

ECHELON CORP  
Form 10-Q  
November 09, 2007  
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**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, 2007

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)

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

**550 Meridian Avenue**

**San Jose, CA 95126**

(Address of principal executive office and zip code)

**77-0203595**  
(IRS Employer

Identification Number)

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(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

As of October 31, 2007, 40,686,102 shares of the registrant's common stock were outstanding.

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**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,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|--|-------------------------------|------------------------------|
| <b>ASSETS</b>                              |                               |                              |
| <b>CURRENT ASSETS:</b>                     |                               |                              |
| Cash and cash equivalents                  | \$ 76,022                     | \$ 37,412                    |
| Short-term investments                     | 47,786                        | 86,745                       |
| Accounts receivable, net                   | 13,603                        | 13,918                       |
| Inventories                                | 10,931                        | 11,359                       |
| Deferred cost of goods sold                | 6,206                         | 19,060                       |
| Other current assets                       | 3,143                         | 2,359                        |
| <b>Total current assets</b>                | <b>157,691</b>                | <b>170,853</b>               |
| Property and equipment, net                | 17,890                        | 15,188                       |
| Goodwill                                   | 8,475                         | 8,278                        |
| Other long-term assets                     | 1,939                         | 1,957                        |
| <b>TOTAL ASSETS</b>                        | <b>\$ 185,995</b>             | <b>\$ 196,276</b>            |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b> |                               |                              |
| <b>CURRENT LIABILITIES:</b>                |                               |                              |
| Accounts payable                           | \$ 9,207                      | \$ 6,893                     |
| Accrued liabilities                        | 7,749                         | 4,697                        |
| Deferred revenues                          | 16,338                        | 26,843                       |
| <b>Total current liabilities</b>           | <b>33,294</b>                 | <b>38,433</b>                |
| <b>LONG-TERM LIABILITIES:</b>              |                               |                              |
| Deferred rent                              | 1,318                         | 1,268                        |
| <b>Total long-term liabilities</b>         | <b>1,318</b>                  | <b>1,268</b>                 |
| <b>STOCKHOLDERS EQUITY:</b>                |                               |                              |
| Common stock                               | 431                           | 416                          |
| Additional paid-in capital                 | 293,378                       | 282,930                      |
| Treasury stock                             | (19,259)                      | (19,259)                     |
| Accumulated other comprehensive income     | 1,565                         | 997                          |
| Accumulated deficit                        | (124,732)                     | (108,509)                    |

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|  |            |            |
|--|------------|------------|
| Total stockholders' equity                 | 151,383    | 156,575    |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 185,995 | \$ 196,276 |

*See accompanying notes to condensed consolidated financial statements.*

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

(In thousands, except per share amounts)

(Unaudited)

|   | Three Months Ended<br>September 30, |                   | Nine Months Ended<br>September 30, |                    |
|---|-------------------------------------|-------------------|------------------------------------|--------------------|
|   | 2007                                | 2006              | 2007                               | 2006               |
| <b>REVENUES:</b>                                    |                                     |                   |                                    |                    |
| Product   | \$ 23,733                           | \$ 13,110         | \$ 89,247                          | \$ 42,893          |
| Service   | 980                                 | 181               | 1,431                              | 517                |
| Total revenues                                      | 24,713                              | 13,291            | 90,678                             | 43,410             |
| <b>COST OF REVENUES:</b>                            |                                     |                   |                                    |                    |
| Cost of product (1)                                 | 13,980                              | 4,936             | 57,922                             | 16,802             |
| Cost of service (1)                                 | 729                                 | 509               | 1,735                              | 1,406              |
| Total cost of revenues                              | 14,709                              | 5,445             | 59,657                             | 18,208             |
| <b>GROSS PROFIT</b>                                 | <b>10,004</b>                       | <b>7,846</b>      | <b>31,021</b>                      | <b>25,202</b>      |
| <b>OPERATING EXPENSES:</b>                          |                                     |                   |                                    |                    |
| Product development (1)                             | 7,789                               | 6,875             | 23,720                             | 21,029             |
| Sales and marketing (1)                             | 4,850                               | 5,076             | 15,218                             | 15,312             |
| General and administrative (1)                      | 4,083                               | 3,746             | 12,082                             | 10,946             |
| Total operating expenses                            | 16,722                              | 15,697            | 51,020                             | 47,287             |
| <b>LOSS FROM OPERATIONS</b>                         | <b>(6,718)</b>                      | <b>(7,851)</b>    | <b>(19,999)</b>                    | <b>(22,085)</b>    |
| INTEREST AND OTHER INCOME, NET                      | 1,381                               | 1,586             | 4,366                              | 4,384              |
| <b>LOSS BEFORE PROVISION FOR INCOME TAXES</b>       | <b>(5,337)</b>                      | <b>(6,265)</b>    | <b>(15,633)</b>                    | <b>(17,701)</b>    |
| INCOME TAX EXPENSE                                  | 108                                 | 80                | 323                                | 240                |
| <b>NET LOSS</b>                                     | <b>\$ (5,445)</b>                   | <b>\$ (6,345)</b> | <b>\$ (15,956)</b>                 | <b>\$ (17,941)</b> |
| <b>NET LOSS PER SHARE:</b>                          |                                     |                   |                                    |                    |
| Basic   | \$ (0.14)                           | \$ (0.16)         | \$ (0.40)                          | \$ (0.45)          |
| Diluted   | \$ (0.14)                           | \$ (0.16)         | \$ (0.40)                          | \$ (0.45)          |
| <b>SHARES USED IN COMPUTING NET LOSS PER SHARE:</b> |                                     |                   |                                    |                    |
| Basic   | 40,121                              | 39,354            | 39,622                             | 39,577             |
| Diluted   | 40,121                              | 39,354            | 39,622                             | 39,577             |

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

|                            |        |       |        |        |
|----------------------------|--------|-------|--------|--------|
| Cost of product            | \$ 180 | \$ 92 | \$ 440 | \$ 307 |
| Cost of service            | 14     | 10    | 37     | 36     |
| Product development        | 537    | 376   | 1,390  | 1,474  |
| Sales and marketing        | 326    | 249   | 890    | 911    |
| General and administrative | 424    | 275   | 1,309  | 989    |

*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<br/>September 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                                | <b>2006</b> |
| <b>CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:</b>  |  |             |
| Net loss   | \$ (15,956)                                | \$ (17,941) |
| Adjustments to reconcile net loss to net cash used in operating activities:  |  |             |
| Depreciation and amortization  | 3,384                                      | 3,270       |
| Loss on disposal of fixed assets   | 4  |             |
| Increase in (reduction of) allowance for doubtful accounts   | 47   | (32)        |
| Reduction of (increase in) accrued investment income   | 403  | (271)       |
| Stock-based compensation   | 4,066                                      | 3,717       |
| Change in operating assets and liabilities:  |  |             |
| Accounts receivable  | 282  | (6,048)     |
| Inventories  | 446  | (5,699)     |
| Deferred cost of goods sold  | 12,854                                     | (11,745)    |
| Other current assets   | (618)                                      | (1,523)     |
| Accounts payable   | 1,953                                      | 3,662       |
| Accrued liabilities  | 2,883                                      | (2,706)     |
| Deferred revenues  | (10,510)                                   | 18,737      |
| Deferred rent  | 93   | 151         |
| Net cash used in operating activities  | (669)                                      | (16,428)    |
| <b>CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:</b>  |  |             |
| Purchases of available-for-sale short-term investments   | (65,545)                                   | (47,761)    |
| Proceeds from maturities and sales of available-for-sale short-term investments  | 104,139                                    | 68,411      |
| Change in other long-term assets   | 44   | 56          |
| Capital expenditures   | (5,752)                                    | (4,103)     |
| Net cash provided by investing activities  | 32,886                                     | 16,603      |
| <b>CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:</b>  |  |             |
| Proceeds from issuance of common stock   | 10,094                                     | 252         |
| Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options | (4,029)                                    | (257)       |
| Repurchase of common stock under stock repurchase program  |  | (5,102)     |
| Net cash provided by (used in) financing activities  | 6,065                                      | (5,107)     |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS   | 328  | 303         |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS   | 38,610                                     | (4,629)     |
| <b>CASH AND CASH EQUIVALENTS:</b>  |  |             |
| Beginning of period  | 37,412                                     | 59,080      |



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|   |           |           |
|---|-----------|-----------|
| End of period   | \$ 76,022 | \$ 54,451 |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b> |           |           |
| Cash paid for income taxes                                | \$ 352    | \$ 183    |

*See accompanying notes to condensed consolidated financial statements.*

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**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, 2006 included in its Annual Report on Form 10-K.

*Reclassifications*

Certain reclassifications have been made to the prior year amounts to conform with the fiscal year 2007 presentation. For the nine months ended September 30, 2006, \$271,000 has been reclassified from operating cash flows to investing cash flows related to investment income included in net income for which cash had not been received prior to September 30, 2006.

*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, collectibility is probable, and there are no post-delivery obligations. For hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For 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.

In accordance with AICPA Statement of Position 97-2 (SOP 97-2), *Software Revenue Recognition*, as amended, 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.

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The Company currently sells a limited number of its LONWORKS® Infrastructure products that are considered multiple element arrangements under SOP 97-2. 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 certain instances, 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. In accordance with SOP 97-2, 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 the 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 latter 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, as described in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, 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.

The Company accounts for the rights of return, price protection, rebates, and other sales incentives offered to its distributors in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 48, *Revenue Recognition When Right of Return Exists*, and EITF 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*. During the first and second quarters of 2006, the Company modified its revenue recognition method for sales made to its distributor partners. Under the revised method, revenue on sales made to distributors is deferred until the distributor sells the products through to its end-use customers. The impact of this revenue recognition methodology revision was a one-time reduction in revenues of approximately \$3.9 million during the nine months ended September 30, 2006.

*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.

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### *Recent Accounting Pronouncements*

With the exception of the Financial Accounting Standards Board ( FASB ) statement described below, there have been no significant changes in recent accounting pronouncements during the three and nine months ended September 30, 2007, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the year ended December 31, 2006.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 ( SFAS 159 ), *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for the Company beginning in its fiscal year ending December 31, 2008, although earlier adoption is permitted. The Company is currently evaluating the impact that SFAS 159 will have on its consolidated financial statements.

### **2. Short-Term Investments**

As of September 30, 2007, the Company's available-for-sale short-term investments had contractual maturities from six to twenty-four months and an average remaining term to maturity of eight months. Except as discussed below, the fair value of available-for-sale short-term investments was determined based on quoted market prices at the reporting date for those instruments.

As of September 30, 2007, \$13.4 million in certain asset-backed commercial paper investments issued by Structured Investment Vehicles, \$8.9 million of which is recorded in short-term investments and \$4.5 million of which is recorded in cash and cash equivalents in the condensed consolidated balance sheet, were considered illiquid based upon the fact that there were no open market bids for these investments. As such, the fair value of these investments was estimated to approximate the amortized cost, or \$13.4 million in total, by a third party pricing firm that supplies pricing estimates to the Company's investment manager. One of these investments was repaid in full by the issuer on its maturity date of October 3, 2007. The two remaining investments mature on November 13, 2007 and January 18, 2008, and are rated A-1+ by Standard and Poor's and P1 by Moody's. In addition, the Company has reviewed the respective issuer's liquidity for the two remaining investments as well as the quality of the underlying collateral to further support each issuer's ability to repay the respective investments at maturity. It is the Company's intent to hold these investments to maturity. As a result, the Company has not recorded an impairment charge or similar write-down of the reported values. However, if these securities were to begin trading below these values in the future, or the issuer were to default on its repayment obligations, the Company may be required to record losses on these investments.

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As of September 30, 2007, 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<br>Cost | Aggregate<br>Fair Value | Unrealized<br>Holding<br>Gains<br>(Losses) |
|---|-------------------|-------------------------|--|
| U.S. corporate securities:                      |                   |                         |  |
| Commercial paper                                | \$ 11,081         | \$ 11,080               | \$ (1)                                     |
| Corporate notes and bonds                       | 27,373            | 27,368                  | (5)  |
|   | 38,454            | 38,448                  | (6)  |
| Foreign corporate notes and bonds               | 524               | 530                     | 6  |
| U.S. government securities                      | 8,797             | 8,808                   | 11   |
| Total investments in debt and equity securities | \$ 47,775         | \$ 47,786               | \$ 11                                      |

**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 and nine months ended September 30, 2007 and September 30, 2006 (in thousands, except per share amounts):

|   | Three Months Ended    |                       | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September 30,<br>2007 | September 30,<br>2006 | September 30,<br>2007 | September 30,<br>2006 |
| Net loss (Numerator):   |                       |                       |                       |                       |
| Net loss, basic & diluted   | \$ (5,445)            | \$ (6,345)            | \$ (15,956)           | \$ (17,941)           |
| Shares (Denominator):   |                       |                       |                       |                       |
| Weighted average common shares outstanding                                    | 40,121                | 39,354                | 39,622                | 39,577                |
| Shares used in basic computation  | 40,121                | 39,354                | 39,622                | 39,577                |
| Common shares issuable upon exercise of stock options (treasury stock method) |                       |                       |                       |                       |
| Shares used in diluted computation  | 40,121                | 39,354                | 39,622                | 39,577                |
| Net loss per share:   |                       |                       |                       |                       |
| Basic   | \$ (0.14)             | \$ (0.16)             | \$ (0.40)             | \$ (0.45)             |
| Diluted   | \$ (0.14)             | \$ (0.16)             | \$ (0.40)             | \$ (0.45)             |

For the three and nine months ended September 30, 2007 and 2006, 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 and stock appreciation rights excluded from this calculation for the three and nine months ended September 30, 2007 was 7,122,102. The number of stock options excluded from this calculation for the three and nine months ended September 30, 2006 was 7,561,024.

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

*Common Stock*

In March and August 2004, 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 three and nine months ended September 30, 2007, the Company did not repurchase any shares under the program. As of September 30, 2007, 795,816 shares were available for repurchase. The stock repurchase program will expire in March 2008.

**Table of Contents***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, 2007 and 2006 is as follows (in thousands):

|  | Three Months Ended<br>September 30, |                   | Nine Months Ended<br>September 30, |                    |
|--|-------------------------------------|-------------------|------------------------------------|--------------------|
|  | 2007                                | 2006              | 2007                               | 2006               |
| Net loss   | \$ (5,445)                          | \$ (6,345)        | \$ (15,956)                        | \$ (17,941)        |
| Other comprehensive income/(loss), net of tax:           |                                     |                   |                                    |                    |
| Foreign currency translation adjustment                  | 406                                 | (63)              | 530                                | 465                |
| Unrealized holding gain on available-for-sale securities | 41                                  | 270               | 38                                 | 320                |
| <b>Comprehensive loss</b>                                | <b>\$ (4,998)</b>                   | <b>\$ (6,138)</b> | <b>\$ (15,388)</b>                 | <b>\$ (17,156)</b> |

*Stock Award Activity*

The total intrinsic value of options exercised during the three and nine months ended September 30, 2007 was approximately \$19.6 million and \$23.6 million, respectively. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the shares.

The total fair value of performance shares vested and released during the three and nine months ended September 30, 2007 was approximately \$1.5 million and \$2.4 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.

**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. The Company currently has four 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), and Telvent Energia y Medioambiente SA (Telvent) and ES Elektrosandberg AB (ES), value added resellers of the Company's NES products. For the three and nine months ended September 30, 2007 and 2006, the percentage of the Company's revenues attributable to sales made to these customers was as follows:

|              | Three Months Ended<br>September 30, |              | Nine Months Ended<br>September 30, |              |
|--------------|-------------------------------------|--------------|------------------------------------|--------------|
|              | 2007                                | 2006         | 2007                               | 2006         |
| Telvent      | 19.1%                               |              | 33.6%                              |              |
| EBV          | 17.6%                               | 32.0%        | 14.7%                              | 25.3%        |
| ES           | 14.0%                               |              | 12.2%                              | 0.1%         |
| Enel         | 12.3%                               | 0.4%         | 8.8%                               | 16.4%        |
| <b>Total</b> | <b>63.0%</b>                        | <b>32.4%</b> | <b>69.3%</b>                       | <b>41.8%</b> |

The Company's contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2007. Please refer to Note 11, Related Party, for additional information regarding the Company's agreement with Enel.





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### **6. Commitments and Contingencies**

#### *Royalties*

The Company has certain royalty commitments associated with the shipment and licensing of certain of its 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 as a component of cost of product revenues in our condensed consolidated statements of operations, was approximately \$133,000 during the three months ended September 30, 2007, and \$142,000 for the comparable period in 2006. Royalty expense was approximately \$432,000 for the nine months ended September 30, 2007, and \$352,000 for the comparable period in 2006.

The Company will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of its products. The Company is currently unable to estimate the maximum amount of these future royalties. However, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

#### *Warranties*

The Company typically sells its products with a limited warranty against defects in manufacture or performance. When evaluating the 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 return rates, and historical costs of repair. In addition, certain other applicable factors, such as technical complexity, may also be taken into consideration when historical information is not yet available for recently introduced products. Estimated reserves for warranty costs are recorded at the time of shipment. In addition, additional warranty reserves may be established when the Company becomes aware of a specific warranty related problem, such as a product recall. Such additional warranty reserves are based on the Company's current estimate of the total out-of-pocket costs expected to be incurred to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. The reserve for warranty costs was \$211,000 as of September 30, 2007 and \$224,000 as of December 31, 2006.

#### *Guarantees*

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

As permitted under Delaware law, the Company has entered into agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company's 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 the Company could be required to make under these indemnification agreements is unlimited. However, the Company has directors and officers insurance coverage that would enable it to recover a portion of any future amounts paid. The Company believes the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

**Table of Contents***Taxes*

The Company conducts 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 the Company's operations in that particular location. While the Company strives 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 accounting principles generally accepted in the United States of America, the Company makes 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 the Company believes that, as of September 30, 2007, it has adequately provided for such contingencies. However, it is possible that the Company's 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 the Company conducts its operations.

*Legal Actions*

From time to time, in the ordinary course of business, the Company is subject to 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, 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, 2007, 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.

**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,<br>2007 | December 31,<br>2006 |
|---------------------|-----------------------|----------------------|
| Purchased materials | \$ 3,773              | \$ 3,378             |
| Work-in-process     | 120                   | 107                  |
| Finished goods      | 7,038                 | 7,874                |
|                     | \$ 10,931             | \$ 11,359            |

**Table of Contents****8. Accrued Liabilities**

Accrued liabilities consist of the following (in thousands):

|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2007          | 2006         |
| Accrued payroll and related costs          | \$ 3,132      | \$ 2,776     |
| Customer deposits                          | 2,887         |              |
| Deferred and other tax-related liabilities | 1,290         | 1,307        |
| Other accrued liabilities                  | 440           | 614          |
|  | \$ 7,749      | \$ 4,697     |

**9. Segment Disclosure**

The Company operates in one principal industry segment: the design, manufacture, and sale of control networking infrastructure products; and markets its products primarily to the building automation, industrial automation, transportation, utility, and home automation markets. The Company's products provide the infrastructure and support required to implement and deploy open and interoperable control networks, enabling everyday devices such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves to be made smart and inter-connected. The Company also provides a range of services to its customers that consist of technical support, training courses covering its networking technology and products, and custom software development.

In total, the Company offers a wide ranging set of control networking infrastructure products and services. Any given customer may purchase a subset of such products and services that are appropriate for that customer's application. For example, a utility might use the Company's Networked Energy Services products to more efficiently manage its distribution grid, while another customer who installs building controls might use the Company's LonWorks Infrastructure transceivers and internet servers to enable the monitoring and management of building occupancy and energy consumption.

The Company manages its business primarily on a geographic basis. The Company's geographic areas are comprised of three main groups: the Americas; Europe, Middle East and Africa ( EMEA ); and Asia Pacific / Japan ( APJ ). Each geographic area provides products and services as further described in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations. The Company evaluates the performance of its geographic areas based on profit or loss from operations. Profit or loss for each geographic area includes sales and marketing expenses and other charges directly attributable to the geographic area and excludes certain expenses that are managed outside the geographic area. Costs excluded from geographic area profit or loss consist primarily of unallocated corporate expenses, which are comprised of product development costs, corporate marketing costs, and other general and administrative expenses, which are separately managed. 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, 2007 and December 31, 2006, long-lived assets of approximately \$24.9 million and \$22.2 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements. Assets and the related depreciation and amortization are not reported by geography because that information is not reviewed by the executive staff when making decisions about resource allocation to the geographic areas based on their performance.

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The Company typically sells its products through a direct sales organization and select third-party electronics representatives in North America. Outside North America, the Company typically 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 information by geography for the three and nine months ended September 30, 2007 and 2006 is as follows (in thousands):

|                                       | Three Months Ended    |                       | Nine Months Ended     |                       |
|---------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                       | September 30,<br>2007 | September 30,<br>2006 | September 30,<br>2007 | September 30,<br>2006 |
| <b>Revenues from customers:</b>       |                       |                       |                       |                       |
| Americas                              | \$ 4,544              | \$ 5,193              | \$ 13,795             | \$ 14,688             |
| EMEA                                  | 15,347                | 5,949                 | 62,447                | 23,528                |
| APJ                                   | 4,822                 | 2,149                 | 14,436                | 5,194                 |
| <b>Total</b>                          | <b>\$ 24,713</b>      | <b>\$ 13,291</b>      | <b>\$ 90,678</b>      | <b>\$ 43,410</b>      |
| <b>Gross profit:</b>                  |                       |                       |                       |                       |
| Americas                              | \$ 2,939              | \$ 3,134              | \$ 9,142              | \$ 8,875              |
| EMEA                                  | 4,314                 | 3,347                 | 13,374                | 13,302                |
| APJ                                   | 2,751                 | 1,365                 | 8,505                 | 3,025                 |
| <b>Total</b>                          | <b>\$ 10,004</b>      | <b>\$ 7,846</b>       | <b>\$ 31,021</b>      | <b>\$ 25,202</b>      |
| <b>Income (loss) from operations:</b> |                       |                       |                       |                       |
| Americas                              | \$ 1,877              | \$ 1,676              | \$ 5,806              | \$ 4,984              |
| EMEA                                  | 2,909                 | 2,007                 | 8,952                 | 9,094                 |
| APJ                                   | 1,662                 | 298                   | 5,138                 | (191)                 |
| Unallocated                           | (13,166)              | (11,832)              | (39,895)              | (35,972)              |
| <b>Total</b>                          | <b>\$ (6,718)</b>     | <b>\$ (7,851)</b>     | <b>\$ (19,999)</b>    | <b>\$ (22,085)</b>    |

Products and services sold to Enel and its designated manufacturers (see discussion of Enel below in Note 11- Related Party) accounted for approximately \$3.0 million, or 12.3% of total revenues for the three months ended September 30, 2007, and \$53,000, or 0.4% for the comparable period in 2006; and \$8.0 million, or 8.8% of total revenues for the nine months ended September 30, 2007, and \$7.1 million, or 16.4% for the comparable period in 2006. Of the \$3.0 million and \$8.0 million Enel project revenue recognized during the three and nine months ended September 30, 2007, respectively, approximately \$568,000 related to revenues generated from custom software development services, while the remaining \$2.5 million and \$7.5 million, respectively, related to products shipped to Enel and its designated manufacturers. There were no custom software development services provided to Enel during the comparable periods in 2006. For the three months ended September 30, 2007, 81.3% of the revenues under the Enel program were derived from products shipped to customers in APJ, while the remaining 18.7% from products and services sold to customers in EMEA. For the nine months ended September 30, 2007, 90.0% of the revenues derived from products shipped under the Enel program were from customers in APJ and the remaining 10.0% were from customers in EMEA.

**10. Income Taxes**

We adopted FASB Interpretation No. 48 ( FIN 48 ), *Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109*, on January 1, 2007. This interpretation prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken on a tax return. FIN 48 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, and disclosure and transition.

As a result of the implementation of FIN 48, the Company recognized no material adjustment in the liability for unrecognized income tax benefits. The Company had unrecognized tax benefits of approximately \$1.2 million as of January 1, 2007, all of which, if recognized, would result in a reduction of the Company's effective tax rate. There have been no significant changes to the Company's unrecognized tax benefits

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since January 1, 2007.

In connection with the adoption of FIN 48, the Company will continue to include interest and penalties related to uncertain tax positions as a component of income tax, which was immaterial for the three and nine months ended September 30, 2007. We do not believe it is reasonably possible that the Company's unrecognized tax benefits will change significantly within the next twelve months.

The Company is subject to taxation in the U.S. and various state and foreign jurisdictions. The tax years 1992-2006 remain open to examination by the federal and most state tax authorities due to certain net operating loss and credit carryforward positions.

The provision for income taxes for the three and nine month periods ended September 30, 2007 and 2006 includes a provision for state and foreign taxes based on the annual estimated effective tax rate applied to the Company and its subsidiaries for the year. The difference between the statutory rate and the Company's effective tax rate is primarily due to the impact of foreign taxes and the valuation allowance on the Company's deferred tax assets.

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**11. Related Party**

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

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. At the same time, the Company 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 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. Both the new development and supply agreement and the software enhancement agreement expire in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

Revenues associated with sales made to Enel and its designated manufacturers for the three and nine months ended September 30, 2007 and 2006 are discussed above in Note 9 Segment Disclosure. As of September 30, 2007 and September 30, 2006, \$158,000 and \$4.1 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 nine 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.

We have been investing in products for use by electricity utilities in management of electricity distribution. We refer to these products (and related services) as our networked energy services, or NES, offerings. We began to receive modest amounts of NES revenue in 2004, which increased to approximately \$883,000 in 2005 and decreased slightly to \$791,000 in 2006. During the first nine months of 2007, NES revenue increased significantly to \$42.9 million due primarily to an increase in NES product shipments, as well as the recognition of a substantial amount of NES revenues that were deferred at the end of 2006 related to NES products that had been shipped but for which the revenue recognition criteria had not yet been met. 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.

During the first and second quarters of 2006, we revised our revenue recognition methodology for sales made to the distributors of our LWI products. Under the revised methodology, we now defer revenue, as well as cost of goods sold, on items shipped to these distributors that remain in their inventories at quarter-end. The revision significantly reduced our first and second quarter 2006 revenues, but did not have an impact on cash flows from operations.

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or require any changes to our historical financial statements. A more thorough explanation of this revision can be found later in this Quarterly Report in the sections of our discussion on Results of Operations entitled LONWORKS Infrastructure revenues and EBV revenues .

We have a history of losses and incurred a net loss for the three and nine months ended September 30, 2007 and expect to incur an operating loss for the full year ending December 31, 2007. This expectation is due primarily to two factors. First, while we expect our 2007 NES revenues will increase substantially compared to those generated in 2006, we do not currently expect that the gross profit generated from these increased sales will be substantial enough to return us to an operating profit for the full year ending December 31, 2007. This is due to the fact that, in general, gross margins generated from sales of our NES products tend to be much lower than those generated from our other revenue sources.

The second factor contributing to our expectation for losses in 2007 relates to the fact that, effective January 1, 2006, we began recording compensation expense associated with stock options and other forms of equity compensation as required under Statement of Financial Accounting Standards No. 123R ( SFAS 123R ), *Share-Based Payment*. For the year ended December 31, 2006, the adoption of this new accounting standard resulted in an increase in equity compensation expenses of approximately \$4.3 million as compared to the comparable period in 2005. Expenses associated with equity-based compensation were \$1.5 million and \$4.1 million for the three and nine months ended September 30, 2007, respectively as compared to \$1.0 million and \$3.7 million for the comparable periods in 2006. We expect equity compensation expense for the full year ending December 31, 2007 will be higher than the \$4.9 million recognized in 2006, which will in turn contribute negatively to our efforts to return to profitability.

### CRITICAL ACCOUNTING ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. 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 revenues, allowance for doubtful accounts, inventories, commitments and contingencies, income taxes, and asset impairments. 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.

We believe the following critical accounting 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.

**Stock-Based Compensation.** Effective January 1, 2006, we adopted the provisions of and account for stock-based compensation in accordance with SFAS 123R. We elected the modified-prospective method, under which prior periods are not revised for comparative purposes. Under the fair value recognition provisions of this statement, 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.



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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.

We estimate the expected term of options granted using the simplified method as illustrated in SEC Staff Accounting Bulletin No. 107 ( SAB 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. The expected volatility is based on the historical volatility of our common stock over the most recent period commensurate with the expected term of the option, and does not consider any implied volatility as there are currently no market traded options on our stock that meet the criteria required for reliance on implied volatility in accordance with SAB 107. 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 option 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.

SFAS 123R also requires 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 multiple option method over their requisite service period, which is generally the vesting period.

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 option grants.

If factors change and we employ different assumptions for estimated 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 and earnings per share.

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**Sales Returns and Allowances.** We sell our products and services to OEMs, systems integrators, and our other customers directly through our sales force and indirectly through distributors located in the geographic markets that we serve. Net revenues consist of product and service revenues reduced by estimated sales returns and allowances. Provisions for estimated sales returns and allowances are recorded at the time of sale, and are based on management's estimates of potential future product returns and allowances (such as pricing credits to certain of our distributor partners) related to product revenues in the current period. In evaluating the adequacy of our sales returns and other allowances, management analyzes historical returns, current and historical economic trends, contractual terms, and changes in customer demand and acceptance of our products.

Other than standard warranty repair work, Enel and its designated contract meter manufacturers do not have rights to return products we ship to them. However, our agreement with Enel contains an acceptance provision, whereby Enel is entitled to inspect products we ship to them to ensure the products conform, in all material respects, to the product's specifications. Once the product has been inspected and approved by Enel, or if the acceptance period lapses before Enel inspects or approves the products, the goods are considered accepted. Prior to shipping our products to Enel, we perform detailed reviews and tests to ensure the products will meet Enel's acceptance criteria. We do not ship products unless they have passed these reviews and tests. As a result, we record revenue for these products upon shipment to Enel. If Enel were to subsequently properly reject any material portion of a shipment for not meeting the agreed upon specifications, we would defer the revenue on that portion of the transaction until such time as Enel and we were able to resolve the discrepancy. Such a deferral could have a material impact on the amount and timing of our Enel related revenues.

Our allowances for sales returns and other sales-related reserves were approximately \$730,000 as of September 30, 2007, and \$791,000 as of December 31, 2006.

**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 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 were 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 \$290,000 as of September 30, 2007, and \$250,000 as of December 31, 2006.

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**Inventory Valuation.** At each balance sheet date, we evaluate our ending inventories for excess quantities and obsolescence. This evaluation includes analyses of sales levels by product and projections of future demand. Inventories on hand, in excess of one year's forecasted demand, are not valued. In addition, we write off 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 \$211,000 as of September 30, 2007, and \$224,000 as of December 31, 2006.

**Deferred Income Taxes.** We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Based on our historical net operating losses, and the uncertainty of our future operating results, we have recorded a valuation allowance that fully reserves our deferred tax assets. If we later determine that, more likely than not, some or all of the net deferred tax assets will be realized, we would then need to reverse some or all of the previously provided valuation allowance. Our deferred tax asset valuation allowance was \$61.2 million as of December 31, 2006.

**Valuation of Goodwill.** We assess the impairment of goodwill on an annual basis during the quarter ending March 31 and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner or use of the acquired assets or the strategy for our overall business;

significant negative industry or economic trends; and

significant changes in the composition of the intangible assets acquired.

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Our review during the quarter ended March 31, 2007 indicated no impairment. If, as a result of an annual or any other impairment review that we perform in the future, we determine that there has been an impairment of our goodwill, we would be required to take an impairment charge. Such a charge could have a material adverse impact on our financial position and/or operating results.

**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, 2007 and September 30, 2006:

|  | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|--|-------------------------------------|---------|------------------------------------|---------|
|  | 2007                                | 2006    | 2007                               | 2006    |
| <b>Revenues:</b>                       |                                     |         |                                    |         |
| Product                                | 96.0%                               | 98.7%   | 98.4%                              | 98.8%   |
| Service                                | 4.0                                 | 1.3     | 1.6                                | 1.2     |
| Total revenues                         | 100.0                               | 100.0   | 100.0                              | 100.0   |
| <b>Cost of revenues:</b>               |                                     |         |                                    |         |
| Cost of product                        | 56.6                                | 37.2    | 63.9                               | 38.7    |
| Cost of service                        | 2.9                                 | 3.8     | 1.9                                | 3.3     |
| Total cost of revenues                 | 59.5                                | 41.0    | 65.8                               | 42.0    |
| Gross profit                           | 40.5                                | 59.0    | 34.2                               | 58.0    |
| <b>Operating expenses:</b>             |                                     |         |                                    |         |
| Product development                    | 31.5                                | 51.7    | 26.2                               | 48.4    |
| Sales and marketing                    | 19.7                                | 38.2    | 16.8                               | 35.3    |
| General and administrative             | 16.5                                | 28.2    | 13.3                               | 25.2    |
| Total operating expenses               | 67.7                                | 118.1   | 56.3                               | 108.9   |
| Loss from operations                   | (27.2)                              | (59.1)  | (22.1)                             | (50.9)  |
| Interest and other income, net         | 5.6                                 | 12.0    | 4.8                                | 10.1    |
| Loss before provision for income taxes | (21.6)                              | (47.1)  | (17.3)                             | (40.8)  |
| Income tax expense                     | 0.4                                 | 0.6     | 0.3                                | 0.5     |
| Net loss                               | (22.0%)                             | (47.7%) | (17.6%)                            | (41.3%) |

**Revenues***Total Revenues*

|                        | Three Months Ended |               | 2007 over | 2007 over |
|------------------------|--------------------|---------------|-----------|-----------|
|                        | September 30,      | September 30, | 2006 \$   | 2006 %    |
| (Dollars in thousands) | 2007               | 2006          | Change    | Change    |
| Total Revenues         | \$ 24,713          | \$ 13,291     | \$ 11,422 | 85.9 %    |

|                        | Nine Months Ended |  | 2007 over | 2007 over |
|------------------------|-------------------|--|-----------|-----------|
| (Dollars in thousands) |                   |  | 2006 \$   | 2006 %    |
|                        |                   |  |           |           |

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|                | September 30,<br>2007 | September 30,<br>2006 | Change    | Change  |
|----------------|-----------------------|-----------------------|-----------|---------|
| Total Revenues | \$ 90,678             | \$ 43,410             | \$ 47,268 | 108.9 % |

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The \$11.4 million increase in total revenues for the three months ended September 30, 2007 as compared to the comparable period in 2006 was primarily the result of an \$8.4 million increase in NES revenues and a \$3.0 million increase in Enel Project revenues. The \$47.3 million increase in total revenues for the nine months ended September 30, 2007 as compared to the comparable period in 2006 was primarily the result of a \$42.2 million increase in NES revenues, a \$4.1 million increase in LONWORKS Infrastructure revenues, and a \$920,000 increase in Enel Project revenues.

*NES revenues*

| <i>(Dollars in thousands)</i> | <b>Three Months Ended</b> |                           | <b>2007 over</b>      | <b>2007 over</b>     |
|-------------------------------|---------------------------|---------------------------|-----------------------|----------------------|
|                               | <b>September 30, 2007</b> | <b>September 30, 2006</b> | <b>2006 \$ Change</b> | <b>2006 % Change</b> |
| NES revenues                  | \$ 8,624                  | \$ 199                    | \$ 8,425              | 4,233.7 %            |

| <i>(Dollars in thousands)</i> | <b>Nine Months Ended</b>  |                           | <b>2007 over</b>      | <b>2007 over</b>     |
|-------------------------------|---------------------------|---------------------------|-----------------------|----------------------|
|                               | <b>September 30, 2007</b> | <b>September 30, 2006</b> | <b>2006 \$ Change</b> | <b>2006 % Change</b> |
| NES revenues                  | \$ 42,896                 | \$ 693                    | \$ 42,203             | 6,089.9%             |

NES revenues recognized during the three and nine months ended September 30, 2007 were primarily related to large scale deployments of our NES system products. NES revenues recognized during the three and nine months ended September 30, 2006 were primarily related to the completion of system trials and, to a lesser extent, shipments of NES products.

We expect that, during the remainder of 2007, shipments of our NES products will continue to increase over 2006 levels. Our ability to recognize revenue on these shipments depends on several factors, including, but not limited to, delivery to the customer of all of the software called for in any given agreement, modification of the 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. 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, 2007, the portion of our NES revenue transactions conducted in currencies other than the U.S. dollar, principally the Australian dollar, was about \$298,000, or 0.7%. There were no NES revenue transactions conducted in foreign currencies during the nine months ended September 30, 2006. In most cases, in the event of a significant contract award, 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.

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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.

*LONWORKS Infrastructure revenues*

| <i>(Dollars in thousands)</i>    | <b>Three Months Ended</b> |                           | <b>2007 over</b>      | <b>2007 over</b>     |
|----------------------------------|---------------------------|---------------------------|-----------------------|----------------------|
|                                  | <b>September 30, 2007</b> | <b>September 30, 2006</b> | <b>2006 \$ Change</b> | <b>2006 % Change</b> |
| LONWORKS Infrastructure Revenues | \$ 13,054                 | \$ 13,040                 | \$ 14                 | 0.1%                 |

| <i>(Dollars in thousands)</i>    | <b>Nine Months Ended</b>  |                           | <b>2007 over</b>      | <b>2007 over</b>     |
|----------------------------------|---------------------------|---------------------------|-----------------------|----------------------|
|                                  | <b>September 30, 2007</b> | <b>September 30, 2006</b> | <b>2006 \$ Change</b> | <b>2006 % Change</b> |
| LONWORKS Infrastructure Revenues | \$ 39,759                 | \$ 35,614                 | \$ 4,145              | 11.6%                |

Our LONWORKS Infrastructure 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. The \$4.1 million increase in LONWORKS Infrastructure revenues for the nine months ended September 30, 2007 as compared to the comparable period in 2006 was primarily attributable to the one-time effect of revisions we made in 2006 to our revenue recognition methodology for sales made to our distributor partners. During the first quarter of 2006, we modified our revenue recognition method for sales made to our European distributor, EBV (see EBV revenue discussion below). Under the revised method, revenue on sales made to EBV is deferred until EBV sells the products through to its end use customers. During the second quarter of 2006, we completed a similar revision to our revenue recognition methodology for sales made to our Asian distributor partners. This revision was necessary as, during the quarter, we modified our agreements with our Asian distributor partners. These contractual modifications, which allow the distributors to return certain of their excess inventory, were made to address changing business conditions in our Asian markets and to expand our customer base there. The revenue recognition methodology revisions for EBV and our Asian distributors resulted in one-time reductions in revenue of approximately \$3.9 million during the nine months ended September 30, 2006.

Excluding the impact of these revenue recognition revisions, LONWORKS Infrastructure revenues increased by approximately \$245,000 for the nine months ended September 30, 2007 as compared to the comparable period in 2006. We believe the \$245,000 increase between the two nine-month periods is due, at least in part, to our customer's utilization of our products in new applications, such as energy management and street lighting controls.

Also impacting the fluctuations in LONWORKS Infrastructure revenues between the two nine month periods ended September 30, 2007 and 2006, were the unfavorable impacts of exchange rates on sales made in foreign currencies, principally the Japanese Yen. These exchange rate fluctuations resulted in a \$42,000 decrease between the two nine month periods. The impact of exchange rate fluctuations between the two three month periods ended September 30, 2007 and 2006 was negligible.

We believe that, as long as current worldwide economic conditions do not deteriorate, full year 2007 LONWORKS Infrastructure revenues will improve from the \$49.4 million recorded in 2006. This expected improvement is primarily related to the fact that, as discussed above, in 2006 we revised our revenue recognition methodology for sales made to our distributor partners, which had the one-time effect of reducing 2006 revenue by approximately \$3.9 million.

Excluding the impact of the 2006 revenue recognition revision, we still currently expect full year 2007 LONWORKS Infrastructure revenues will improve modestly over amounts recorded in 2006. This expected improvement, however, will be subject to further fluctuations in exchange rates between the U.S. dollar and the

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foreign currencies in which we generate revenues, principally the Japanese Yen. If the U.S. dollar were to strengthen against these currencies, our revenues would decrease. Conversely, if the U.S. dollar were to weaken against these currencies, our revenues would increase. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in foreign currencies and the magnitude of the exchange rate fluctuation from year to year. Through the first nine months of 2007, the portion of our LONWORKS Infrastructure revenues conducted in currencies other than the U.S. dollar, principally the Japanese Yen, was about 6.9% as compared to 6.4% for the comparable period in 2006. We do not currently expect that, during the remainder of 2007, the amount of our LONWORKS Infrastructure revenues conducted in these or other foreign currencies will fluctuate significantly from that experienced in 2006. Given the historical and expected future level of sales made in foreign currencies, we do not currently plan to hedge against these currency rate fluctuations. However, if the portion of our LONWORKS Infrastructure revenues conducted in foreign currencies were 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> | <b>Three Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|---------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>      | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>               | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Enel Project Revenues         | \$ 3,036                  | \$ 53                | \$ 2,983         | 5,628.3%         |

| <i>(Dollars in thousands)</i> | <b>Nine Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|--------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>     | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>              | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Enel Project Revenues         | \$ 8,023                 | \$ 7,103             | \$ 920           | 13.0%            |

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. There were no revenues from either of these new agreements during 2006. The \$3.0 million and \$8.0 million of Enel project revenue recognized during the quarter and nine months ended September 30, 2007, respectively, related primarily to shipments under the new development and supply agreement, and to a lesser extent, from revenues attributable to the software enhancement agreement. Both the development and supply agreement and the software enhancement agreement expire on December 31, 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

Early in 2006, Enel asked us to provide them with spare parts for use in their system in Italy. The \$53,000 and \$7.1 million of Enel project revenue recognized during the three and nine months ended September 30, 2006, respectively, represent shipments we made against that request. 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.

We believe that during the remainder of 2007, revenues attributable to the Enel project will continue to increase over the \$7.1 million reported in 2006, and will relate primarily to products shipped under the new development and supply agreement.



**Table of Contents***EBV revenues*

| <i>(Dollars in thousands)</i> | <b>Three Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|---------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>      | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>               | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| EBV Revenues                  | \$ 4,340                  | \$ 4,255             | \$ 85            | 2.0%             |

| <i>(Dollars in thousands)</i> | <b>Nine Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|--------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>     | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>              | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| EBV Revenues                  | \$ 13,348                | \$ 10,965            | \$ 2,383         | 21.7%            |

Sales to EBV, our largest distributor and the sole independent distributor of our products in Europe, accounted for 17.6% of our total revenues for the three months ended September 30, 2007 and 32.0% of our total revenues for the comparable period in 2006; and 14.7% of our total revenues for the nine months ended September 30, 2007 and 25.3% for the comparable period in 2006. While EBV revenues increased by only 2.0% during the quarter ended September 30, 2007 as compared to the comparable period in 2006, they increased substantially during the nine months ended September 30, 2007 as compared to the comparable period in 2006. The primary factor contributing to the \$2.4 million increase between the two nine-month periods was the fact that, during the first quarter of 2006, we revised our revenue recognition methodology for sales made to EBV. Under the revised methodology, revenues, as well as cost of goods sold, are deferred on items shipped to EBV that remain in EBV's inventories at quarter-end. Revenue is then recognized on these products, along with the corresponding gross margin, when EBV sells them to its customers in future periods. This revision resulted in a one-time revenue decrease of approximately \$2.9 million for the quarter ended March 31, 2006. The revision did not have an impact on cash flows from operations or require any changes to historical financial statements.

Excluding the impact of the accounting method revision, EBV's shipments to its customers decreased by approximately \$517,000 during the first nine months of 2007 as compared to the comparable period in 2006. We believe this decrease is the result of the Restriction of Hazardous Substances, or RoHS, regulations, which became effective in the European Union July 1, 2006. Under these new rules, manufacturers such as Echelon were required to eliminate certain hazardous substances (e.g., lead, cadmium, mercury, etc.) from the products they sell into the region. We believe that many of EBV's customers increased their purchases of our non-RoHS compliant products during the first half of 2006, prior to effective date of the new regulations. This resulted in a high level of EBV revenue during the first half of 2006.

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 2007. 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 future financial position could be harmed.

*Product revenues*

| <i>(Dollars in thousands)</i> | <b>Three Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|---------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>      | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>               | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Product Revenues              | \$ 23,733                 | \$ 13,110            | \$ 10,623        | 81.0%            |

| <i>(Dollars in thousands)</i> | <b>Nine Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|--------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>     | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>              | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Product Revenues              | \$ 89,247                | \$ 42,893            | \$ 46,354        | 108.1%           |

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The \$10.6 million increase in product revenues for the three months ended September 30, 2007 as compared to the comparable period in 2006 was primarily the result of an \$8.2 million increase in NES product revenues and a \$2.4 million increase in Enel Project product revenues. The \$46.4 million increase in product revenues for the nine months ended September 30, 2007 as compared to the comparable period in 2006 was primarily the result of a \$41.9 million increase in NES product revenues, a \$4.1 million increase in LonWorks Infrastructure product revenues, and a \$353,000 increase in Enel Project product revenues.

*Service revenues*

| <i>(Dollars in thousands)</i> | <b>Three Months Ended</b> |                           | <b>2007 over</b>      | <b>2007 over</b>     |
|-------------------------------|---------------------------|---------------------------|-----------------------|----------------------|
|                               | <b>September 30, 2007</b> | <b>September 30, 2006</b> | <b>2006 \$ Change</b> | <b>2006 % Change</b> |
| Service Revenues              | \$ 980                    | \$ 181                    | \$ 799                | 441.4%               |

| <i>(Dollars in thousands)</i> | <b>Nine Months Ended</b>  |                           | <b>2007 over</b>      | <b>2007 over</b>     |
|-------------------------------|---------------------------|---------------------------|-----------------------|----------------------|
|                               | <b>September 30, 2007</b> | <b>September 30, 2006</b> | <b>2006 \$ Change</b> | <b>2006 % Change</b> |
| Service Revenues              | \$ 1,431                  | \$ 517                    | \$ 914                | 176.8%               |

The \$799,000 increase in service revenues during the three months ended September 30, 2007 as compared to the comparable period in 2006, and the \$914,000 increase during the nine months ended September 30, 2007 as compared to the comparable period in 2006, were primarily due to approximately \$568,000 of custom software development revenues generated from the Enel Project. To a lesser extent, NES support revenue increases of \$201,000 and \$338,000 for the three and nine months ended September 30, 2007, respectively, also contributed to the increase in service revenues between the periods. Primarily due to the Enel software enhancement project, as well as increases in NES service revenues associated with our large scale deployment projects, we currently expect that our full year 2007 service revenues will increase from the \$761,000 recorded in 2006.

*Gross Profit and Gross Margin*

| <i>(Dollars in thousands)</i> | <b>Three Months Ended</b> |                           | <b>2007 over</b>      | <b>2007 over</b>     |
|-------------------------------|---------------------------|---------------------------|-----------------------|----------------------|
|                               | <b>September 30, 2007</b> | <b>September 30, 2006</b> | <b>2006 \$ Change</b> | <b>2006 % Change</b> |
| Gross Profit                  | \$ 10,004                 | \$ 7,846                  | \$ 2,158              | 27.5%                |
| Gross Margin                  | 40.5%                     | 59.0%                     |                       | (18.5)               |

| <i>(Dollars in thousands)</i> | <b>Nine Months Ended</b>  |                           | <b>2007 over</b>      | <b>2007 over</b>     |
|-------------------------------|---------------------------|---------------------------|-----------------------|----------------------|
|                               | <b>September 30, 2007</b> | <b>September 30, 2006</b> | <b>2006 \$ Change</b> | <b>2006 % Change</b> |
| Gross Profit                  | \$ 31,021                 | \$ 25,202                 | \$ 5,819              | 23.1%                |
| Gross Margin                  | 34.2%                     | 58.0%                     |                       | (23.8)               |

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 fringe 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.

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Both the 18.5 percentage point decrease in gross margin during the third quarter of 2007, as well as the 23.8 percentage point decrease during the first nine months of 2007, were due primarily to the mix of revenues reported. In each case, the proportion of our revenues attributable to sales of our NES system products increased significantly as compared to the comparable periods in 2006. In general, gross margins generated from sales of our NES system products are much lower than those generated from both sales of our LONWORKS Infrastructure 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 quarter and nine months ended September 30, 2007, overall gross margins will be lower. Conversely, when NES revenues comprise a lower percentage of overall revenues, as they were during the three and nine months ended September 30, 2006, overall gross margins will be higher.

Partially offsetting the decrease in gross margins during the three and nine months ended September 30, 2007 as compared to the comparable periods in 2006 was the impact of higher 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 increase, as they did in the three and nine months ended September 30, 2007 as compared to the comparable periods in 2006, gross margins are favorably impacted.

We expect that, for full year 2007, overall gross margin will decrease significantly from the 58.0% experienced in 2006 due to the significant increase we expect in NES revenues.

**Operating Expenses***Product Development*

| <i>(Dollars in thousands)</i> | <b>Three Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|---------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>      | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>               | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Product Development           | \$ 7,789                  | \$ 6,875             | \$ 914           | 13.3%            |

| <i>(Dollars in thousands)</i> | <b>Nine Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|--------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>     | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>              | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Product Development           | \$ 23,720                | \$ 21,029            | \$ 2,691         | 12.8%            |

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

The \$914,000 and \$2.7 million increases in product development expenses for the three and nine months ended September 30, 2007 as compared to the comparable periods in 2006 were primarily due to increases in compensation expenses for our product development personnel, which was primarily due to an increase in headcount in our product development organization. To a lesser extent, fees paid to third party service providers and equipment and supplies used in the development process also contributed to the increases between the two three and nine month periods.

We expect that, for full year 2007, product development expenses will increase over 2006 levels. This increase will primarily be the result of increased development efforts related to our NES system products.

**Table of Contents***Sales and Marketing*

| <i>(Dollars in thousands)</i> | Three Months Ended    |                       | 2007 over         | 2007 over        |
|-------------------------------|-----------------------|-----------------------|-------------------|------------------|
|                               | September 30,<br>2007 | September 30,<br>2006 | 2006 \$<br>Change | 2006 %<br>Change |
| Sales and Marketing           | \$ 4,850              | \$ 5,076              | \$ (226)          | (4.5%)           |

| <i>(Dollars in thousands)</i> | Nine Months Ended     |                       | 2007 over         | 2007 over        |
|-------------------------------|-----------------------|-----------------------|-------------------|------------------|
|                               | September 30,<br>2007 | September 30,<br>2006 | 2006 \$<br>Change | 2006 %<br>Change |
| Sales and Marketing           | \$ 15,218             | \$ 15,312             | \$ (94)           | (0.6%)           |

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 \$226,000 and \$94,000 reductions in sales and marketing expenses for the three and nine months ended September 30, 2007 as compared to the comparable periods in 2006 were primarily the result of decreases in commission expenses for our sales and marketing personnel.

Also contributing to the changes in sales and marketing expenses between 2006 and 2007 were the impacts of foreign currency exchange rate fluctuations between the U.S. dollar and the local currencies in several of the foreign countries in which we have operations, including the Euro, the British Pound Sterling, and the Japanese Yen. These exchange rate fluctuations caused sales and marketing expenses to increase by approximately \$95,000 during the third quarter of 2007 as compared to the comparable period in 2006, and to increase by approximately \$287,000 during the nine months ended September 30, 2007 as compared to the comparable period in 2006.

We expect that, during 2007, our sales and marketing expenses will increase modestly over 2006 levels. In addition, if the United States dollar were to weaken against the foreign currencies where we do business, our sales and marketing expenses could increase further. 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> | Three Months Ended    |                       | 2007 over         | 2007 over        |
|-------------------------------|-----------------------|-----------------------|-------------------|------------------|
|                               | September 30,<br>2007 | September 30,<br>2006 | 2006 \$<br>Change | 2006 %<br>Change |
| General and Administrative    | \$ 4,083              | \$ 3,746              | \$ 337            | 9.0%             |

| <i>(Dollars in thousands)</i> | Nine Months Ended     |                       | 2007 over         | 2007 over        |
|-------------------------------|-----------------------|-----------------------|-------------------|------------------|
|                               | September 30,<br>2007 | September 30,<br>2006 | 2006 \$<br>Change | 2006 %<br>Change |
| General and Administrative    | \$ 12,082             | \$ 10,946             | \$ 1,136          | 10.4%            |

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

Both the \$337,000 and \$1.1 million increases in general and administrative expenses during the three and nine months ended September 30, 2007, respectively, as compared to the comparable periods in 2006, were primarily attributable to increases in compensation related expenses for our executive, accounting, and administrative personnel, and to a lesser extent, fees paid to our independent accountants and other third party service providers.

We believe that, during 2007, general and administrative costs will increase over 2006 levels.

**Table of Contents****Interest and Other Income, Net**

| <i>(Dollars in thousands)</i>  | <b>Three Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|--------------------------------|---------------------------|----------------------|------------------|------------------|
|                                | <b>September 30,</b>      | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                                | <b>2007</b>               | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Interest and Other Income, Net | \$ 1,381                  | \$ 1,586             | \$ (205)         | (12.9%)          |

| <i>(Dollars in thousands)</i>  | <b>Nine Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|--------------------------------|--------------------------|----------------------|------------------|------------------|
|                                | <b>September 30,</b>     | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                                | <b>2007</b>              | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Interest and Other Income, Net | \$ 4,366                 | \$ 4,384             | \$ (18)          | (0.4%)           |

Interest and other income, net primarily reflects interest earned by our company on cash and short-term investment balances. In addition, foreign exchange translation gains and losses related to short-term intercompany balances are also reflected in this amount.

During the third quarter of 2007, interest and other income, net decreased by approximately \$205,000 as compared to the comparable period in 2006. This decrease was primarily due to a \$159,000 increase in foreign exchange translation losses, and to a lesser extent, by a \$45,000 decrease in interest income. During the nine months ended September 30, 2007, interest and other income, net decreased by approximately \$18,000 as compared to the comparable period in 2006. This reduction was primarily the result of a \$123,000 decrease in interest income, partially offset by a \$97,000 reduction in foreign exchange translation and transaction losses. The reduction in interest income for both the three and nine months ended September 30, 2007 as compared to the comparable periods in 2006 is primarily the result of a reduction in our average invested cash balance between the periods.

We expect that our anticipated operating losses for 2007 will require us to use a portion of our existing cash and short-term investment portfolio to fund ongoing business operations. As a result, we expect that the average amount of our invested cash will decrease during 2007, which will result in reduced interest income if interest rates remain unchanged or were to decrease. In addition, future fluctuations in the exchange rates between the United States dollar and the currencies in which we maintain our short-term intercompany balances (principally the European Euro and the British Pound Sterling) will also affect our interest and other income, net.

**Provision for Income Taxes**

| <i>(Dollars in thousands)</i> | <b>Three Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|---------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>      | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>               | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Provision for Income Taxes    | \$ 108                    | \$ 80                | \$ 28            | 35.0%            |

| <i>(Dollars in thousands)</i> | <b>Nine Months Ended</b> |                      | <b>2007 over</b> | <b>2007 over</b> |
|-------------------------------|--------------------------|----------------------|------------------|------------------|
|                               | <b>September 30,</b>     | <b>September 30,</b> | <b>2006 \$</b>   | <b>2006 %</b>    |
|                               | <b>2007</b>              | <b>2006</b>          | <b>Change</b>    | <b>Change</b>    |
| Provision for Income Taxes    | \$ 323                   | \$ 240               | \$ 83            | 34.6%            |

The provision for income taxes for 2007 includes a provision for state and foreign taxes based on our annual estimated effective tax rate for the year. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes and our valuation allowance on our deferred tax assets. Income taxes of \$108,000 and \$80,000 for the three months ended September 30, 2007 and 2006, respectively, and \$323,000 and \$240,000 for the nine months ended September 30, 2007 and 2006, respectively, consist primarily of taxes related to profitable foreign subsidiaries and various state minimum taxes.

Although we expect to generate a loss before provision for income taxes in 2007, we will be required to book income tax expense to cover, at a minimum, the foreign taxes owed on income generated by our profitable foreign subsidiaries as well as state minimum taxes. We currently expect our 2007 provision for income taxes will be slightly higher than the amounts provided for in 2006.

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**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 Echelon 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.

**Operating Lease Commitments.** We lease our present corporate headquarters facility in San Jose, California, under two non-cancelable operating leases. The first lease agreement expires in 2011 and the second lease agreement expires in 2013. Upon expiration, both lease agreements provide for extensions of up to ten years. As part of these lease transactions, we provided the lessor with security deposits in the form of two standby letters of credit totaling \$6.2 million.

In addition to our corporate headquarters facility, we also lease facilities for our sales, marketing, distribution, and product development personnel located elsewhere within the United States and in nine foreign countries throughout Europe and Asia. These operating leases are of shorter duration, generally one to five years, 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 that 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 on our consolidated statements of operations, was approximately \$133,000 during the three months ended September 30, 2007, and \$142,000 for the comparable period in 2006. Royalty expense was approximately \$432,000 for the nine months ended September 30, 2007, and \$352,000 for the comparable period in 2006.

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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, 2007, 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.

**Legal Actions.** From time to time, in the ordinary course of business, we are subject to 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, 2007, 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 from operating cash flows. From inception through September 30, 2007, we raised \$288.3 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 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 program during the three and nine months ended September 30, 2007. Since inception, we have repurchased a total of 2,204,184 shares under the program at a cost of \$16.1 million. As of September 30, 2007, 795,816 shares are available for repurchase. The stock repurchase program will expire in March 2008.

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The following table presents selected financial information as of September 30, 2007 and for each of the last three fiscal years (dollars in thousands):

|  | September 30,<br>2007 | 2006       | December 31,<br>2005 | 2004       |
|--|-----------------------|------------|----------------------|------------|
| Cash, cash equivalents, and short-term investments | \$ 123,808            | \$ 124,157 | \$ 154,480           | \$ 160,364 |
| Trade accounts receivable, net                     | 13,603                | 13,918     | 11,006               | 17,261     |
| Working capital                                    | 124,397               | 132,420    | 157,474              | 173,391    |
| Stockholders' equity                               | 151,383               | 156,575    | 181,308              | 211,062    |

As of September 30, 2007, we had \$123.8 million in cash, cash equivalents, and short-term investments, a decrease of \$349,000 as compared to December 31, 2006. 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 program.

**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 depreciation, amortization, in-process research and development charges, and stock-based compensation, as well as fluctuations in operating asset and liability balances. Net cash used in operating activities was \$669,000 for the nine months ended September 30, 2007, a \$15.8 million decrease from the comparable period in 2006. During the nine months ended September 30, 2007, net cash used in operating activities was primarily a result of our net loss of \$16.0 million, partially offset by changes in our operating assets and liabilities of \$7.4 million, stock-based compensation expenses of \$4.1 million, depreciation and amortization expense of \$3.4 million, a reduction of accrued investment income of \$403,000, and an increase in our allowance for doubtful accounts of \$47,000. During the nine months ended September 30, 2006, net cash used in operating activities was primarily a result of our net loss of \$17.9 million, changes in our operating assets and liabilities of \$5.2 million, an increase in accrued investment income of \$271,000, and a reduction in our bad debt reserve balance of \$32,000; partially offset by stock-based compensation expenses of \$3.7 million and depreciation and amortization expense of \$3.3 million. For the nine months ended September 30, 2006, \$271,000 has been reclassified from operating cash flows to investing cash flows related to investment income included in net income for which cash had not been received prior to September 30, 2006.

**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 provided by investing activities was \$32.9 million for the nine months ended September 30, 2007, a \$16.3 million increase from the comparable period in 2006. During the nine months ended September 30, 2007, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of \$104.1 million, and changes in our other long-term assets of \$44,000; partially offset by purchases of available-for-sale short-term investments of \$65.5 million, and capital expenditures of \$5.8 million. During the nine months ended September 30, 2006, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of \$68.4 million, and changes in our other long-term assets of \$56,000; partially offset by purchases of available-for-sale short-term investments of \$47.8 million, and capital expenditures of \$4.1 million.

**Cash flows from financing activities.** Cash flows from financing activities have historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase programs.



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Net cash provided by financing activities was \$6.1 million for the nine months ended September 30, 2007, an \$11.2 million increase over the comparable period in 2006. During the nine month period ended September 30, 2007, net cash provided by financing activities was attributable to proceeds of \$10.1 million from issuance of common stock as a result of options exercised by our employees; partially offset by \$4.0 million of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of stock options. During the nine month period ended September 30, 2006, net cash used in financing activities was attributable to \$5.1 million of open-market purchases of our common stock under our stock repurchase program, and by \$257,000 of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of stock options; partially offset by \$252,000 of proceeds from issuance of common stock as a result of options exercised by our employees.

We use well-regarded investment management firms to manage our invested cash. Our portfolio of investments managed by these investment managers is primarily composed of highly rated United States corporate obligations, United States government securities, and to a lesser extent, foreign corporate obligations, certificates of deposit, and money market funds. All investments are made according to guidelines and within compliance of policies approved by the Audit Committee of our board of directors.

As of September 30, 2007, our investment portfolio contained three asset backed commercial paper instruments issued by Structured Investment Vehicles ( SIVs ) with a par value of \$4.5 million each, or \$13.5 million in total. In general, a SIV is an investment company that generates investment returns through yield curve arbitrage by purchasing high grade medium and long-term fixed income instruments and funding those purchases by issuing low cost, short-term senior debt instruments such as asset-backed commercial paper and asset-backed medium term notes. These investments are considered illiquid based upon the fact that there were no open market bids for these investments as of September 30, 2007, or through November 9, 2007, the date of this filing. As such, the fair value of these investments was estimated to approximate the amortized cost, or \$13.4 million in total, by a third party pricing firm that supplies pricing estimates to our investment manager. One of these investments was repaid in full by the issuer on its maturity date of October 3, 2007. The two remaining investments mature on November 13, 2007 and January 18, 2008, and are rated A-1+ by Standard and Poor's and P1 by Moody's. In addition, we have reviewed the respective issuer's liquidity for the two remaining investments as well as the quality of the underlying collateral to further support each issuer's ability to repay the respective investments at maturity. It is our intent to hold these investments to maturity. As a result, we have not recorded an impairment charge or similar write-down of the reported values. However, if these securities were to begin trading below these values in the future, or the issuer were to default on its repayment obligations, we may be required to record losses on these investments, which would in turn negatively impact our results of operations and our financial condition.

We expect that cash requirements for our payroll and other operating costs will continue at or slightly above existing levels. We also expect that we will continue to acquire capital assets such as manufacturing equipment, computer systems and related software, office equipment, furniture and fixtures, and leasehold improvements, as the need for these items arises. Furthermore, our cash reserves may be used to strategically acquire other companies, products, or technologies that are complementary to our business.

Our existing cash, cash equivalents, and investment balances will likely decline during the remainder of 2007 as a result of our anticipated operating losses. In addition, any weakening of current economic conditions, or changes in our planned cash outlay, could also negatively affect our existing cash, cash equivalents, and investment balances. However, based on our current business plan and revenue prospects, we believe that our existing cash and short-term investment balances will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. Cash from operations could be 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*. In the unlikely event that we

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would require additional financing within this period, 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, 2007, and the years ended December 31, 2006, 2005, and 2004, 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, M. Kenneth Oshman, our Chairman of the Board and Chief Executive Officer, uses private air travel services for business trips for himself and for any employees accompanying him. Prior to January 1, 2005, a company controlled by Armas Clifford Markkula, a director of our company, provided these private air travel services. Our net expense with respect to such private air travel services is no greater than comparable first class commercial air travel services. Such net outlays to date have not been material.

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. As of October 31, 2007, a nominee of Enel has not been elected to 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 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. Both the new development and supply agreement and the software enhancement agreement expire in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

For the three and nine months ended September 30, 2007, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$3.0 million and \$8.0 million, respectively. As of September 30, 2007, \$158,000 of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers. For the quarter and nine months ended September 30, 2006, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$53,000 and \$7.1 million, respectively. As of September 30, 2006, \$4.1 million of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

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**RECENTLY ISSUED ACCOUNTING STANDARDS**

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 ( SFAS 159 ), *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for Echelon beginning in our fiscal year ending December 31, 2008, although earlier adoption is permitted. We are currently evaluating the impact that SFAS 159 will have on our consolidated financial statements.

**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.*

**Our NES revenues may not be predictable.**

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 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. 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:

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 NES system field trials.

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 approval process is often referred to as homologation or type testing. 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.

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Once a utility decides to move forward with a large-scale deployment of 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 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 are met in a future period. As a consequence, 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 and our investors will have increasing difficulty in projecting our financial results.

### **Sales of our NES system may fail to meet our financial targets.**

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 yielded very little gross profit, while our NES related operating expenses have increased significantly. Additionally, gross margins on our NES system offerings are currently lower than gross margins on our other product offerings.

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 revenues;

Increase gross margin from our NES revenues by reducing the cost of manufacturing our NES system products;

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.

### **We depend on a limited number of key suppliers.**

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 WKK Technology, TYCO TEPC/Transpower, and Flextronics. 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, and finished products, and manufacturing yields. In addition, CEMs can experience turnover and instability, exposing us to additional risks as well as missed commitments to our customers.

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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. 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 cannot be certain that these and other key suppliers will continue to supply us with critical products or components. 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 replacement. In addition, as our NES business grows, we will be required to expand our business with our key suppliers or find additional sources of supply. 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 and in-process inventory between locations 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 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.

### **We may incur penalties and/or be liable for damages with respect to sales of our NES system products.**

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 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.

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### **Our products use components or materials that may be subject to price fluctuations, shortages, or interruptions of supply.**

We may be vulnerable to price increases for products, components, or materials, such as copper and cobalt. 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.

### **The markets for our products are highly competitive.**

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, and rapid changes in customer 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:

our ability to anticipate changes in customer requirements and to develop new or improved products that 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;

warranties, indemnities, and other contractual terms; and

customer relationships and market awareness.

Competitors for our NES system products include the Bayard Capital group of companies, DCSI, Elster, General Electric, Iskraemeco, Itron/Actaris, Kamstrup, Sensus, and Siemens, 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.

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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 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 150 member companies with promoter members such as Eaton, Freescale, Motorola, Texas Instruments, STMicroelectronics, Ember, Siemens, Honeywell, Mitsubishi Electric, Samsung, Schneider Electric, Tendril, Huawei Technologies, and Philips.

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. 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 undetected errors or failures when first introduced, as new versions are released, or as a result of the manufacturing 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.

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.

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.

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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.

### **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 various 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.

### **We face financial and operational risks associated with international operations.**

We have operations located in nine countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 81.6% of our total net revenues for the three months ended September 30, 2007, and 60.9% for the comparable period in 2006; and 84.8% of our total net revenues for the nine months ended September 30, 2007, and 66.3% for the comparable period in 2006. We expect that international sales will continue to constitute a significant portion of our total net revenues as our NES revenues, which currently result predominantly from international sales, will increase significantly in 2007 as compared to 2006.



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Changes in the value of currencies in which we conduct our business relative to the U.S. dollar could 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.

With respect to 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, the majority of our products are assembled by CEMs in China, and to a lesser extent, in the European Union, although our transactions with these vendors have historically been denominated in U.S. dollars. These vendors 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.

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:

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 and unexpected changes in regulatory requirements, tariffs, and other trade barriers;

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

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

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

international terrorism and anti-American sentiment; 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.

**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 purchase 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.

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, and undertaking other activities. To date, we do not have any significant experience with providing these types of services. As a result, if we sold 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 we expect to incur substantial losses again in 2007. 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;

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shipment and payment schedules may be delayed;

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, 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 accepted 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 as required under SFAS No. 123R will decrease our earnings;

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

results of impairment tests for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, and SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, with respect to goodwill and other identified intangible assets that we acquired in the past or that we may acquire in the future 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.

**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.

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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.

### **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.

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.

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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. 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.

### **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, our President and Chief Operating Officer, and our technical personnel. Our future success will depend on our ability to attract, integrate, motivate and retain qualified technical, sales, operations, and managerial personnel, as well as our ability to successfully implement a plan for management succession.

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.

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**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;

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

our stock has very limited analyst coverage.

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

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

As of October 31, 2007, 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 33.7% of our outstanding stock.

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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 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, 2006.

**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, 2007 and September 30, 2006, 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.

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If foreign exchange rates were to fluctuate by 10% from rates at September 30, 2007, and September 30, 2006, 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**

Our review of our internal controls over financial reporting was made within the context of the relevant professional auditing standards defining internal controls over financial reporting, reportable conditions, and material weaknesses. As part of our evaluation of internal controls over financial reporting, we also address other, less significant control matters that we or our auditors identify, and we determine what revision or improvement to make, if any, in accordance with our on-going procedures.

#### ***Limitations on the Effectiveness of Controls***

Since we began reviewing our internal controls over financial reporting, we have identified a number of procedures where an opportunity to improve our internal controls existed. As part of our ongoing effort to maximize our internal controls over financial reporting, each of these control improvement opportunities has been, or is in the process of being, remediated by management.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934, or the Exchange Act, Rules 13a-15(e) and 15d-15(e)) or our internal controls over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected.

#### ***Conclusions Regarding Disclosure Controls and Procedures and Internal Controls Over Financial Reporting***

Our CEO and our CFO have reviewed our disclosure controls and procedures and our internal controls over financial reporting in order to both evaluate their effectiveness and to ensure they have been designed to provide reasonable assurance of achieving their objectives. The objective of these controls is to make sure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, they have concluded that as of September 30, 2007, our disclosure controls and procedures and our internal controls over financial reporting are effective at this reasonable assurance level.



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***Changes in Internal Controls 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, 2007 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 2006 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, 2007 and June 30, 2007, and is incorporated herein by reference.

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

In March and August 2004, our board of directors approved a stock repurchase program, which authorizes us to repurchase up to 3,000,000 shares of our common stock in the open market, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. The board of directors extended the term of the stock repurchase program in March 2006 and again in February 2007. Since inception, we have repurchased a total of 2,204,184 shares under the program at a cost of \$16.1 million. As of September 30, 2007, 795,816 shares are available for repurchase. The stock repurchase program will expire in March 2008. The following table provides information about the repurchase of our common stock during the quarter ended September 30, 2007:

| <b>Period</b>             | <b>Total<br/>Number of<br/>Shares<br/>Purchased<br/>(1)</b> | <b>Average<br/>Price Paid<br/>per<br/>Share</b> | <b>Total Number of<br/>Shares Purchased<br/>as Part of Publicly<br/>Announced Plans or<br/>Programs</b> | <b>Maximum<br/>Number of Shares<br/>that May Yet Be<br/>Purchased Under<br/>the Plans or<br/>Programs (1)</b> |
|---------------------------|---|---|---|---|
| July 1- July 31           | 15,030  | \$ 22.15  |   | 795,816   |
| August 1- August 31       | 257,969   | \$ 27.58  |   | 795,816   |
| September 1- September 30 | 34,455  | \$ 28.97  |   | 795,816   |
| Total                     | 307,454   | \$ 27.47  |   | 795,816   |

- (1) 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.

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**ITEM 6. EXHIBITS**

**Exhibit**

| <b>No.</b> | <b>Description of Document</b>   |
|------------|--|
| 3.3*       | Amended and Restated Bylaws of Registrant.   |
| 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. |

\* Previously filed.

**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 9, 2007

By: /s/ Oliver R. Stanfield  
Oliver R. Stanfield,  
Executive Vice President and Chief Financial Officer  
(Duly Authorized Officer and Principal Financial and  
Accounting Officer)

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