

ECHELON CORP  
Form 10-Q  
November 09, 2006

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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, 2006**

**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)

**77-0203595**

(IRS Employer  
Identification Number)

**550 Meridian Avenue**

**San Jose, CA 95126**

(Address of principal executive office and zip code)

**(408) 938-5200**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant 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):

Accelerated filer  Non-accelerated filer

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Large  
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, 2006, 39,258,957 shares of the registrant's common stock were outstanding.

**ECHELON CORPORATION**  
**FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 2006**

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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 “Liquidity and Capital Resources,” “Recently Issued Accounting Standards” and “Factors That May Affect Future Results of Operations,” and elsewhere in this report. These statements include statements concerning projected revenues, international revenues, expenses, gross profit, income, product development and market acceptance of our products.*

In this report, the words “may,” “could,” “would,” “might,” “will,” “should,” “plan,” forecast,” “anticipate,” “believe,” “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

Securities and Exchange Commission (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.

## PART I. FINANCIAL INFORMATION

## ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**ECHELON CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands)

	<b>September 30,</b>	<b>December 31,</b>
	<b>2006</b>	<b>2005</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 54,451	\$ 59,080
Short-term investments	75,341	95,400
Accounts receivable, net	17,086	11,006
Inventories	8,939	3,240
Other current assets	15,557	2,289
Total current assets	171,374	171,015
Property and equipment, net	15,719	14,886
Goodwill	8,180	8,018
Other long-term assets	1,963	2,019
<b>TOTAL ASSETS</b>	<b>\$ 197,236</b>	<b>\$ 195,938</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 7,634	\$ 3,972
Accrued liabilities	4,767	7,473
Deferred revenues	20,833	2,096
Total current liabilities	33,234	13,541
<b>LONG-TERM LIABILITIES:</b>		
Deferred rent	1,240	1,089
Total long-term liabilities	1,240	1,089
<b>STOCKHOLDERS' EQUITY:</b>		
Common stock	416	415
Additional paid-in capital	281,716	278,005
Treasury stock	(18,027)	(12,925)
Accumulated other comprehensive income (loss)	667	(118)
Accumulated deficit	(102,010)	(84,069)
Total stockholders' equity	162,762	181,308
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 197,236</b>	<b>\$ 195,938</b>

*See accompanying notes to condensed consolidated financial statements.*

**ECHELON CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>REVENUES:</b>				
Product	\$ 13,110	\$ 16,068	\$ 42,893	\$ 54,852
Service	181	183	517	562
Total revenues	13,291	16,251	43,410	55,414
<b>COST OF REVENUES:</b>				
Cost of product (1)	4,936	7,085	16,802	23,107
Cost of service (1)	509	525	1,406	1,629
Total cost of revenues	5,445	7,610	18,208	24,736
<b>GROSS PROFIT</b>	<b>7,846</b>	<b>8,641</b>	<b>25,202</b>	<b>30,678</b>
<b>OPERATING EXPENSES:</b>				
Product development (1)	6,875	6,170	21,029	18,747
Sales and marketing (1)	5,076	5,164	15,312	15,585
General and administrative (1)	3,746	8,550	10,946	16,597
Total operating expenses	15,697	19,884	47,287	50,929
<b>LOSS FROM OPERATIONS</b>	<b>(7,851)</b>	<b>(11,243)</b>	<b>(22,085)</b>	<b>(20,251)</b>
<b>INTEREST AND OTHER INCOME, NET</b>	<b>1,586</b>	<b>1,225</b>	<b>4,384</b>	<b>3,567</b>
<b>LOSS BEFORE PROVISION FOR INCOME TAXES</b>	<b>(6,265)</b>	<b>(10,018)</b>	<b>(17,701)</b>	<b>(16,684)</b>
<b>INCOME TAX EXPENSE</b>	<b>80</b>	<b>100</b>	<b>240</b>	<b>300</b>
<b>NET LOSS</b>	<b>\$ (6,345)</b>	<b>\$ (10,118)</b>	<b>\$ (17,941)</b>	<b>\$ (16,984)</b>
<b>NET LOSS PER SHARE:</b>				
Basic	\$ (0.16)	\$ (0.25)	\$ (0.45)	\$ (0.42)
Diluted	\$ (0.16)	\$ (0.25)	\$ (0.45)	\$ (0.42)
<b>SHARES USED IN COMPUTING NET LOSS PER SHARE:</b>				
Basic	39,354	40,074	39,577	40,538
Diluted	39,354	40,074	39,577	40,538
<b>(1) Amounts include stock-based compensation costs as follows:</b>				
Cost of product	\$ 92	\$ 17	\$ 307	\$ 35
Cost of service	10	1	36	1
Product development	376	44	1,474	68
Sales and marketing	249	33	911	57

General and administrative	275	75	989	195
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*See accompanying notes to condensed consolidated financial statements.*

**ECHELON CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands)

	Nine Months Ended September 30,	
	2006	2005
<b>CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:</b>		
Net loss	\$ (17,941)	\$ (16,984)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,270	3,115
Loss on disposal of fixed assets	--	45
Recovery of doubtful accounts	(32)	(1)
Stock-based compensation	3,717	356
Change in operating assets and liabilities:		
Accounts receivable	(6,048)	7,839
Inventories	(5,699)	397
Other current assets	(13,268)	(701)
Accounts payable	3,662	137
Accrued liabilities	(2,706)	6,058
Deferred revenues	18,737	(160)
Deferred rent	151	203
Net cash provided by (used in) operating activities	(16,157)	304
<b>CASH FLOWS PROVIDED BY (USED FOR) INVESTING ACTIVITIES:</b>		
Purchase of available-for-sale short-term investments	(47,761)	(92,408)
Proceeds from maturities and sales of available-for-sale short-term investments	68,140	89,794
Release of restricted investments	--	11,106
Change in other long-term assets	(106)	250
Capital expenditures	(4,103)	(1,464)
Net cash provided by investing activities	16,170	7,278
<b>CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:</b>		
Repurchase of common stock	(5,102)	(7,869)
Proceeds from (costs associated with) issuance of common stock	(5)	--
Net cash used in financing activities	(5,107)	(7,869)
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH</b>	<b>465</b>	<b>(867)</b>
<b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(4,629)</b>	<b>(1,154)</b>
<b>CASH AND CASH EQUIVALENTS:</b>		
Beginning of period	59,080	35,510
End of period	\$ 54,451	\$ 34,356



**SUPPLEMENTAL DISCLOSURES OF CASH FLOW  
INFORMATION:**

Net cash paid for income taxes	\$	183	\$	298
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*See accompanying notes to condensed consolidated financial statements.*

**ECHELON CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**1. 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, 2005 included in its Annual Report on Form 10-K.

**2. Summary of Significant Accounting Policies**

*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated.

*Foreign Currency Translation*

For foreign subsidiaries using the local currency as their functional currency, assets and liabilities are translated at exchange rates in effect at the balance sheet date and income and expenses are translated at average exchange rates. The effects of these translation adjustments are reported as a separate component of stockholders’ equity. Remeasurement adjustments for non-functional currency monetary assets and liabilities are included in other income (expense) in the accompanying condensed consolidated statements of operations.

*Use of Estimates in the Preparation of Financial Statements*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*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. Revenues from software licensing arrangements accounted for approximately 10.3% of total revenues for the quarter ended September 30, 2006 and 8.0% for the same period in 2005; and 9.8% of total revenues for the nine months ended September 30, 2006 and 6.9% for the same period in 2005. 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 and certain of the Company's distributors for which no rights of return exist, these criteria are generally met at the time of shipment. For sales made to the Company's distributor partners that do have rights to return certain excess inventory, these criteria are generally met at the time the distributor sells the products through to its end-use customer. For sales of shrink-wrapped software, these criteria are generally met upon shipment to the final end-user.

In accordance with Statement of Position 97-2, or SOP 97-2, *Software Revenue Recognition*, revenue earned on software arrangements involving multiple elements is allocated to each element based upon the relative fair values of the elements. The Company uses the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date. In these instances, the amount of revenue deferred at the time of sale is based on vendor specific objective evidence ("VSOE") of the fair value for each undelivered element. If VSOE of fair value does not exist for each undelivered element, all revenue attributable to the multi-element arrangement is deferred until sufficient VSOE of fair value exists for each undelivered element or all elements have been delivered.

The Company currently sells a limited number of 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 these PCS packages. 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.

The Company accounts for 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*.

Service revenue is recognized as the training services are performed, or ratably over the term of the support period. In the case of custom software development services, revenue is recognized when the customer accepts the software.

#### *Stock-Based Compensation*

Effective January 1, 2006, the Company began recording compensation expense associated with stock options and other forms of equity compensation in accordance with SFAS No. 123R ("SFAS 123R"), *Share-Based Payment*, and Securities and Exchange Commission Staff Accounting Bulletin No. 107 ("SAB 107"). SFAS 123R eliminates the ability to account for stock-based compensation transactions using the intrinsic value method under Accounting Principles Board Opinion No. 25 ("APB 25"), *Accounting for Stock Issued to Employees*, and instead generally requires that such transactions be accounted for using a fair-value-based method.

The Company has elected to adopt SFAS 123R using the modified prospective method. Consequently, there have been no retroactive adjustments made to prior period financial statements reflecting the impact of the adoption. Under the modified prospective method, beginning January 1, 2006, stock-based compensation expense is recorded for all new and unvested stock options and performance shares as the requisite service is rendered. Stock-based compensation expense for awards granted prior to January 1, 2006 is based on the grant date fair-value as determined under the pro forma provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*.

As permitted under SFAS 123R, the Company uses the Black-Scholes-Merton ("BSM") option-pricing model to determine the fair-value of stock-based awards. The BSM model is consistent with the option-pricing model the Company used to value stock-based awards granted prior to January 1, 2006 for pro-forma disclosure purposes under SFAS 123.



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Prior to January 1, 2006, the Company accounted for equity compensation according to the provisions of APB 25, and applied the disclosure provisions of SFAS 123 as amended by SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*, as if the fair-value-based method had been applied in measuring compensation expense. Under APB 25, no compensation expense was recorded in the Company's statement of operations for stock options where the exercise price was equal to or greater than the fair market value of the underlying stock on the date of grant. However, during 2005, the Company did record compensation expense for performance share awards issued during 2005. The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation for the three and nine months ended September 30, 2005 (in thousands, except per share amounts).

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
Net loss as reported	\$ (10,118)	\$ (16,984)
Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects	170	356
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,322)	(7,264)
Pro forma net loss	\$ (12,270)	\$ (23,892)
Basic net loss per share:		
As reported	\$ (0.25)	\$ (0.42)
Pro forma	\$ (0.31)	\$ (0.59)
Diluted net loss per share:		
As reported	\$ (0.25)	\$ (0.42)
Pro forma	\$ (0.31)	\$ (0.59)

The weighted-average grant date fair value of options granted during the three and nine months ended September 30, 2005 was \$3.77 and \$3.63, respectively, and was determined using the following weighted average assumptions:

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
Expected dividend yield	0.0%	0.0%
Risk-free interest rate	4.1%	4.0%
Expected volatility	57.5%	57.7%
Expected life (in years)	3.7	3.6

Further information regarding stock-based compensation can be found in Note 4 of these Notes to Condensed Consolidated Financial Statements.

*Cash and Cash Equivalents*

The Company considers bank deposits, money market investments and all debt and equity securities with an original maturity of three months or less as cash and cash equivalents.

*Short-Term Investments*

The Company classifies its investments in marketable debt securities as available-for-sale in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. As of September 30, 2006, the Company's available-for-sale securities had contractual maturities from six to twenty-four months and an average remaining term to maturity of six months. The fair value of available-for-sale securities was determined based on quoted market prices at the reporting date for those instruments. As of September 30, 2006, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses by major security type were as follows (in thousands):

	<b>Amortized Cost</b>	<b>Aggregate Fair Value</b>	<b>Unrealized Holding Gains/ (Losses)</b>
U.S. corporate securities:			
Commercial paper	\$ 13,650	\$ 13,654	\$ 4
Corporate notes and bonds	29,622	29,573	(49)
	43,272	43,227	(45)
Foreign corporate notes and bonds	1,492	1,484	(8)
U.S. government securities	30,653	30,630	(23)
Total investments in debt and equity securities	\$ 75,417	\$ 75,341	\$ (76)

*Computation of Net Loss Per Share*

Net loss per share has been calculated under SFAS No. 128, ("SFAS 128"), *Earnings per Share*. SFAS 128 requires companies to compute earnings per share under two different methods, basic and diluted. Basic net income per share is calculated by dividing net income by the weighted average shares of common stock outstanding during the period. Diluted net income per share is calculated by adjusting the weighted average number of outstanding shares assuming conversion of all potentially dilutive stock options and warrants under the treasury stock method.

The following is a reconciliation of the numerators and denominators of the basic and diluted net loss per share computations for the three months and nine months ended September 30, 2006 and September 30, 2005 (in thousands, except per share amounts):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net loss (Numerator):				
Net loss	\$ (6,345)	\$ (10,118)	\$ (17,941)	\$ (16,984)
Shares (Denominator):				
Weighted average common shares outstanding	39,354	40,074	39,577	40,538
Shares used in basic computation	39,354	40,074	39,577	40,538
Common shares issuable upon exercise of stock options (treasury stock method)	--	--	--	--
Shares used in diluted computation	39,354	40,074	39,577	40,538
Net loss per share:				
Basic	\$ (0.16)	\$ (0.25)	\$ (0.45)	\$ (0.42)
Diluted	\$ (0.16)	\$ (0.25)	\$ (0.45)	\$ (0.42)

In accordance with SFAS 128, for the three and nine months ended September 30, 2006 and 2005, 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 excluded from this calculation for the three and nine months ended September 30, 2006 was 7,561,024. The number of stock options excluded from this calculation for the three and nine months ended September 30, 2005 was 8,213,544.

#### *Impairment of Long-Lived Assets Including Goodwill*

The Company reviews property, plant, and equipment and certain identifiable intangibles, excluding goodwill, for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability is measured by comparing the asset's carrying value to the future undiscounted cash flows the asset is expected to generate. If property, plant, and equipment and certain identifiable intangibles are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair market value. For the three and nine month periods ended September 30, 2006 and 2005, the Company has made no material adjustments to its long-lived assets.

Costs in excess of the fair value of tangible and other intangible assets acquired and liabilities assumed in a purchase business combination are recorded as goodwill. The Company evaluates goodwill, at a minimum, on an annual basis during the first quarter and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. If the carrying amount of the reporting unit exceeds its fair value, goodwill is considered impaired and a second step is performed to measure the amount of impairment loss, if any. To date, the Company has recorded no impairment of goodwill as a result of its required tests.

SFAS 142 also requires that intangible assets with definite lives be amortized over their estimated useful lives and reviewed for impairment in accordance with SFAS No. 144, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. As of September 30, 2006, the Company's acquired intangible assets with a definite life, which consisted of purchased technology, have been fully amortized.

#### *Recently Issued Accounting Standards*

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 ("SFAS 157"), *Fair Value Measurements*. SFAS 157 defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosure related to the use of fair value measures in financial statements. SFAS 157 does not expand the use of fair value measures in financial statements, but standardizes its definition and guidance in GAAP. The Standard emphasizes that fair value is a market-based measurement and not an entity-specific measurement based on an exchange transaction in which the entity sells an asset or transfers a liability (exit price). SFAS 157 establishes a fair value hierarchy from observable market data as the highest level to fair value based on an entity's own fair value assumptions as the lowest level. SFAS 157 is to be effective for the Company's financial statements issued in 2008; however, earlier application is encouraged. The Company believes that the adoption of SFAS 157 will not have a material impact on its consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin No. 108 (“SAB 108:”), *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements*. SAB 108 provides guidance on how the effects of the carryover or reversal of prior year financial statement misstatements should be considered in quantifying a current year misstatement. Prior practice allowed the evaluation of materiality on the basis of (1) the error quantified as the amount by which the current year income statement was misstated (rollover method) or (2) the cumulative error quantified as the cumulative amount by which the current year balance sheet was misstated (iron curtain method). Reliance on either method in prior years could have resulted in misstatement of the financial statements. The guidance provided in SAB 108 requires both methods to be used in evaluating materiality. Immaterial prior year errors may be corrected with the first filing of prior year financial statements after adoption. The cumulative effect of the correction would be reflected in the opening balance sheet with appropriate disclosure of the nature and amount of each individual error corrected in the cumulative adjustment, as well as a disclosure of the cause of the error and that the error had been deemed to be immaterial in the past. The provisions of SAB 108 are effective as of the beginning of our 2007 fiscal year. The Company believes that the adoption of SAB 108 will not have a material impact on its consolidated financial statements.

In July 2006, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 48 (“FIN 48”), *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that the Company recognize in its financial statements the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of our 2007 fiscal year, with the cumulative effect, if any, of the change in accounting principal recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its condensed consolidated financial statements.

In February 2006, the FASB issued SFAS No. 155 (“SFAS 155”), *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133 (“SFAS 133”), *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140 (“SFAS 140”), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. SFAS 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. As the Company does not currently engage in hedging activities, it does not currently expect the adoption of SFAS 155 will have a material impact on its consolidated financial position, results of operations, or cash flows.

In June 2005, the FASB issued SFAS No. 154 (“SFAS 154”), *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for how an entity accounts for, and reports, a change in accounting principle. Previously, most voluntary changes in accounting principles were implemented by reflecting a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods’ financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, SFAS 154 does not change the transition provisions of any existing accounting pronouncements. The adoption of SFAS 154 did not have a material impact on the Company’s consolidated financial statements.

### **3. Stockholders’ Equity and Employee Stock Option Plans**



*Preferred Stock*

With the closing of the Company's initial public offering ("IPO") in July 1998, all of the then outstanding preferred stock automatically converted into 7,887,381 shares of common stock. Upon conversion of the outstanding preferred stock to common stock, such preferred stock was retired. As of September 30, 2006, the Company was authorized to issue 5,000,000 shares of new \$0.01 par value preferred stock, of which none was outstanding as of September 30, 2006.

*Common Stock*

As of September 30, 2006, the Company was authorized to issue 100,000,000 shares of \$0.01 par value common stock, of which 39,257,966 were outstanding.

In March and August 2004 and March 2006, the Company's board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company's common stock. During the quarter ended September 30, 2006, the Company repurchased 322,612 shares under the program at a cost of approximately \$2.6 million. During the nine months ended September 30, 2006, the Company repurchased 642,067 shares under the program at a cost of approximately \$5.1 million. As of September 30, 2006, 949,934 shares were available for repurchase. The stock repurchase program will expire in March 2007.

*Comprehensive Loss*

Comprehensive income for the Company consists of net income 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, 2006 and 2005 is as follows (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Net loss	\$ (6,345)	\$ (10,118)	\$ (17,941)	\$ (16,984)
Other comprehensive income/(loss), net of tax:				
Foreign currency translation adjustment	(63)	(89)	465	(867)
Unrealized holding gain/(loss) on available-for-sale securities	270	(83)	320	9
Comprehensive loss	\$ (6,138)	\$ (10,290)	\$ (17,156)	\$ (17,842)

*Employee Stock Option Exchange Program*

On September 21, 2004, the Company announced a voluntary employee stock option exchange program (the "Exchange Program") whereby eligible employees were given an opportunity to exchange some or all of their outstanding options for a predetermined number of new stock options. Under the Exchange Program, participating eligible employees would receive one new stock option for each exchanged option with an exercise price less than \$12.00 per share. For exchanged options with an exercise price equal to or greater than \$12.00 per share, participants would receive between 0.2 and 0.67 new options for each option exchanged, depending on the exercise price of the exchanged option. The Company's Chief Executive Officer, President and Chief Operating Officer, and Executive Vice President and Chief Financial Officer, along with members of the board of directors, were not eligible to participate in the Exchange Program.

On October 21, 2004, in accordance with the Exchange Program, the Company accepted and cancelled options to purchase 3,816,812 shares of its common stock. On April 22, 2005, which was the first business day that was nine months and one day after cancellation of the exchanged options, the Company granted new stock options totaling 2,148,725 shares. With the exception of new options granted to participating executive officers, the new options were granted at an exercise price of \$6.11, the closing price of the Company's stock on April 22, 2005. In accordance with the terms of the Exchange Program, the exercise price for new options granted to participating executive officers was \$8.52, which was the greater of the fair market value of the Company's stock on the date of grant, or 115% of the closing price of the Company's stock on the date the exchanged options were cancelled. For certain foreign employees, local laws restricted the Company from issuing the new options on April 22, 2005. For those employees, 7,268 new options were issued on May 25, 2005 at an exercise price of \$6.35, the closing price of the Company's stock on that date.

New options granted under the Exchange Program have a term equal to the greater of the remaining term of the exchanged options or two years from the new option grant date. New options were subject to a one-year cliff-vesting schedule, at which time the new option vested to the same percentage as the exchanged option would have been on that date. After one year from the date of grant, the new options continue to vest and become exercisable as to 1/48th of the shares subject to the new option on each monthly anniversary of the new option grant date. All vesting of the new options is subject to the participating employee's continued employment with the Company on each relevant vesting date.

The Exchange Program had no impact on the Company's financial position, results of operations, or cash flows during 2005 or 2004.

#### *Option Vesting Acceleration*

On September 17, 2004, the Company's board of directors approved the acceleration of vesting for 668,340 outstanding options previously issued to the Company's Chief Executive Officer, President and Chief Operating Officer, and Executive Vice President and Chief Financial Officer. The accelerated options had exercise prices ranging from \$10.89 to \$16.69. The fair market value of the Company's stock on September 17, 2004 was \$8.27. The acceleration of the vesting of these options did not result in a compensation charge, as there was no intrinsic value in the options as of the acceleration date. For pro forma disclosure requirements under SFAS 123, the unamortized stock-based compensation related to these options prior to the vesting acceleration was approximately \$3.2 million, all of which was recognized in 2004. The Company's board of directors approved the vesting acceleration for the three executive officers, as they were not eligible to participate in the previously discussed Exchange Program, and because doing so reduced the future stock compensation expense required to be included in the Company's results from operations under SFAS 123R.

On November 18, 2005, the Company's board of directors approved the acceleration of vesting for 1,201,550 outstanding options previously awarded to employees and officers. The accelerated options had exercise prices ranging from \$8.34 per share to \$20.34 per share. The fair market value of the Company's stock on November 18, 2005 was \$8.06. The acceleration of the vesting of these options did not result in a charge, as there was no intrinsic value in the options as of the acceleration date. For pro forma disclosure requirements under SFAS 123, the unamortized stock-based compensation related to these options prior to the vesting acceleration was approximately \$3.5 million, all of which was recognized in 2005. The Company's board of directors approved the vesting acceleration for these options in order to reduce the future stock compensation expense required to be reflected in the Company's statement of operations under SFAS 123R.

#### *Stock Option Program Description*

The Company has two plans under which it grants options: the 1997 Stock Plan (the "1997 Plan") and the 1998 Director Option Plan (the "Director Option Plan"). A more detailed description of each plan can be found below and in the

Company's Annual Report on Form 10-K.

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Stock option and other equity compensation grants are designed to reward employees, officers, and directors for their long-term contribution to the Company, to align their interest with those of the Company's stockholders in creating stockholder value, and to provide incentives for them to remain with the Company. The number and frequency of equity compensation grants is based on competitive practices, operating results of the Company, and accounting regulations. Since the inception of the 1997 Plan, the Company has granted options to all of its employees.

Historically, the Company has issued new shares upon the exercise of stock options. However, treasury shares are also available for issuance, although the Company does not currently intend to use treasury shares for this purpose.

#### *1997 Stock Plan*

The 1997 Stock Plan (the "1997 Plan") is a stockholder approved plan that provides for broad-based grants to employees, including executive officers. Based on the terms of individual option grants, options granted under the 1997 Plan generally expire five years after the date of grant, although options granted from June 15, 2000 through May 5, 2003, generally have a term of ten years. Options granted under the 1997 Plan generally vest at a rate of 25% per year over four years. In addition to incentive and nonstatutory stock options, the 1997 Plan also permits the granting of stock purchase rights, stock appreciation rights, performance units, and performance shares. As of September 30, 2006, other than stock options, the Company has only granted performance shares under the 1997 Plan. Certain of these performance shares vest 100% on the two-year anniversary of the grant date, while the remaining performance shares vest 25% per year over four years.

#### *1998 Directors Option Plan*

Non-employee directors are entitled to participate in the stockholder approved 1998 Director Option Plan (the "Director Plan"). The Director Plan provides for the automatic grant of 25,000 shares of common stock (the "First Option") to each non-employee director on the date he or she first becomes a director. Each non-employee director is also automatically granted an option to purchase 10,000 shares (a "Subsequent Option") on the date of the Company's Annual Stockholder Meeting provided that he or she is re-elected to the Board or otherwise remains on the Board, and provided that on such date, he or she shall have served on the Board for at least the preceding nine months. Each First Option and each Subsequent Option have a term of five years and vest immediately upon grant.

*Stock Award Activity*

The following table summarizes stock award activity, including stock options and performance shares, and related information for the three and nine month periods ended September 30, 2006 and 2005:

	Shares Available for Grant	Number Outstanding	Options Outstanding	
				Weighted-Average Exercise Price Per Share
BALANCE AT JUNE 30, 2005	7,995,704	7,346,802	\$	11.66
Options granted	(1,043,980)	1,043,980		8.18
Performance shares granted	(305,710)	---		---
Options exercised	---	---		---
Options forfeited or expired	177,238	(177,238)		9.38
BALANCE AT SEPTEMBER 30, 2005	6,823,252	8,213,544	\$	11.26
BALANCE AT JUNE 30, 2006	8,930,789	7,608,798	\$	11.23
Options granted	(32,800)	32,800		8.33
Performance shares granted	(10,934)	---		---
Options exercised	---	(11,018)		6.17
Options forfeited or expired	69,556	(69,556)		18.88
Performance shares forfeited or expired	1,671	---		---
BALANCE AT SEPTEMBER 30, 2006	8,958,279	7,561,024	\$	11.15
	Shares Available for Grant	Number Outstanding	Options Outstanding	
				Weighted-Average Exercise Price Per Share
BALANCE AT DECEMBER 31, 2004	8,109,556	5,594,842	\$	14.91
Options granted	(3,537,064)	3,537,064		6.98
Performance shares granted	(415,065)	---		---
Options exercised	---	---		---
Options forfeited or expired	918,362	(918,362)		16.98
Additional shares reserved	1,747,463	---		---
BALANCE AT SEPTEMBER 30, 2005	6,823,252	8,213,544	\$	11.26
BALANCE AT DECEMBER 31, 2005	6,949,420	8,089,473	\$	11.24
Options granted	(101,825)	101,825		8.21
Performance shares granted	(120,601)	---		---
Options exercised	---	(115,268)		6.12
Options forfeited or expired	515,006	(515,006)		13.02
Performance shares forfeited or expired	24,259	---		---
Additional shares reserved	1,692,020	---		---
BALANCE AT SEPTEMBER 30, 2006	8,958,279	7,561,024	\$	11.15

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The following table provides additional information for significant ranges of outstanding and exercisable stock options as of September 30, 2006:

Exercise Price Range	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price per Share	Aggregate Intrinsic Value
\$6.11	1,535,311	3.26	\$ 6.11	\$ 3,254,859
6.26-8.17	274,293	2.41	7.20	281,327
8.19	951,130	3.87	8.19	38,045
8.24-10.65	655,640	3.70	9.20	--
10.89	840,920	2.46	10.89	--
11.14-12.88	575,132	4.69	11.66	--
12.91	792,870	1.64	12.91	--
13.00-16.06	305,200	4.22	14.12	--
16.35	825,562	4.18	16.35	--
\$16.36-\$30.76	804,966	4.33	18.91	--
<b>Outstanding</b>	<b>7,561,024</b>	<b>3.45</b>	<b>\$ 11.15</b>	<b>\$ 3,574,231</b>
<b>Vested and expected to vest</b>	<b>7,489,270</b>	<b>3.44</b>	<b>\$ 11.18</b>	<b>\$ 3,547,844</b>
<b>Exercisable</b>	<b>6,497,776</b>	<b>3.43</b>	<b>\$ 11.73</b>	<b>\$ 2,921,352</b>

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of \$8.23 as of September 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date.

The following table provides additional information regarding performance share activity for the three and nine month periods ended September 30, 2006 and 2005:

	Number Nonvested and Outstanding	Weighted-Average Grant Date Fair-Value
BALANCE AT JUNE 30, 2005	109,355	\$ 6.77
Performance shares granted	305,710	8.19
<b>BALANCE AT SEPTEMBER 30, 2005</b>	<b>415,065</b>	<b>\$ 7.82</b>
BALANCE AT JUNE 30, 2006	500,047	\$ 8.07
Performance shares granted	10,934	8.33
Performance shares vested and released	(71,222)	8.19
Performance shares forfeited	(1,671)	8.19
<b>BALANCE AT SEPTEMBER 30, 2006</b>	<b>438,088</b>	<b>\$ 8.05</b>

	Number Nonvested and Outstanding	Weighted-Average Grant Date Fair-Value
BALANCE AT DECEMBER 31, 2004	---	\$ ---
Performance shares granted	415,065	7.82
BALANCE AT SEPTEMBER 30, 2005	415,065	\$ 7.82
BALANCE AT DECEMBER 31, 2005	412,968	\$ 7.82
Performance shares granted	120,601	8.94
Performance shares vested and released	(71,222)	8.19
Performance shares forfeited	(24,259)	8.04
BALANCE AT SEPTEMBER 30, 2006	438,088	\$ 8.05

No performance shares vested during the three or nine month periods ended September 30, 2005.

#### 4. Stock-Based Compensation:

##### *Impact of Adopting SFAS 123R*

The Company adopted SFAS 123R on January 1, 2006, using the modified prospective method. The impact of adopting SFAS 123R on the Company's loss from continuing operations, pre-tax loss, net loss, basic and diluted net loss per share, cash flows from operations, and cash flows from financing activities for the three and nine months ended September 30, 2006 is summarized in the following tables (in thousands, except per share amounts):

	Intrinsic Value Method (A)	Fair Value Method (B)	Impact of Adoption (A) - (B)
<b>Three months ended September 30, 2006</b>			
Loss from continuing operations	\$ (7,167)	\$ (7,851)	\$ (684)
Loss before provision for income taxes	\$ (5,581)	\$ (6,265)	\$ (684)
Net loss	\$ (5,661)	\$ (6,345)	\$ (684)
Net loss per share - basic	\$ (0.14)	\$ (0.16)	\$ (0.02)
Net loss per share - diluted	\$ (0.14)	\$ (0.16)	\$ (0.02)
Cash flows from operations	\$ (7,888)	\$ (7,888)	\$ --
Cash flows from financing activities	\$ (2,753)	\$ (2,753)	\$ --

	Intrinsic Value Method (A)	Fair Value Method (B)	Impact of Adoption (A) - (B)
<b>Nine months ended September 30, 2006</b>			
Loss from continuing operations	\$ (19,281)	\$ (22,085)	\$ (2,804)
Loss before provision for income taxes	\$ (14,897)	\$ (17,701)	\$ (2,804)
Net loss	\$ (15,137)	\$ (17,941)	\$ (2,804)
Net loss per share - basic	\$ (0.38)	\$ (0.45)	\$ (0.07)
Net loss per share - diluted	\$ (0.38)	\$ (0.45)	\$ (0.07)
Cash flows from operations	\$ (16,157)	\$ (16,157)	\$ --
Cash flows from financing activities	\$ (5,107)	\$ (5,107)	\$ --

*Valuation of Options Granted*

SFAS 123R requires the use of a valuation model to calculate the fair-value of stock-based awards. The Company has elected to use the BSM option-pricing model, which incorporates various assumptions including volatility, expected term of the option from the date of grant to the time of exercise, risk-free interest rates, and dividend yields. The BSM option-pricing model was developed for use in estimating the fair-value of traded options having no vesting or hedging restrictions and that are fully transferable. As the Company's employee stock options have certain characteristics that differ significantly from traded options, and because changes in the subjective assumptions used in the BSM option-pricing model can materially affect the estimated fair-value, in management's opinion, the Company's estimate of fair-value for its options based on the BSM option-pricing model may not provide an accurate measure of the fair-value an independent third-party would assign in an arms-length transaction.

The weighted average calculated fair value of options granted during the three and nine months ended September 30, 2006, was \$3.58 and \$2.78, respectively, and was determined using the following weighted average assumptions:

	<b>Three Months Ended September 30, 2006</b>	<b>Nine Months Ended September 30, 2006</b>
Expected dividend yield	0.0%	0.0%
Risk-free interest rate	4.8%	4.8%
Expected volatility	51.2%	48.8%
Expected life (in years)	3.8	2.6

The expected dividend yield reflects the fact that the Company has not paid any dividends in the past and does not currently intend to pay dividends in the foreseeable future. The risk-free interest rate assumption is based on U.S. Treasury yields in effect at the time of grant for the expected life of the option. The expected volatility is based on the historical volatility of the Company's common stock over the most recent period commensurate with the expected life of the option, and does not include any implied volatility as there currently are no market traded options on the Company's stock that meet the criteria required for reliance on implied volatility in accordance with SAB 107. The expected life of the option has been calculated using the simplified method as permitted under 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 simplified method was chosen due to the fact that there has been only limited exercise activity for options granted over the last several years, and thus, management has concluded that such exercise data does not provide a reasonable basis upon which to estimate expected term.

*Expense Allocation*

Compensation expense for all share-based payment awards, including those granted prior to January 1, 2006, has been recognized in accordance with SFAS 123R using the accelerated multiple-option approach. As stock-based compensation expense recognized in the Consolidated Statement of Operations for the three and nine months ended September 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures have been estimated based on historical experience. In the Company's pro forma information required under SFAS 123 for periods prior to January 1, 2006, the Company accounted for forfeitures as they occurred. As of September 30, 2006, total compensation cost related to non-vested stock options and other equity based awards not yet recognized was \$5.4 million, which is expected to be recognized over the next 18 months on a weighted-average basis.

The following table summarizes the stock-based compensation expense related to employee stock options and performance shares under SFAS 123R for the three and nine months ended September 30, 2006 and 2005, which was allocated as follows (in thousands):





	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Cost of sales - product	\$ 92	\$ 17
Cost of sales - service	10	1
Stock-based compensation expense included in cost of sales	102	18
Product development	376	44
Sales and marketing	249	33
General and administrative	275	75
Stock-based compensation expense included in operating expenses	900	152
Total stock-based compensation expense related to stock options and performance shares	1,002	170
Tax benefit	--	--
Stock-based compensation expense related to stock options and performance shares, net of tax	\$ 1,002	\$ 170

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Cost of sales - product	\$ 307	\$ 35
Cost of sales - service	36	1
Stock-based compensation expense included in cost of sales	343	36
Product development	1,474	68
Sales and marketing	911	57
General and administrative	989	195
Stock-based compensation expense included in operating expenses	3,374	320
Total stock-based compensation expense related to stock options and performance shares	3,717	356
Tax benefit	--	--
Stock-based compensation expense related to stock options and performance shares, net of tax	\$ 3,717	\$ 356

Of the \$1.0 million of compensation expense recorded for the quarter ended September 30, 2006, approximately \$126,000 related to equity compensation awards granted during 2006, while the remaining \$876,000 related to equity compensation awards granted on or before December 31, 2005. Of the \$3.7 million of compensation expense recorded for the nine month period ended September 30, 2006, approximately \$411,000 related to equity compensation awards granted during 2006, while the remaining \$3.3 million related to equity compensation awards granted on or before December 31, 2005. Compensation expense of \$170,000 and \$356,000 for the three and nine months ended September 30, 2005, respectively, related solely to performance share awards, and did not reflect any compensation expense for stock options as the Company accounted for those equity compensation awards in accordance with APB 25. Under APB 25, no compensation expense was recorded in the Company's statement of operations for stock options where the exercise price was equal to or greater than the fair market value of the underlying stock on the date of grant.

During the three and nine month periods ended September 30, 2006 and 2005, no stock-based compensation expense was capitalized as part of the cost of an asset.

*Comparative Results*

The following table reflects net loss and diluted net loss per share for the three and nine months ended September 30, 2006 compared with the pro forma information for the three and nine months ended September 30, 2005 (in thousands, except per share amounts):

	Three Months Ended September 30,	
	2006	2005
Net loss - as reported for the prior period (1)	N/A	\$ (10,118)
Stock-based compensation expense related to employee stock options and performance share awards (2)	\$ 1,002	\$ 2,152
Tax benefit	--	--
Stock-based compensation expense related to stock options and performance share awards, net of tax (3)	\$ 1,002	\$ 2,152
Net loss, including the effect of stock-based compensation expense (4)	\$ (6,345)	\$ (12,270)
Diluted net loss per share - as reported for the prior period (1)	N/A	\$ (0.25)
Diluted net loss per share, including the effect of stock-based compensation expense (4)	\$ (0.16)	\$ (0.31)
	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Net loss - as reported for the prior period (1)	N/A	\$ (16,984)
Stock-based compensation expense related to employee stock options and performance share awards (2)	\$ 3,717	\$ 6,908
Tax benefit	--	--
Stock-based compensation expense related to stock options and performance share awards, net of tax (3)	\$ 3,717	\$ 6,908
Net loss, including the effect of stock-based compensation expense (4)	\$ (17,941)	\$ (23,892)
Diluted net loss per share - as reported for the prior period (1)	N/A	\$ (0.42)
Diluted net loss per share, including the effect of stock-based compensation expense (3)	\$ (0.45)	\$ (0.59)

(1) Net loss and net loss per share prior to January 1, 2006 did not include stock-based compensation expense for employee stock options under SFAS 123 because the Company did not adopt the recognition provisions of SFAS 123. Net loss and net loss per share prior to January 1, 2006 did include stock-based compensation expense for performance share awards.

- (2) Stock-based compensation expense related to employee stock options and performance share awards for the three and nine months ended September 30, 2005 are net of amounts already reflected in the net loss for the respective periods.

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(3) Stock-based compensation expense prior to January 1, 2006 is calculated based on the pro forma application of SFAS 123.

(4) Net loss and net loss per share prior to January 1, 2006 represents pro forma information based on SFAS 123.

## 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. For the last several years, the Company has had two customers that represent a majority of the Company's revenues: Enel S.p.A. ("Enel"), an Italian utility company (including Enel's third party meter manufacturers), and EBV Elektronik GmbH ("EBV"), the Company's primary distributor of its LonWorks® Infrastructure products in Europe. For the three and nine months ended September 30, 2006 and 2005, the percentage of the Company's revenues attributable to sales made to these two customers were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Enel	0.40%	27.00%	16.40%	37.10%
EBV	32.00%	22.70%	25.30%	20.50%
Total	32.40%	49.70%	41.70%	57.60%

The Company's contract with EBV, which has been in effect since 1997 and to date has been renewed annually thereafter, expires in December 2006.

The Company's original contract with Enel expired in June 2005, and shipments under that contract were completed in 2005. During 2006, the Company has supplied Enel and its third party meter manufacturers with spare parts for Enel's Contatore Elettronico system. Recently, Enel and the Company entered into a new development and supply agreement as well as a software enhancement agreement. Under the development and supply agreement, Enel will purchase additional metering kit and data concentrator products from the Company, assuming initial acceptance tests are completed successfully. Under the software enhancement agreement, the Company will provide software enhancements to Enel for use in its Contatore Elettronico system. The Company does not currently anticipate any material revenues from either of these new agreements during 2006. Both the new 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.

## 6. Commitments and Contingencies

### *Lease Commitments*

The Company leases its facilities under operating leases that expire on various dates through 2013. In December 1999, the Company entered into a lease agreement with a real estate developer for its existing corporate headquarters in San Jose, California. This agreement requires minimum rental payments for ten years totaling approximately \$20.6 million and also required that the Company provide a \$3.0 million security deposit, which requirement has since been reduced to \$1.5 million. The Company satisfied the security deposit requirement by causing to have issued a standby letter of credit ("LOC") in July 2000. The LOC is subject to annual renewals and is currently secured by a line of credit at the bank that issued the LOC. At the end of the current ten-year lease term, the Company has the right, pursuant to the lease agreement, to extend the lease for two sequential five-year terms.

In October 2000, the Company entered into another lease agreement with the same real estate developer for an additional building at its headquarters site. Construction on the second building was completed in May 2003, at which time monthly rental payments commenced. This second lease agreement also requires minimum rental payments for ten years totaling approximately \$23.4 million. In addition, this second lease agreement also required a security deposit of \$5.0 million. The Company satisfied this security deposit requirement by causing to have issued another LOC in October 2001. This LOC is also subject to annual renewals and is currently secured by a line of credit at the bank that issued it. At the end of the current ten-year lease term, the Company has the right, pursuant to the lease agreement, to extend the lease for two sequential five-year terms.

In addition to its corporate headquarters facility, the Company also leases facilities for its 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 three years, and in some instances are cancelable with advance notice.

#### *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 consolidated statements of income, was approximately \$142,000 during the quarter ended September 30, 2006, and \$115,000 for the same period in 2005. Royalty expense was approximately \$352,000 for the nine months ended September 30, 2006, and \$363,000 for the same period in 2005.

The Company will continue to be obligated for royalty payments in the future. The Company is currently unable to estimate the cumulative 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.

#### *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 or related to the officer's or director's tenure with the Company. 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 could 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.

*Legal Actions*

On May 3, 2004, the Company announced that Enel filed a request for arbitration to resolve a dispute regarding the Company's marketing and supply obligations under the Research and Development and Technological Cooperation Agreement dated June 28, 2000. The arbitration took place in London in early March 2005 under the rules of arbitration of the International Court of Arbitration of the International Chamber of Commerce, or ICC. The Company received the arbitration panel's decision on September 29, 2005. The arbitration tribunal awarded Enel €4,019,750 in damages plus interest from December 15, 2004 and the sums of \$52,000 and €150,000 in arbitration and legal related costs, respectively. These amounts, which total approximately \$5.2 million, were included in the Company's results of operations for the year ended December 31, 2005. As of December 31, 2005, approximately \$3.0 million of the \$5.2 million award was unpaid and was reflected in accrued liabilities. As of September 30, 2006, all amounts due Enel under the arbitration ruling have been paid. The arbitration tribunal refused Enel's request to extend the supply or marketing obligations of Echelon.

In addition to the matter described above, from time to time, in the ordinary course of business, the Company is also 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, 2006, 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. Inventories consist of the following (in thousands):

	<b>September 30, 2006</b>		<b>December 31, 2005</b>	
Purchased materials	\$	2,322	\$	1,064
Work-in-process		9		61
Finished goods		6,608		2,115
	\$	8,939	\$	3,240

**8. Accrued Liabilities**

Accrued liabilities consist of the following (in thousands):

	<b>September 30, 2006</b>		<b>December 31, 2005</b>	
Accrued payroll and related costs	\$	3,000	\$	2,630
Accrued taxes		1,187		1,128
Other accrued liabilities		580		3,715
	\$	4,767	\$	7,473

## 9. Segment Disclosure

The Company reports operating segment and other segment information in accordance with SFAS No. 131 ("SFAS 131"), *Disclosures about Segments of an Enterprise and Related Information*. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company's chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer, the Chief Operating Officer, and their direct reports. SFAS 131 also requires disclosures about products and services, geographic areas, and major customers.

The Company operates its business as one reportable segment: the design, manufacture and sale of products for the control network industry, and markets its products primarily to the building automation, industrial automation, transportation, and utility/home automation markets. The Company's products are generally marketed under the LonWorks® brand name, which provides the infrastructure and support required to implement and deploy open, interoperable, control network solutions. All of the Company's products either incorporate or operate with the Neuron® Chip and/or the LonWorks protocol. The Company also provides services to customers that consist of technical support and training courses covering its LonWorks network technology and products. The Company offers about 90 products and services that together constitute the LonWorks system. In general, any given customer purchases a subset of such products and services that are appropriate for that customer's application.

The Company manages its business primarily on a geographic basis. The Company's geographic areas are comprised of three main regions: 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 area and excludes certain expenses that are managed outside the geographic area. Costs excluded from area profit or loss primarily consist of unallocated corporate expenses, which are comprised of product development costs, corporate marketing costs and other general and administrative expenses, each of 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, 2006, and December 31, 2005, long-lived assets of about \$22.8 million and \$22.0 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.

In North America, the Company sells its products through a direct sales organization and select third-party electronics representatives. Outside North America, the Company sells its products through direct sales organizations in EMEA and APJ, whose efforts are supplemented by local distributors. Revenues are attributed to geographic areas based on the country where the products are shipped. Summary information by geography for the three and nine months ended September 30, 2006 and 2005 is as follows (in thousands):





	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues from customers:				
Americas	\$ 5,193	\$ 4,488	\$ 14,688	\$ 12,568
EMEA	5,949	9,341	23,528	36,817
APJ	2,149	2,422	5,194	6,029
Total	\$ 13,291	\$ 16,251	\$ 43,410	\$ 55,414
Gross profit:				
Americas	\$ 3,134	\$ 2,599	\$ 8,875	\$ 7,565
EMEA	3,347	4,700	13,302	19,599
APJ	1,365	1,342	3,025	3,514
Total	\$ 7,846	\$ 8,641	\$ 25,202	\$ 30,678
Income (loss) from operations:				
Americas	\$ 1,676	\$ 1,481	\$ 4,984	\$ 4,172
EMEA	2,007	3,352	9,094	15,239
APJ	298	191	(191)	68
Unallocated	(11,832)	(16,267)	(35,972)	(39,730)
Total	\$ (7,851)	\$ (11,243)	\$ (22,085)	\$ (20,251)

Products sold to Enel and its designated manufacturers accounted for approximately \$53,000, or 0.4% of total revenues for the quarter ended September 30, 2006, and \$4.4 million, or 27.0% for the same period in 2005; and \$7.1 million, or 16.4% of total revenues for nine months ended September 30, 2006, and \$20.6 million, or 37.1% for the same period in 2005. For the quarter ended September 30, 2006, 100.0% of the revenues under the Enel program were derived from products shipped to customers in EMEA. For the nine months ended September 30, 2006, 97.2% of the revenues derived from products shipped under the Enel program were from customers in EMEA and the remaining 2.8% from customers in APJ.

EBV, the primary independent distributor of the Company's LonWorks infrastructure products in Europe, accounted for 32.0% of total revenues for the quarter ended September 30, 2006 and 22.7% for the same period in 2005; and 25.3% of total revenues for the nine months ended September 30, 2006 and 20.5% for the same period in 2005.

## 10. Income Taxes

The provision for income taxes for the three months and nine months ended September 30, 2006 and 2005 includes a provision for Federal, 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.

## 11. Related Party

During the quarter and nine months ended September 30, 2006, and the years ended December 31, 2005, 2004, and 2003, 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.

In June 2000, the Company entered into a stock purchase agreement with Enel. 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. For the quarter and nine months ended September 30, 2006, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$53,000 and \$7.1 million, respectively. For the quarter and nine months ended September 30, 2005, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$4.4 million and \$20.6 million, respectively. As of September 30, 2006 and September 30, 2005, \$4.1 million and \$5.3 million, respectively, of the Company's total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

In October 2006, Enel and the Company entered into a new development and supply agreement as well as a software enhancement agreement. Under the development and supply agreement, Enel will purchase additional metering kit and data concentrator products from the Company, assuming initial acceptance tests are completed successfully. Under the software enhancement agreement, the Company will provide software enhancements to Enel for use in its Contatore Elettronico system. The Company does not currently anticipate any material revenues from either of these new agreements during 2006. Both the new 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.

On May 3, 2004, the Company announced that Enel filed a request for arbitration to resolve a dispute regarding the Company's marketing and supply obligations under the R&D Agreement. An arbitration award was issued on September 29, 2005. For additional information regarding the arbitration, please refer to the "Legal Actions" section of Note 6, Commitments and Contingencies.

## **12. Warranty Reserves**

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 and predicted failure rates, 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 \$239,000 as of September 30, 2006 and \$469,000 as of December 31, 2005.

## **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, including but not limited to: our belief that control networks based on our products can reduce life-cycle costs, save energy, are more flexible than centralized systems and permit control systems to be comprised of products and services from a variety of vendors; our belief that the NES system brings cost savings in a wide range of a utility's functions, from metering and customer services to distribution operations and value-added services; our belief that new products and product enhancements, such as our NES offering and Panoramix platform, will make it easier for our customers to aggregate and process information from remote LonWorks networks, thereby increasing overall network management capabilities; our belief that the benefits derived from our NES system deliver a more compelling return on investment than "traditional" AMR systems; our expectation that Enel will purchase spare parts from us with a value of approximately \$7.1 million in 2006 and our belief that we will not be able to find one or more replacements for the Enel project revenue reduction; our expectation that shipments of our NES products will increase significantly; our belief that, in general, as long as the current worldwide economic recovery continues to gain momentum, overall revenues from our LonWorks Infrastructure business will continue to improve during 2006 as compared to 2005; our belief that market conditions in Asia, particularly Japan, will continue to be challenging in 2006; our belief that, during 2006, our gross margin will decrease slightly as compared to 2005 levels; our belief that, during 2006, our sales and marketing and product development expenses will increase over 2005 levels; our belief that many of our customers will continue to refrain from purchasing our customer support and training offerings during 2006 in an effort to minimize their operating expenses; our belief 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; our belief that we will incur a substantial loss in 2006; our belief that the amount of our LonWorks Infrastructure revenues earned in foreign currencies will not fluctuate significantly between 2005 and 2006; our expectation that our initial NES system roll-out to Nuon will be completed in early 2007 and that Nuon will then issue a public tender for an even larger deployment; and our belief that the estimates and judgments made regarding future events in connection with the preparation of our financial statements are reasonable. These statements may be identified by the use of words such as "we believe," "expect," "anticipate," "intend," "plan," and similar expressions. In addition, forward-looking statements include, but are not limited to, statements about our beliefs, estimates, or plans about our ability to maintain low manufacturing and operating costs and costs per unit, our ability to estimate revenues, pricing pressures, returns, reserves, demand for our products, selling, general, and administrative expenses, taxes, research, development, and engineering expenses, spending on property, plant, and equipment, expected sales of our products and the market for our products generally and certain customers specifically, and our beliefs regarding our liquidity needs.*

*Forward-looking statements are estimates reflecting the best judgment of our senior management, and they involve a number of risks and uncertainties that could cause actual results to differ materially from those suggested by the forward-looking statements. Our business is subject to a number of risks and uncertainties. While this discussion represents our current judgment on the future direction of our business, these risks and uncertainties could cause actual results to differ materially from any future performance suggested herein. Some of the important factors that may influence possible differences are continued competitive factors, technological developments, pricing pressures, changes in customer demand, and general economic conditions, as well as those discussed above in "Factors That May Affect Future Results of Operations." We undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of such statements. Readers should review the Risk Factors in Part II Item 1A in this report, as well as other documents filed from time to time by us with the SEC.*

### **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 support a wide array of products and services based on our LONWORKS technology that enable original equipment manufacturers (“OEMs”) and systems integrators to design and implement open, interoperable, distributed control networks. We offer these hardware and software products to OEMs and systems integrators in the building, industrial, transportation, utility/home, and other automation markets.

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We have been investing in products for use by electricity utilities for use in management of electricity distribution. We began to receive modest amounts of revenue resulting from these investments in 2004, which increased to approximately \$883,000 in 2005. We refer to this revenue as networked energy services, or NES, revenue. We sell certain of our products to Enel and certain suppliers of Enel for use in Enel's Contatore Elettronico electricity meter management project in Italy. We refer to Echelon's revenue derived from sales to Enel and Enel's designated manufacturers as Enel Project revenue. We refer to all other revenue as LONWORKS Infrastructure revenue. We also provide a variety of technical training courses related to our products and the underlying technology. Some of our customers also rely on us to provide customer support on a per-incident or term contract basis.

We have a history of losses and, although we achieved profitability in past fiscal periods, we incurred a loss for the quarter and nine months ended September 30, 2006 and expect to incur substantial operating losses for the remainder of 2006. This expectation is due primarily to two factors. First, we have already experienced, and we expect that, during the remainder of 2006, we will experience a further reduction in the amount of Enel Project revenue as compared to 2005. This expected reduction is the result of the completion of our Enel Project shipments in 2005. Partially offsetting this anticipated year-over-year reduction are 2006 revenues associated with the shipment of spare parts to Enel, which have been completed as of September 30, 2006. In October 2006, we entered into two additional agreements with Enel, a new development and supply agreement and a software enhancement agreement. Under the new development and supply agreement, Enel will purchase additional metering kit and data concentrator products from us, assuming initial acceptance tests are completed successfully. Under the software enhancement agreement, we will provide software enhancements to Enel for use in its Contatore Elettronico system. We do not currently anticipate any material revenues from either of these new agreements during 2006. Both the new 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.

The second factor contributing to our expectation for losses in 2006 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 SFAS 123R. For the nine months ended September 30, 2006, the adoption of this new accounting standard has resulted in an increase in equity compensation expenses of approximately \$3.4 million as compared to the same period in 2005.

During the first and second quarters of 2006, we revised our revenue recognition methodology for sales made to the distributors of our LONWORKS Infrastructure 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 will not have an impact on cash flows from operations or require any changes to our historical financial statements. A more thorough explanation of this revision can be found later in this report in the "LONWORKS Infrastructure revenues" and "EBV revenues" sections of our discussion on Results of Operations.

### **CRITICAL ACCOUNTING ESTIMATES**

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. 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.

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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. Sales to certain distributors are made under terms allowing limited rights of return. Sales to EBV, our largest distributor, accounted for 32.0% of total net revenues for the quarter ended September 30, 2006, and 22.7% for the same period in 2005, and 25.3% of total revenues for the nine months ended September 30, 2006 and 20.5% for the same period in 2005. Worldwide sales to distributors, including those to EBV, accounted for approximately 46.3% of total net revenues for the quarter ended September 30, 2006, and 32.3% for the same period in 2005; and 34.4% of total net revenues for the nine months ended September 30, 2006 and 28.2% for the same period in 2005.

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 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 \$694,000 as of September 30, 2006, and \$1.2 million as of December 31, 2005.

**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 calculated fair value of the award and is recognized as expense ratably over the requisite service period, which is the vesting period.

We currently use the Black-Scholes-Merton ("BSM") option-pricing model to determine the calculated fair value of stock options. The determination of the calculated fair value of stock-based payment awards on the date of grant using the BSM option-pricing model is affected by our stock price on the date of grant, as well as a number of highly complex and subjective variables. These variables include the expected volatility of our stock price over the expected term of the option, actual and projected employee stock option exercise behaviors, 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 life of the option, and does not include 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.

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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.

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.

The BSM option-pricing model was developed for use in estimating the calculated 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. Existing valuation models, including the BSM and lattice binomial models, may not provide reliable measures of fair values of our stock-based compensation. Consequently, there is a risk that our estimates of the calculated fair values of our stock-based compensation awards on the grant dates may be significantly different from the actual values realized, if any, upon the exercise, expiration, early termination, or forfeiture of those stock-based payments in the future. For example, our employee stock options may expire worthless or otherwise result in zero intrinsic value as compared to the calculated fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that is significantly higher than the calculated fair values originally estimated on the grant date and reported in our financial statements. There currently is no market-based mechanism or other practical application to verify the reliability and accuracy of the estimated fair values resulting from these valuation models, nor is there a means to compare and adjust the estimates to actual values.

The guidance of SFAS 123R and SAB 107 is relatively new. The application of these principles may be subject to further interpretation and refinement over time. 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 materially affect the calculated fair value estimate of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods, and assumptions.

Further information regarding stock-based compensation can be found in Note 4 of our Notes to Condensed Consolidated Financial Statements contained in this report.

**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 worsened, 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 \$250,000 as of September 30, 2006, and \$300,000 as of December 31, 2005.



**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 \$239,000 as of September 30, 2006, and \$469,000 as of December 31, 2005.

**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 \$52.2 million as of December 31, 2005.

**Valuation of Goodwill and Other Intangible Assets.** We assess the impairment of goodwill and identifiable intangible assets on an annual basis 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.

When we determine that the carrying value of goodwill and other intangible assets may not be recoverable based upon the existence of one or more of the above indicators, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model.

When we adopted SFAS 142, *Goodwill and Other Intangible Assets*, in 2002, we ceased amortizing goodwill, which had a net unamortized balance of \$1.7 million as of December 31, 2001. Since then, primarily as a result of acquisitions in 2002 and 2003, the net balance of goodwill has grown to \$8.2 million as of September 30, 2006. We review goodwill for impairment annually during the quarter ending March 31. Our review during the quarter ended March 31, 2006 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 or other intangible assets, 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 Consolidated Statements of Operations for the three and nine months ended September 30, 2006 and September 30, 2005:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Revenues:</b>				
Product	98.7%	98.9%	98.8%	99.0%
Service	1.3	1.1	1.2	1.0
Total revenues	100.0	100.0	100.0	100.0
<b>Cost of revenues:</b>				
Cost of product	37.2	43.6	38.7	41.7
Cost of service	3.8	3.2	3.3	2.9
Total cost of revenues	41.0	46.8	42.0	44.6
Gross profit	59.0	53.2	58.0	55.4
<b>Operating expenses:</b>				
Product development	51.7	38.0	48.4	33.8
Sales and marketing	38.2	31.8	35.3	28.1
General and administrative	28.2	52.6	25.2	30.0
Total operating expenses	118.1	122.4	108.9	91.9
Loss from operations	(59.1)	(69.2)	(50.9)	(36.5)
Interest and other income, net	12.0	7.5	10.1	6.4
Loss before provision for income taxes	(47.1)	(61.7)	(40.8)	(30.1)
Income tax expense	0.6	0.6	0.5	0.5
Net loss	(47.7%)	(62.3%)	(41.3%)	(30.6%)

**Revenues***Total Revenues*

		Three Months Ended		2006 over	2006 over
<i>(Dollars in thousands)</i>		September 30,	September 30,	2005	2005
		2006	2005	\$ Change	% Change
Total Revenues	\$	13,291	\$ 16,251	\$ (2,960)	(18.2%)

		Nine Months Ended		2006 over	2006 over
<i>(Dollars in thousands)</i>		September 30,	September 30,	2005	2005
		2006	2005	\$ Change	% Change
Total Revenues	\$	43,410	\$ 55,414	\$ (12,004)	(21.7%)

The \$3.0 million decrease in total revenues for the quarter ended September 30, 2006 as compared to the same period in 2005 was primarily the result of a \$4.3 million decrease in Enel Project revenues, partially offset by a \$1.3 million increase in LonWorks Infrastructure revenues. The \$12.0 million decrease in total revenues for the nine months ended September 30, 2006 as compared to the same period in 2005 was primarily the result of a \$13.5 million reduction in Enel Project revenues partially offset by a \$1.3 million increase in LonWorks Infrastructure revenues, and a \$150,000 increase in NES revenues.



*LonWorks Infrastructure revenues*

		Three Months Ended		2006 over	2006 over
<i>(Dollars in thousands)</i>	September 30, 2006	September 30, 2005	2005	\$ Change	% Change
LonWorks Infrastructure Revenues	\$ 13,040	\$ 11,702	\$	1,338	11.4%

		Nine Months Ended		2006 over	2006 over
<i>(Dollars in thousands)</i>	September 30, 2006	September 30, 2005	2005	\$ Change	% Change
LonWorks Infrastructure Revenues	\$ 35,614	\$ 34,291	\$	1,323	3.9%

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 \$1.3 million increase in LonWorks Infrastructure revenues for the quarter ended September 30, 2006 as compared to the same period in 2005 was evident in all of the geographic markets that we serve, particularly in the Americas and EMEA, and to a lesser extent, in Asia. Partially offsetting this increase was the unfavorable impact of exchange rates on sales made in foreign currencies, which resulted in a \$43,000 decrease between the two quarters. We believe the overall \$1.3 million increase 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.

The \$1.3 million increase in LonWorks Infrastructure revenue for the nine months ended September 30, 2006 as compared to the same period in 2005 was negatively impacted by revisions that we made earlier 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 impact of these revenue recognition methodology revisions made during the first and second quarters of 2006 was a one-time reduction in LonWorks Infrastructure revenues of approximately \$3.9 million.

Excluding the impact of these revenue recognition revisions, LonWorks Infrastructure revenues for the nine months ended September 30, 2006 would have increased by approximately \$5.2 million as compared to the same period in 2005. This increase was spread across all of the geographic markets that we serve, particularly EMEA and the Americas, and to a lesser extent, in Asia. Partially offsetting this increase was the unfavorable impact of exchange rates made in foreign currencies, which resulted in a \$141,000 decrease between the two periods. As was the case for the quarter-over-quarter increase, we believe these overall increase is due, at least in part, to our customer's utilization of our products in new applications, as well as generally more favorable worldwide economic conditions.



As long as current worldwide economic conditions do not deteriorate, we believe that full year 2006 revenues from our LonWorks Infrastructure business will improve from the \$46.6 million recorded in 2005. This expected improvement, however, will be subject to further fluctuations in the exchange rates between the U.S. dollar and the Japanese Yen. If the U.S. dollar were to strengthen against the Japanese Yen, our revenues would decrease. Conversely, if the U.S. dollar were to weaken against the Japanese Yen, our revenues would increase. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in Japanese Yen (or other foreign currencies) and the magnitude of the exchange rate fluctuation from year to year. Through the first nine months of 2006, the portion of our LonWorks Infrastructure revenues conducted in currencies other than the U.S. dollar, principally the Japanese Yen, was about 6.4% as compared to 4.6% for the same period in 2005. We do not currently expect that, during the remainder of 2006, the amount of our LonWorks Infrastructure revenues conducted in these or other foreign currencies will fluctuate significantly from that experienced in 2005. 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>	Three Months Ended		2006 over	2006 over
	September 30, 2006	September 30, 2005	2005 \$ Change	2005 % Change
Enel Project Revenues	\$ 53	\$ 4,388	\$ (4,335)	(98.8%)

  

<i>(Dollars in thousands)</i>	Nine Months Ended		2006 over	2006 over
	September 30, 2006	September 30, 2005	2005 \$ Change	2005 % Change
Enel Project Revenues	\$ 7,103	\$ 20,580	\$ (13,477)	(65.5%)

The \$4.3 million decrease in Enel Project revenues for the quarter ended September 30, 2006, as compared to the same period in 2005, was primarily attributable to a reduction in the number of electricity metering components (also referred to as metering kit products) sold. The \$13.5 million decrease in Enel Project revenues for the nine months ended September 30, 2006, as compared to the same period in 2005, was primarily attributable to the completion of our sales of components and products for the deployment phase of Enel's Contatore Elettronico project during 2005. Early in 2006, Enel asked us to provide them with spare parts for use in their system in Italy. We agreed to this request, and the \$7.1 million of Enel project revenue recognized during the first nine months of 2006 represents our shipments against this request. We do not currently expect any additional revenue from the Enel project during 2006. However, we recently signed agreements with Enel for the sale of additional products and the development of certain data concentrator software enhancements. We expect revenues from these new agreements will commence in 2007, and will continue through at least 2009, when the agreements are scheduled to terminate.

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.

Given our historical dependence on one customer, we continue to seek opportunities to expand our customer base. In 2002, we formed a sales and marketing organization that has since been tasked with identifying other customers for our NES system products. However, we can give no assurance that our efforts in the networked energy services area will be successful.



*NES revenues*

		Three Months Ended			
<i>(Dollars in thousands)</i>		September 30, 2006	September 30, 2005	2006 over 2005 \$ Change	2006 over 2005 % Change
NES revenues	\$	199	\$ 162	\$ 37	22.8%

  

		Nine Months Ended			
<i>(Dollars in thousands)</i>		September 30, 2006	September 30, 2005	2006 over 2005 \$ Change	2006 over 2005 % Change
NES revenues	\$	693	\$ 543	\$ 150	27.6%

For both the three and nine-month periods ended September 30, 2006 and 2005, NES revenues have primarily related to the completion of system trials and, to a lesser extent, shipment of NES products.

During 2006, shipments of our NES products have increased significantly over 2005 levels, due primarily to the fact that in late 2005 and so far during 2006, we and our NES value-added reseller, or VAR, partners have won a number of utility tenders for intelligent metering systems in Sweden, the Netherlands, and Australia, and have also entered into a variety trials of our NES system in other countries. While shipments have increased substantially during 2006, we do not expect that our 2006 NES revenues will grow at the same rate. This is because our ability to recognize revenue on shipments made in conjunction with these projects, as well as shipments for other NES projects that we may win in