and liabilities of \$1.8 million. During the nine months ended September 30, 2008, net cash provided by operating activities was primarily the result of stock-based compensation expenses of \$10.7 million, depreciation and amortization expense of \$5.8 million, changes in our operating assets and liabilities of \$4.4 million, and a reduction in our accrued investment income of \$645,000, partially offset by our net loss of \$19.6 million.

**Cash flows from investing activities.** Cash flows from investing activities have historically been driven by transactions involving our short-term investment portfolio, capital expenditures, changes in our long-term assets, and acquisitions. Net cash used in investing activities was \$20.6 million for the nine months ended September 30, 2009, an increase in cash outflows of approximately \$32.7 million as compared to the same period in 2008. During the nine months ended September 30, 2009, net cash used in investing activities was primarily the result of purchases of available-for-sale short-term investments of \$99.8 million and capital expenditures of \$1.3 million, partially offset by proceeds from maturities and sales of available-for-sale short-term investments of \$79.4 million and changes in our other long-term assets of \$1.0 million. During the nine months ended September 30, 2008, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of \$61.0 million, partially offset by purchases of available-for-sale short-term investments of \$45.4 million and capital expenditures of \$3.5 million.

**Cash flows from financing activities.** Cash flows from financing activities has historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase programs and principal payments on our lease financing obligations. Net cash provided by financing activities was \$51,000 for the nine months ended September 30, 2009, an increase in cash inflows of approximately \$9.7 million as compared to the same period in 2008. During the nine months ended September 30, 2009, net cash provided by financing activities was primarily the result of \$1.8 million from the exercise of stock options by our employees, partially offset by \$1.1 million in principal payments on our building lease financing obligations, and \$699,000 worth of shares repurchased from employees for payment of employee taxes on vesting of share awards and upon exercise of stock options. During the nine months ended September 30, 2008, net cash used in financing activities was primarily the result of \$8.9 million worth of open-market repurchases of our common stock under our stock repurchase program, \$1.5 million in principal payments on our building lease financing obligations, and \$1.4 million worth of shares repurchased from employees for payment of employee taxes on vesting of share awards and upon exercise of stock options; partially offset by proceeds of \$2.0 million from the exercise of stock options by our employees.

We use well-regarded investment managers to manage our invested cash. Our portfolio of investments managed by these investment managers is primarily composed of highly rated U.S. government securities, and to a less extent, money market funds and U.S. corporate obligations. All investments are made according to guidelines and within compliance of policies approved by the Audit Committee of our Board of Directors.

We maintain a \$10.0 million line of credit with our primary bank. As of September 30, 2009, our primary bank has issued, against the line of credit, a standby letter of credit totaling \$37,000. Other than causing to have issued standby letters of credit, we have never drawn against the line of credit, nor have amounts ever been drawn against the standby letters of credit issued by the bank.

In the future, our cash reserves may be used to strategically acquire other companies, products, or technologies that are complementary to our business. In addition, our combined cash, cash equivalents, and short-term investments balances could be negatively affected by various risks and uncertainties, including, but not limited to, the risks detailed later in this discussion in the section titled *Factors That May Affect Future Results of Operations*. For example, any continued weakening of economic conditions or changes in our planned cash outlay could negatively affect our existing cash reserves.

---

**Table of Contents**

Based on our current business plan and revenue prospects, we believe that our existing cash reserves will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. However, we currently expect that our combined cash, cash equivalent, and short-term investment balance will decline during the remainder of 2009. We expect that cash requirements for our payroll and other operating costs will continue at about existing levels. We also expect that we will continue to acquire capital assets such as computer systems and related software, office and manufacturing equipment, furniture and fixtures, and leasehold improvements, as the need for these items arises. In the event that we require additional financing, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

**RELATED PARTY TRANSACTIONS**

During the three and nine months ended September 30, 2009, and the years ended December 31, 2008, 2007, and 2006, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, our Chairman and Chief Executive Officer, M. Kenneth Oshman, uses his private plane or charter aircraft for company business for himself and any employees that accompany him. In August 2008, our Board of Directors approved a reimbursement arrangement whereby our company will reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. During the three and nine months ended September 30, 2009, we recognized a total of approximately \$38,000 and \$169,000, respectively, in expenses pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the condensed consolidated statements of operations. The Audit Committee of the Company's Board of Directors regularly reviews these reimbursements.

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for \$130.7 million (see Note 11 to our accompanying condensed consolidated financial statements for additional information on our transactions with Enel). The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our knowledge, Enel has not disposed of any of its 3.0 million shares.

Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. A representative of Enel is not presently serving on our board.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from us. Under the software enhancement agreement, we provide software enhancements to Enel for use in its Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

For the three months ended September 30, 2009 and 2008, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$1.2 million and \$5.5 million, respectively. For the nine months ended September 30, 2009 and 2008, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$4.2 million and \$8.4 million, respectively. As of September 30, 2009, and December 31, 2008, \$630,000 and \$5.0 million, respectively, of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

---

**Table of Contents**

**RECENTLY ISSUED ACCOUNTING STANDARDS**

See the section entitled *Recent Accounting Pronouncements* in Note 1 of Notes to Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q, which is incorporated herein by reference, for a full description of recent accounting pronouncements or changes in accounting pronouncements during the nine months ended September 30, 2009, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the year ended December 31, 2008.

**FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS**

*Interested persons should carefully consider the risks described below in evaluating our company. Additional risks and uncertainties not presently known to us, or that we currently consider immaterial, may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock would likely decline.*

**Adverse changes in general economic or political conditions in any of the major countries in which we do business could adversely affect our business or operating results.**

Our business can be affected by a number of factors that are beyond our control, such as general geopolitical, economic, and business conditions. Recent turmoil in the worldwide financial markets, and the present economic slowdown and the uncertainty over its breadth, depth and duration continue to put pressure on the global economy and have a negative effect on our business. Further, the worldwide financial and credit crisis continues to limit the availability of liquidity and credit to fund the continuation and expansion of business operations worldwide. The shortage of liquidity and credit combined with losses in worldwide equity markets are causing the current economic recession in the United States and around the world to continue.

While we do not currently depend on access to the credit markets to finance our operations, there can be no assurance that the deterioration in financial markets will not impair our ability to obtain financing in the future, including, but not limited to, our ability to draw on funds under our existing credit facilities or our ability to incur indebtedness if that became necessary. If we were not able to obtain additional financing when needed, our ability to invest in additional research and development resources and sales and marketing resources could be adversely affected, which could hinder our ability to sell competitive products into our markets on a timely basis.

In addition, there could be a number of follow-on effects from the credit crisis on our business, such as the insolvency of certain of our key customers, which could impair our distribution channels, or result in the inability of our customers to obtain credit to finance purchases of our products. Also, the recently enacted U.S. economic stimulus legislation has caused potential customers to delay their purchases until they determine whether and when the economic incentives will become available to them under the legislation.

This uncertainty about future economic and political conditions makes it difficult for us to forecast operating results and to make decisions about future investments. We have already seen the effects of the economic slowdown on both of our LWI and NES revenues. If economic activity in the U.S. and other countries' economies remains weak, many customers may continue to delay, reduce, or even eliminate their purchases of networking technology products. This could result in reductions in sales of our products, longer sales cycles, slower adoption of our technologies, increased price competition, and increased exposure to excess and obsolete inventory. For example, distributors could decide to further reduce inventories of our products. Also, the inability to obtain credit could cause a utility to postpone its decision to move forward with a large scale deployment of our NES system. If conditions in the global economy, U.S. economy or other key vertical or geographic markets we serve remain uncertain or weaken further, we would experience material negative impacts on our business, financial condition, results of operations, cash flow, capital resources, and liquidity.

**Our NES revenues may not be predictable, which could cause volatility in the price of our stock.**

We and our partners sell our NES system to utilities. For several reasons, sales cycles with utility companies are generally extended and unpredictable. Utilities generally have complex budgeting, purchasing, and regulatory processes that govern their capital spending. In addition, in many instances, a utility may require one or more field trials of an automated meter infrastructure (AMI) system (such as one based on our NES system) before moving to a volume deployment. There is also generally an extended development and integration effort required in order to incorporate a new technology into a utility's existing infrastructure. In

---

**Table of Contents**

addition, in the U.S., utilities have delayed deployments as they have sought incentives under the U.S. economic stimulus legislation. A number of other factors may also need to be addressed before the utility decides to engage in a full-scale deployment of our NES system, including:

regulatory factors or internal utility requirements that may affect the AMI system or the timing of its deployment;

the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments;

the deployment schedule for projects undertaken by our utility or systems integrator customers; and

delays in installing, operating, and evaluating the results of an AMI field trial that is based on our NES system.

As a result, we can often spend up to two years working either directly or through a reseller to make a sale to a utility. At the end of that lengthy sales process, there is no guarantee that we will be selected by the utility.

In addition, shipment of NES products to a particular jurisdiction or customer is generally dependent on either obtaining regulatory approval for the NES meter or other products from a third party for the relevant jurisdiction, or satisfying the customer's internal testing requirements, or both. This certification approval process is often referred to as homologation. Further, shipment of NES products into some jurisdictions requires our contract manufacturers to pass certain tests and meet various standards related to the production of our NES meters. Failure to receive any such approval on a timely basis or at all, or failure to maintain any such approval, would have a material adverse impact on our ability to ship our NES system products, and would therefore have an adverse affect on our results of operations and our financial condition.

Once a utility decides to move forward with a large-scale deployment of an AMI project that is based on our NES system, the timing of and our ability to recognize revenue on our NES system product shipments will depend on several factors. These factors, some of which may not be under our control, include shipment schedules that may be delayed or subject to modification, other contractual provisions, such as customer acceptance of all or any part of the AMI system, and our ability to manufacture and deliver quality products according to expected schedules. In addition, the complex revenue recognition rules relating to products such as our NES system may also require us to defer some or all of the revenue associated with NES product shipments until certain conditions, such as the acceptance of software deliverables, are met in a future period. By way of example, at the end of 2006, our revenue recognition policies required us to defer approximately \$14.4 million of NES revenue due to customer requests for modified functionality in a software feature even though we had already shipped the associated hardware, which had been accepted and in some cases paid for by the customers.

As a consequence of these long sales cycles, unpredictable delay factors, and complex revenue recognition policies, our ability to predict the amount of NES revenues that we may expect to recognize in any given fiscal quarter is likely to be limited. As NES revenues account for an increasing percentage of our overall revenues, we are likely to have increasing difficulty in projecting our overall financial results. Our inability to accurately forecast future revenues is likely to cause our stock price to be volatile.

**Sales of our NES system may fail to meet our financial targets, which would harm our results of operations.**

We have invested and intend to continue to invest significant resources in the development and sales of our NES system. Our long-term financial goals include expectations for a reasonable return on these investments. However, to date the revenues generated from sales of our NES system products have not yielded gross margins in line with our long term goals for this product line, although our NES related operating expenses have increased significantly.

In order to achieve our financial targets, we must meet the following objectives:

Increase market acceptance of our NES system products in order to increase NES revenues;

## Edgar Filing: ECHELON CORP - Form 10-Q

Increase gross margin from our NES revenues by continuing to reduce the cost of manufacturing our NES system products, while at the same time managing manufacturing cost pressures associated with commodity prices and foreign exchange fluctuations;

Manage the manufacturing transition to reduced-cost NES products; and

Manage our operating expenses to a reasonable percentage of revenues.

We cannot assure you that we will meet any or all of these objectives to the extent necessary to achieve our financial goals and, if we fail to achieve our goals, our results of operations are likely to be harmed.

---

**Table of Contents**

**We are exposed to credit risk and payment delinquencies on our accounts receivable, and this risk has been heightened during the current decline in economic conditions.**

We only recognize revenue when we believe collectibility is reasonably assured. However, almost none of our outstanding accounts receivables are covered by collateral or credit insurance. In addition, our standard terms and conditions permit payment within a specified number of days following shipment of product, or in some cases, after the customer's acceptance of our products. While we have procedures to monitor and limit exposure to credit risk on our receivables, there can be no assurance such procedures will effectively limit our credit risk and avoid losses. Additionally, when one of our resellers makes a sale to a utility, we face further credit risk due to the fact that the reseller may not be able to pay us until it receives payment from the utility. As economic conditions change and worsen, certain of our direct or indirect customers may face liquidity concerns and may be unable to timely satisfy their payment obligations to us or our resellers, which could have a material adverse effect on our financial condition and results of operations.

**If we are not able to develop or enhance our products in a timely manner, our revenues will suffer.**

Due to the nature of development efforts in general, we often experience delays in the introduction of new or improved products beyond our original projected shipping date for such products. Historically, when these delays have occurred, we experienced an increase in our development costs and a delay in our ability to generate revenues from these new products. In addition, such delays could impair our relationship with any of our customers that were relying on the timely delivery of our products in order to complete their own products or projects. We believe that similar new product introduction delays in the future could also increase our costs and delay our revenues.

**Because we depend on a limited number of key suppliers and in certain cases, a sole supplier, the failure of any key supplier to produce timely and compliant products could result in a failure to ship products, which would harm our results of operations and financial position.**

Our future success will depend significantly on our ability to timely manufacture our products cost effectively, in sufficient volumes, and in accordance with quality standards. For most of our products requiring assembly, we rely on a limited number of contract electronic manufacturers (CEMs), principally Jabil and TYCO. These CEMs procure material and assemble, test, and inspect the final products to our specifications. This strategy involves certain risks, including reduced control over quality, costs, delivery schedules, availability of materials, components, finished products, and manufacturing yields. As a result of these and other risks, our CEMs could demand price increases for manufacturing our products. In addition, CEMs can experience turnover and instability, exposing us to additional risks as well as missed commitments to our customers.

We also maintain manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products, including those used in our NES system. The Neuron Chip, which is an important component that we and our customers use in control network devices, is currently manufactured and distributed by two providers, Toshiba and Cypress Semiconductor. Toshiba has informed us that it does not intend to renew its Neuron Chip agreement with us when it expires in January 2010. However, we have agreed with Toshiba that Toshiba will continue to accept orders for Neuron Chips from its customers through September 2011 for deliveries through December 2012. In the meantime, we are working closely with Toshiba to provide a smooth migration path for Toshiba's customers using our new Neuron 5000 processor, which we intend to purchase from Open-Silicon. Another semiconductor supplier, STMicroelectronics, manufactures our power line smart transceiver products, for which we have no alternative source. In addition, we currently purchase several key products and components from sole or limited source suppliers with which we do not maintain signed agreements that would obligate them to supply to us on negotiated terms.

We are continuing to review the impact the ongoing worldwide financial crisis is having on our suppliers. Some of these suppliers are large, well capitalized companies, while others are smaller and more highly leveraged. In order to mitigate these risks, we may take actions such as increasing our inventory levels and/or adding additional sources of supply. Such actions may increase our costs and increase the risk of excess and obsolete inventories. Even if we undertake such actions, there can be no assurance that we will be able to prevent any disruption in the supply of goods and services we receive from these suppliers.

We may also elect to change any of these key suppliers. For example, earlier this year we completed the process of ending our relationship with a former CEM partner, Flextronics. As part of this transition, we moved the production of products Flextronics built for us to alternative CEMs. We were also required to purchase certain raw material and in-process inventory from Flextronics that Flextronics procured in anticipation of our production requirements. In addition, if any of our key suppliers were to stop manufacturing our products or supplying us with our key components, it could be expensive and time consuming to find a



## Table of Contents

replacement. Also, as our NES business grows, we will be required to expand our business with our key suppliers or find additional sources of supply, as we have recently done with Jabil. There is no guarantee that we would be able to find acceptable alternative or additional sources. Additional risks that we face if we must transition between CEMs include:

moving raw material, in-process inventory, and capital equipment between locations, some of which may be in different parts of the world;

reestablishing acceptable manufacturing processes with a new work force; and

exposure to excess or obsolete inventory held by contract manufacturers for use in our products.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with our product, assembly and test specifications could result in our failure to ship products, which would adversely affect our revenues and gross profit, and could result in claims against us by our customers, which could harm our results of operations and financial position.

**Because our products use components or materials that may be subject to price fluctuations, shortages, or interruptions of supply, we may be unable to ship our products in a timely fashion, which would adversely affect our revenues, harm our reputation and negatively impact our results of operations.**

We may be vulnerable to price increases for products, components, or materials, such as copper and cobalt. We generally do not enter into forward contracts or other methods of hedging against supply risk of these raw materials. In addition, in the past we have occasionally experienced shortages or interruptions in supply for certain of these items, including products or components that have been or will be discontinued, which caused us to delay shipments beyond targeted or announced dates. To help address these issues, we may decide to purchase quantities of these items that are in excess of our estimated requirements. As a result, we could be forced to increase our excess and obsolete inventory reserves to provide for these excess quantities, which could harm our operating results.

If we experience any shortage of products or components of acceptable quality, or any interruption in the supply of these products or components, or if we are not able to procure them from alternate sources at acceptable prices and within a reasonable period of time, our revenues, gross profits or both could decrease. In addition, under the terms of some of our contracts with our customers, we may also be subject to penalties if we fail to deliver our products on time.

**Because we may incur penalties and/or be liable for damages with respect to sales of our NES system products, we could incur unanticipated liabilities that would negatively affect our operating results.**

In the event of late deliveries, late or improper installations or operations, failure to meet product specifications or other product failures, failure to achieve performance specifications, indemnities or other compliance issues, the agreements governing the sales of the NES system may expose us to penalties, damages and other liabilities. Even in the absence of such contractual provisions, we may agree, or may be required by law, to assume certain liabilities for the benefit of our customers. Any such liabilities would have an adverse effect on our financial condition and operating results.

**Because the markets for our products are highly competitive, we may lose sales to our competitors, which would harm our revenues and results of operations.**

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, rapid changes in customer or regulatory requirements, and localized market requirements. In each of our markets, we compete with a wide array of manufacturers, vendors, strategic alliances, systems developers and other businesses.

The principal competitive factors that affect the markets for our products include the following:



## Edgar Filing: ECHELON CORP - Form 10-Q

our ability to anticipate changes in customer or regulatory requirements and to develop or improve our products to meet these requirements in a timely manner;

the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;

our product reputation, quality, performance, and conformance with established industry standards;

our ability to meet a customer's required delivery schedules;

our customer service and support;

---

## **Table of Contents**

warranties, indemnities, and other contractual terms; and

customer relationships and market awareness.

Competitors for our NES system products include Aclara, Elster, Enel, GE, IBM, Iskraemeco, Itron, the Landis+Gyr group of companies, Siemens, and Silver Spring Networks, which directly or through IT integrators such as IBM or telecommunications companies such as Telenor, offer metering systems that compete with our NES system offering.

For our LWI products, our competitors include some of the largest companies in the electronics industry, operating either alone or together with trade associations and partners. Key company competitors include companies such as Siemens and Cisco in the building industry; Allen-Bradley (a subsidiary of Rockwell Automation), Groupe Schneider and Siemens in the industrial automation industry; Siemens in the transportation industry; and Zensys in the home control market. Key industry standard and trade group competitors include BACnet, DALI, and Konnex in the buildings industry; DeviceNet, HART, and Profibus in the industrial control market; DLMS in the utility industry; Echonet, ZigBee and the Z-Wave alliance in the home control market; and the Train Control Network (TCN) in the rail transportation market. Each of these standards and/or alliances is backed by one or more competitors. For example, the ZigBee alliance includes over 300 member companies with promoter members such as Ember, Emerson, Freescale, Itron, Kroger, Landis+Gyr, Philips, Reliant Energy, Schneider Electric, STMicroelectronics, Tendril, and Texas Instruments.

Many of our competitors, alone or together with their trade associations and partners, have significantly greater financial, technical, marketing, service and other resources, significantly greater name recognition, and broader product offerings. In addition, the utility metering market is experiencing a trend towards consolidation. As a result, these competitors may be able to devote greater resources to the development, marketing, and sale of their products, and may be able to respond more quickly to changes in customer requirements or product technology. Some of our competitors may also be eligible for stimulus money, which could give them an additional financial advantage. If we are unable to compete effectively in any of the markets we serve, our revenues, results of operations, and financial position would be harmed.

### **Liabilities resulting from defects in or misuse of our products, whether or not covered by insurance, may delay our revenues and increase our liabilities and expenses.**

Our products may contain or may be alleged to contain undetected errors or failures when first introduced, as new versions are released, or as a result of the manufacturing or shipping process. In addition, our customers or their installation partners may improperly install or implement our products, which could delay completion of a deployment or hinder our ability to win a subsequent award. Furthermore, because of the low cost and interoperable nature of our products, LONWORKS technology could be used in a manner for which it was not intended.

Even if we determine that an alleged error or failure in our products does not exist, we may incur expense and shipments and revenue may be delayed while we analyze the alleged error or failure. If errors or failures are found in our products, we may not be able to successfully correct them in a timely manner, or at all. Such errors or failures could delay our product shipments and divert our engineering resources while we attempt to correct them. In addition, we could decide to extend the warranty period, or incur other costs outside of our normal warranty coverage, to help address any known errors or failures in our products and mitigate the impact on our customers. This could delay our revenues and increase our expenses.

To address these issues, the agreements we maintain with our customers may contain provisions intended to limit our exposure to potential errors and omissions claims as well as any liabilities arising from them. In certain very limited instances, these agreements require that we be named as an additional insured on our customers' insurance policies. However, our customer contracts and additional insured coverage may not effectively protect us against the liabilities and expenses associated with errors or failures attributable to our products.

Defects in our products may also cause us to be liable for losses in the event of property damage, harm or death to persons, claims against our directors or officers, and the like. Such liabilities could harm our reputation, expose our company to liability, and adversely affect our operating results and financial position.

To help reduce our exposure to these types of liabilities, we currently maintain property, general commercial liability, errors and omissions, directors and officers, and other lines of insurance. However, it is possible that such insurance may not be available in the future or, if available, may be insufficient in amount to cover any particular claim, or we might not carry insurance that covers a specific claim. In addition, we believe that the premiums for the types of insurance we carry will continue to fluctuate from period to period. Significant cost increases could also result in increased premiums or reduced coverage limits. Consequently, if we elect to reduce our coverage, or if we do not carry insurance for a particular type of claim, we will face increased exposure to these types of claims.



---

**Table of Contents**

**Due to the financial and operational risks associated with our international operations, our revenues may decline due to risks unrelated to our ability to sell our products.**

We have operations located in ten countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 82.0% of our total net revenues for the quarter ended September 30, 2009, and 70.8% of our total net revenues for the same period in 2008; and 80.0% of our total net revenues for the nine months ended September 30, 2009, and 78.5% for the same period in 2008. We expect that international sales will continue to constitute a significant portion of our total net revenues.

Changes in the value of currencies in which we conduct our business relative to the U.S. dollar have caused and could continue to cause fluctuations in our reported financial results. The three primary areas where we are exposed to foreign currency fluctuations are revenues, cost of goods sold, and operating expenses.

In general, we sell our products to foreign customers primarily in U.S. dollars. As such, fluctuations in exchange rates have had in the past and could continue to have an impact on revenues. As the value of the dollar rises, our products will become more expensive to our foreign customers, which could result in their decision to postpone or cancel a planned purchase.

With respect to the relatively minimal amount of our revenues generated in foreign currencies, our historical foreign currency exposure has been related primarily to the Japanese Yen and has not been material to our consolidated results of operations. However, in the future, we expect that some foreign utilities may require us to price our NES system in the utility's local currency, which will increase our exposure to foreign currency risk. In addition, we have agreed with EBV, our European distributor, that upon notice from EBV, we will sell our products to EBV in European Euros rather than U.S. dollars. If EBV were to exercise this right, our revenue exposure to foreign currency fluctuations would increase.

For our cost of goods sold, our products are generally assembled by CEMs in China. Although our transactions with these vendors have historically been denominated in U.S. dollars, in the future they may require us to pay in their local currency, or demand a U.S. dollar price adjustment or other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases. In addition, any future increase in labor costs in the markets where our products are manufactured could also result in higher costs to procure our products.

We use the local currency to pay for our operating expenses in the various countries where we have operations. If the value of the U.S. dollar declines as compared to the local currency where the expenses are incurred, our expenses, when translated back into U.S. dollars, will increase.

To date, we have not hedged any of our foreign currency exposures and currently do not maintain any hedges to mitigate our foreign currency risks. Consequently, any resulting adverse foreign currency fluctuations could significantly harm our revenues, cost of goods sold, or operating expenses.

Additional risks inherent in our international business activities include the following:

the imposition of tariffs or other trade barriers on the importation of our products;

timing of and costs associated with localizing products for foreign countries and lack of acceptance of non-local products in foreign countries;

inherent challenges in managing international operations;

the burdens of complying with a wide variety of foreign laws, the applicability of foreign laws that could affect our business or revenues, such as laws that purport to require that we return payments that we received from insolvent customers in certain circumstances; and unexpected changes in regulatory requirements, tariffs, and other trade barriers;

Edgar Filing: ECHELON CORP - Form 10-Q

economic and political conditions in the countries where we do business;

differing vacation and holiday patterns in other countries, particularly in Europe;

---

**Table of Contents**

labor actions generally affecting individual countries, regions, or any of our customers, which could result in reduced demand for, or could delay delivery or acceptance of, our products;

international terrorism; and

potentially adverse tax consequences, including restrictions on repatriation of earnings.

Any of these factors could have a material adverse effect on our revenues, results of operations, and our financial condition.

**If we do not maintain adequate distribution channels, our revenues will be harmed.**

We market our NES system products directly, as well as through selected VARs and integration partners. We believe that a significant portion of our NES system sales will be made through our VARs and integration partners, rather than directly by our company. To date, our VARs and integration partners have greater experience in overseeing projects for utilities. As a result, if our relationships with our VARs and integration partners are not successful, or if we are not able to create similar distribution channels for our NES system products with other companies in other geographic areas, revenues from sales of our NES system products may not meet our financial targets, which will harm our operating results and financial condition.

Currently, significant portions of our LWI revenues are derived from sales to distributors, including EBV, the primary independent distributor of our products to OEMs in Europe. Historically, sales to EBV, as well as sales to our other distributor partners, have accounted for a substantial portion of our total LWI revenues. Agreements with our distributor partners are generally renewed on an annual basis. If any of these agreements are not renewed, we would be required to locate another distributor or add our own distribution capability to meet the needs of our end-use customers. Any replacement distribution channel could prove less effective than our current arrangements. In addition, if any of our distributor partners fail to dedicate sufficient resources to market and sell our products, our revenues would suffer. Furthermore, if they significantly reduce their inventory levels for our products, service levels to our end-use customers could decrease.

**Our executive officers and technical personnel are critical to our business.**

Our company's success depends substantially on the performance of our executive officers and key employees. Due to the specialized technical nature of our business, we are particularly dependent on our Chief Executive Officer and our technical personnel. In November 2009, we announced that our Chairman and CEO had been diagnosed with lung cancer and would step down as CEO to focus on his treatment. At the same time, we announced that one of our existing directors would become our CEO on an interim basis, while we search for a new CEO. Our future success will depend on our ability to attract, integrate, motivate and retain a successor CEO and qualified technical, sales, operations, and managerial personnel.

Competition for qualified personnel in our business areas is intense, and we may not be able to continue to attract and retain qualified executive officers and key personnel. Our product development and marketing functions are largely based in Silicon Valley, which is a highly competitive marketplace. It may be particularly difficult to recruit, relocate and retain qualified personnel in this geographic area. Moreover, the cost of living, including the cost of housing, in Silicon Valley is known to be high. Because we are legally prohibited from making loans to executive officers, we will not be able to assist potential key personnel as they acquire housing or incur other costs that might be associated with joining our company. In addition, if we lose the services of any of our key personnel and are not able to find suitable replacements in a timely manner, our business could be disrupted, other key personnel may decide to leave, and we may incur increased operating expenses in finding and compensating their replacements.

**The sales cycle for our LWI products is lengthy and unpredictable.**

The sales cycle between initial LWI customer contact and execution of a contract or license agreement with a customer or purchaser of our products, can vary widely. Initially, we must educate our customers about the potential applications of and cost savings associated with our products. If we are successful in this effort, OEMs typically conduct extensive and lengthy product evaluations before making a decision to design our products into their offerings. Once the OEM decides to incorporate our products, volume purchases of our products are generally delayed until the OEM's product development, system integration, and product introduction periods have been completed. In addition, changes in our customer's budgets, or the priority they assign to control network development, could also affect the sales cycle.



## **Table of Contents**

We generally have little or no control over these factors, any of which could prevent or substantially delay our ability to complete a transaction and could adversely affect the timing of our revenues and results of operations.

### **If we sell our NES system products directly to a utility, we will face additional risks.**

If we sell our NES system products to a utility directly, we may be required to assume responsibility for installing the NES system in the utility's territory, integrating the NES system into the utility's operating and billing system, overseeing management of the combined system, working with other of the utility's contractors, and undertaking other activities. To date, we do not have any significant experience with providing these types of services. As a result, if we sell directly to a utility, it may be necessary for us to contract with third parties to satisfy these obligations. We cannot assure you that we would find appropriate third parties to provide these services on reasonable terms, or at all. Assuming responsibility for these or other services would add to the costs and risks associated with NES system installations, and could also negatively affect the timing of our revenues and cash flows related to these transactions.

### **Fluctuations in our operating results may cause our stock price to decline.**

Our quarterly and annual results have varied significantly from period to period, and we have sometimes failed to meet securities analysts' expectations. Moreover, we have a history of losses and cannot assure you that we will achieve sustained profitability in the future. Our future operating results will depend on many factors, many of which are outside of our control, including the following:

the mix of products and services that we sell may change to a less profitable mix;

shipment, payment schedules, and product acceptance may be delayed;

we may be required to modify or add to our NES product offerings to meet a utility's requirements, which could delay delivery and/or acceptance of our products;

the complex revenue recognition rules relating to products such as our NES system could require us to defer some or all of the revenue associated with NES product shipments until certain conditions, such as delivery and acceptance criteria for our software and/or hardware products, are met in a future period;

our contract electronic manufacturers may not be able to provide quality products on a timely basis, especially during periods where capacity in the CEM market is limited;

our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;

our products may not be purchased by utilities, OEMs, systems integrators, service providers and end-users at the levels we project;

downturns in any customer's or potential customer's business, or declines in general economic conditions, could cause significant reductions in capital spending, thereby reducing the levels of orders from our customers;

recording of expense relating to equity compensation will decrease our earnings;



## Edgar Filing: ECHELON CORP - Form 10-Q

we may incur costs associated with any future business acquisitions; and

any future impairment charges related to goodwill, other intangible assets, and other long-lived assets required under generally accepted accounting principles in the United States may negatively affect our earnings and financial condition.

Any of the above factors could, individually or in the aggregate, have a material adverse effect on our results of operations and our financial condition, which could cause our stock price to decline.

---

## **Table of Contents**

### **We may be unable to promote and expand acceptance of our open, interoperable control systems over competing protocols, standards, or technologies.**

LONWORKS technology is open, meaning that many of our technology patents are broadly licensed without royalties or license fees. As a result, our customers are able to develop hardware and software solutions that compete with some of our products. Because some of our customers are OEMs that develop and market their own control systems, these customers in particular could develop competing products based on our open technology. For instance, we have published all of the network management commands required to develop software that competes with our LNS software.

In addition, many of our competitors are dedicated to promoting closed or proprietary systems, technologies, software and network protocols or product standards that differ from or are incompatible with ours. We also face strong competition from large trade associations that promote alternative technologies and standards for particular vertical applications or for use in specific countries. These include BACnet, DALI, and KNX in the buildings market; DeviceNet, HART, and ProfiBus in the industrial controls market; TCN in the rail transportation market; DLMS in the metering market; and Echonet, ZigBee, and Z-Wave in the home control market.

Our technologies, protocols, or standards may not be successful or we may not be able to compete with new or enhanced products or standards introduced by our competitors, which would have a material adverse affect on our revenues, results of operations, and financial condition.

### **Voluntary standards and governmental regulatory actions in our markets could limit our ability to sell our products.**

Standards bodies, which are formal and informal associations that attempt to set voluntary, non-governmental product standards, are influential in many of our target markets. We participate in many voluntary standards organizations around the world in order to both help prevent the adoption of exclusionary standards and to promote voluntary standards for our products. However, we do not have the resources to participate in all voluntary standards processes that may affect our markets.

In addition, many of our products and the industries in which they are used are subject to U.S. and foreign regulation. For example, the power line medium, which is the communications medium used by some of our products, is subject to special regulations in North America, Europe and Japan. In general, these regulations limit the ability of companies to use power lines as a communication medium. In addition, some of our competitors have attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their own products.

The adoption of voluntary standards or the passage of governmental regulations that are incompatible with our products or technology could limit the market opportunity for our products, which could harm our revenues, results of operations, and financial condition.

### **Our business may suffer if it is alleged or found that our products infringe the intellectual property rights of others.**

We may be contractually obligated to indemnify our customers or other third parties that use our products in the event our products are alleged to infringe a third party's intellectual property rights. From time to time, we may also receive notice that a third party believes that our products may be infringing patents or other intellectual property rights of that third party. Responding to those claims, regardless of their merit, can be time consuming, result in costly litigation, divert management's attention and resources, and cause us to incur significant expenses.

As the result of such a claim, we may elect or be required to redesign our products, some of our product offerings could be delayed, or we could be required to cease distributing some of our products. In the alternative, we could seek a license to the third party's intellectual property. Even if our products do not infringe, we may elect to take a license or settle to avoid incurring litigation costs. However, it is possible that we would not be able to obtain such a license or settle on reasonable terms, or at all.

Lastly, our customers may not purchase our products if they are concerned our products may infringe third party intellectual property rights. This could reduce the market opportunity for the sale of our products and services.

## **Table of Contents**

Any of the foregoing risks could have a material adverse affect on our revenues, results of operations, and financial condition.

### **We have limited ability to protect our intellectual property rights.**

Our success depends significantly upon our intellectual property rights. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements and other contractual provisions to establish, maintain and protect these intellectual property rights, all of which afford only limited protection. If any of our patents fail to protect our technology, or if we do not obtain patents in certain countries, our competitors may find it easier to offer equivalent or superior technology.

We have also registered or applied for registration for certain trademarks, and will continue to evaluate the registration of additional trademarks as appropriate. If we fail to properly register or maintain our trademarks or to otherwise take all necessary steps to protect our trademarks, the value associated with the trademarks may diminish. In addition, if we fail to protect our trade secrets or other intellectual property rights, we may not be able to compete as effectively in our markets.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services or use information that we regard as proprietary, or it may not be economically feasible to enforce them. Any of our patents, trademarks, copyrights or intellectual property rights could be challenged, invalidated or circumvented. In addition, we cannot assure you that we have taken or will take all necessary steps to protect our intellectual property rights. Third parties may also independently develop similar technology without breach of our trade secrets or other proprietary rights. In addition, the laws of some foreign countries, including several in which we operate or sell our products, do not protect proprietary rights to as great an extent as do the laws of the United States and it may take longer to receive a remedy from a court outside of the United States. Also, some of our products are licensed under shrink-wrap license agreements that are not signed by licensees and therefore may not be binding under the laws of certain jurisdictions.

From time to time, litigation may be necessary to defend and enforce our proprietary rights. As a result, we could incur substantial costs and divert management resources, which could harm our business, regardless of the final outcome. Despite our efforts to safeguard and maintain our proprietary rights both in the United States and abroad, we may be unsuccessful in doing so. Also, the steps that we take to safeguard and maintain our proprietary rights may be inadequate to deter third parties from infringing, misusing, misappropriating, or independently developing our technology or intellectual property rights, or to prevent an unauthorized third party from misappropriating our products or technology.

### **The trading price of our stock has been volatile, and may fluctuate due to factors beyond our control.**

The trading price of our common stock is subject to significant fluctuations in response to numerous factors, including the following:

significant stockholders may sell some or all of their holdings of our stock;

investors may be concerned about our ability to develop additional customers for our products and services; and

volatility in our stock price may be unrelated or disproportionate to our operating performance.

Any of these factors could have a negative impact on the market price of our stock.

### **Our existing stockholders control a significant percentage of our stock, which will limit other stockholders ability to influence corporate matters.**

As of October 31, 2009, our directors and executive officers, together with certain entities affiliated with them (including, for this purpose, Enel, which has the right to nominate a director to our board of directors), beneficially owned 30.0% of our outstanding stock.

## **Table of Contents**

When we sold 3.0 million newly issued shares of our common stock to Enel on September 11, 2000, we granted Enel the right to nominate a director to our board of directors, although a nominee of Enel does not currently sit on our board. In connection with the stock sale, our directors and our Chief Financial Officer agreed to enter into a voting agreement with Enel in which each of them agreed to vote in favor of Enel's nominee to our board of directors. In addition, Enel agreed to vote for our board's recommendations for the election of directors, approval of accountants, approval of Echelon's equity compensation plans, and certain other matters. As a result, our directors and executive officers, together with certain entities affiliated with them, may be able to control substantially all matters requiring approval by our stockholders, including the election of all directors and approval of certain other corporate matters.

### **Natural disasters, power outages, and other factors outside of our control such as widespread pandemics could disrupt our business.**

We must protect our business and our network infrastructure against damage from earthquake, flood, hurricane and similar events, as well as from power outages. A natural disaster, power outage, or other unanticipated problem could also adversely affect our business by, among other things, harming our primary data center or other internal operations, limiting our ability to communicate with our customers, and limiting our ability to sell our products. We do not insure against several natural disasters, including earthquakes.

Any outbreak of a widespread communicable disease pandemic, such as the outbreak of the H1N1 influenza virus or the SARS epidemic of 2003, could similarly impact our operations. Such impact could include, among other things, the inability for our sales and operations personnel located in affected regions to travel and conduct business freely, the impact any such disease may have on one or more of the distributors for our products in those regions, and increased supply chain costs. Additionally, any future health-related disruptions at our third-party contract manufacturers or other key suppliers could affect our ability to supply our customers with products in a timely manner, which would harm our results of operations.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

We have not experienced any material change in our exposure to interest rate and foreign currency risks since the date of our Annual Report on Form 10-K for the year ended December 31, 2008.

**Market Risk Disclosures.** The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments to hedge these exposures.

**Interest Rate Sensitivity.** We maintain a short-term investment portfolio consisting mainly of fixed income securities with a weighted average maturity of less than one year. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately and uniformly by 10% from levels at September 30, 2009, and December 31, 2008, the fair value of the portfolio would decline by an immaterial amount. We currently intend to hold our fixed income investments until maturity, and therefore we would not expect our operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates. If necessary, we may sell short-term investments prior to maturity to meet the liquidity needs of the company.

**Foreign Currency Exchange Risk.** We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant. If foreign exchange rates were to fluctuate by 10% from rates at September 30, 2009, and December 31, 2008, our financial position and results of operations would not be materially affected. However, we could experience a material impact in the future.

## **ITEM 4. CONTROLS AND PROCEDURES**

### **Evaluation of Effectiveness of Disclosure Controls and Procedures**

We have designed our disclosure controls and procedures to ensure that information we are required to disclose in reports that we file or submit under the Securities and Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. As of the end of the period covered by this Quarterly Report on Form 10-Q, under the supervision of our Chief Executive Officer and our



**Table of Contents**

Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such terms are defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities and Exchange Act of 1934. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of September 30, 2009.

**Changes in Internal Control Over Financial Reporting**

There were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended September 30, 2009, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

For a discussion regarding our legal proceedings and matters, please refer to the Legal Actions section of Note 6, Commitments and Contingencies, to our condensed consolidated financial statements included under Item 1 of Part I, Financial Information, which information is incorporated herein by reference.

**ITEM 1A. RISK FACTORS**

A restated description of the risk factors associated with our business is included under Factors That May Affect Future Results Of Operations in Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in Item 2 of Part I of this report. This restated description includes any material changes to and supersedes the description of the risk factors associated with our business previously disclosed in Part I Item 1A of our 2008 Annual Report on Form 10-K and in Part II Item 1A of our Quarterly Reports on Form 10-Q for the quarters ended March 31 and June 30, 2009, and is incorporated herein by reference.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In April 2008, our board of directors approved a new stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. There were no repurchases under the new stock repurchase program during the quarter ended September 30, 2009. Since inception, we have repurchased a total of 750,000 shares under the program at a cost of \$8.9 million. As of September 30, 2009, 2,250,000 shares were available for repurchase. The stock repurchase program will expire in April 2011.

The following table provides information about the repurchase of our common stock during the quarter ended September 30, 2009:

	<b>Total Number of Shares Purchased <sup>(1)</sup></b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs <sup>(1)</sup></b>
July 1- July 31	6,528	\$ 8.15		2,250,000
August 1- August 31	23,065	\$ 9.91		2,250,000
September 1- September 30	24,572	\$ 12.36		2,250,000
Total	54,165	\$ 10.81		2,250,000

<sup>(1)</sup> Shares purchased that were not part of our publicly announced repurchase program represent those shares surrendered to us by employees in order to satisfy stock-for-stock option exercises and/or withholding tax obligations related to stock-based compensation. These purchases do not reduce the number of shares that may yet be purchased under our publicly announced repurchase program.

---

**Table of Contents**

**ITEM 6. EXHIBITS**

**Exhibit**

<b>No.</b>	<b>Description of Document</b>
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith

**SIGNATURE**

Pursuant to the requirements 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.

**ECHELON CORPORATION**

Date: November 4, 2009

By: */s/* OLIVER R. STANFIELD  
Oliver R. Stanfield,

**Executive Vice President and Chief Financial Officer**

**(Duly Authorized Officer and Principal Financial and Accounting Officer)**



**Table of Contents**

**EXHIBIT INDEX**

**Exhibit**

<b>No.</b>	<b>Description of Document</b>
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith