ECHELON CORP
Form 10-Q
November 02, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10 Q

(Mark one)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2012
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	77 0203595
(State or other jurisdiction of incorporation or organization)	(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 x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	..	Accelerated filer	x
Non-accelerated filer¨	(do not check if a smaller reporting company)	Smaller reporting company	..

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x
As of October 31, 2012, 43,024,289 shares of the registrant's common stock were outstanding.

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FORM 10 Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2012
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FORWARD-LOOKING INFORMATION

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

In this report, the words "may," "could," "would," "might," "will," "should," "plan," " forecast," "anticipate," "believe," "expe "estimate," "predict," "potential," "continue," "future," "moving toward" or the negative of these terms or other similar express also identify forward-looking statements. Our actual results could differ materially from those forward-looking statements contained in this report as a result of a number of risk factors including, but not limited to, those set forth in the section entitled "Factors That May Affect Future Results of Operations" and elsewhere in this report. You should carefully consider these risks, in addition to the other information in this report and in our other filings with the SEC.

All forward-looking statements and reasons why results may differ included in this report are made as of the date of this report, and we assume no obligation to update any such forward-looking statement or reason why such results might differ.

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

	September 30, 2012	December 31, 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$18,686	$17,658
Short-term investments	43,981	40,998
Accounts receivable, net	16,942	35,215
Inventories	10,532	11,125
Deferred cost of goods sold	924	6,536
Other current assets	3,062	4,044
Total current assets	94,127	115,576
Property and equipment, net	22,751	27,201
Goodwill	8,213	8,235
Other long term assets	710	693
Total assets	$125,801	$151,705
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$8,930	$18,313
Accrued liabilities	4,265	7,755
Current portion of lease financing obligations	2,040	1,870
Deferred revenues	5,468	12,716
Total current liabilities	20,703	40,654
LONG-TERM LIABILITIES:		
Lease financing obligations, excluding current portion	18,711	20,193
Other long-term liabilities	1,556	1,750
Total long-term liabilities	20,267	21,943
STOCKHOLDERS' EQUITY:		
Common stock	462	457
Additional paid-in capital	351,262	346,952
Treasury stock	(28,130)	(28,130)
Accumulated other comprehensive income	227	244
Accumulated deficit	(239,128)	(230,415)
Total Echelon Corporation stockholders' equity	84,693	89,108
Noncontrolling interest in subsidiary	138	—
Total stockholders' equity	84,831	89,108
Total liabilities and stockholders' equity	$125,801	$151,705

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues:				
Product	$28,056	$43,010	$107,387	$113,215
Service	1,008	817	2,832	2,737
Total revenues [2]	29,064	43,827	110,219	115,952
Cost of revenues:				
Cost of product [1]	16,672	25,419	63,352	63,037
Cost of service [1]	493	501	1,601	1,661
Total cost of revenues	17,165	25,920	64,953	64,698
Gross profit	11,899	17,907	45,266	51,254
Operating expenses:				
Product development [1]	7,256	7,533	23,450	26,005
Sales and marketing [1]	4,807	5,885	16,512	19,183
General and administrative [1]	3,679	3,747	11,624	13,408
Restructuring charges	—	—	1,176	—
Total operating expenses	15,742	17,165	52,762	58,596
Income (loss) from operations	(3,843)	742	(7,496)	(7,342)
Interest and other income (expense), net	(184)	390	(194)	(123)
Interest expense on lease financing obligations	(336)	(363)	(1,031)	(1,111)
Income (loss) before provision for income taxes	(4,363)	769	(8,721)	(8,576)
Income tax expense	57	114	148	229
Net income (loss)	$(4,420)	$655	$(8,869)	$(8,805)
Net loss attributable to non controlling interest	156	—	156	—
Net income (loss) attributable to Echelon Corporation stockholders	(4,264)	655	(8,713)	(8,805)
Net income (loss) per share:				
Basic	$(0.10)	$0.02	$(0.20)	$(0.21)
Diluted	$(0.10)	$0.02	$(0.20)	$(0.21)
Shares used in computing net income (loss) per share:				
Basic	42,806	42,232	42,564	42,040
Diluted	42,806	42,987	42,564	42,040

(1) See Note 4 for summary of amounts included representing stock-based compensation expense.

(2) Includes related party amounts of $1,768 and $2,001 for the three months ended September 30, 2012 and 2011, respectively, and $3,527 and $4,969 for the nine months ended September 30, 2012 and 2011, respectively. See Note 11 for additional information on related party transactions.

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income (loss)	$(4,420)	$655	$(8,869)	$(8,805)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustment	264	(696)	(19)	(6)
Unrealized holding gain (loss) on available-for-sale securities	2	(10)	2	(11)
Total other comprehensive income (loss)	266	(706)	(17)	(17)
Comprehensive loss	$(4,154)	$(51)	$(8,886)	$(8,822)
Less: comprehensive loss attributable to NCI	$156	$—	$156	$—
Comprehensive loss attributable to Echelon Corporation Stockholders	$(3,998)	$(51)	$(8,730)	$(8,822)

See accompanying notes to condensed consolidated financial statements.

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

	Nine Months Ended September 30, 2012	2011
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net loss including non controlling interest	$(8,869)	$(8,805)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	5,308	4,530
Increase in (reduction of) allowance for doubtful accounts	17	(13)
Loss on disposal of fixed assets	—	92
Reduction of (increase in) accrued investment income	(3)	64
Stock-based compensation	5,565	6,744
Change in operating assets and liabilities:		
Accounts receivable	18,244	(1,920)
Inventories	587	(1,619)
Deferred cost of goods sold	5,611	762
Other current assets	981	(1,147)
Accounts payable	(9,279)	2,998
Accrued liabilities	(3,597)	892
Deferred revenues	(7,290)	(1,975)
Deferred rent	(33)	(41)
Net cash provided by operating activities	7,242	562
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchases of available for sale short term investments	(66,947)	(38,978)
Proceeds from maturities and sales of available for sale short term investments	63,970	58,862
Change in other long term assets	(20)	(10)
Capital expenditures	(814)	(1,965)
Net cash provided by (used in) investing activities	(3,811)	17,909
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Principal payments of lease financing obligations	(1,461)	(1,286)
Proceeds from exercise of stock options	—	945
Proceeds from noncontrolling interests	294	—
Repurchase of common stock from employees for payment of taxes on vesting of restricted stock units and upon exercise of stock options	(1,249)	(2,093)
Net cash used in financing activities	(2,416)	(2,434)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	13	(27)
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,028	16,010
CASH AND CASH EQUIVALENTS:		
Beginning of period	17,658	7,675

End of period	$18,686	$23,685
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest on lease financing obligations	$1,024	$1,104
Cash paid for income taxes	$241	$297

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Summary of Significant Accounting Policies:

Basis of Presentation

The condensed consolidated financial statements include the accounts of Echelon Corporation, a Delaware corporation, its wholly-owned subsidiaries, and a subsidiary in which it has a controlling interest (collectively referred to as the "Company"). The Company reports noncontrolling interests in consolidated entities as a component of equity separate from the Company's equity. All material inter-company transactions between and among the Company and its consolidated subsidiaries and other consolidated entities have been eliminated in consolidation.

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, 2011 included in its Annual Report on Form 10 K.

There have been no material changes to the Company's significant accounting policies as compared to the significant accounting policies described in our Annual Report on Form 10 K for the fiscal year ended December 31, 2011.

Risks and Uncertainties

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

- The Company's sales are currently concentrated with a relatively small group of customers, as approximately 53.7% of net revenues for the quarter ended September 30, 2012, and 62.9% of net revenues for the nine months ended September 30, 2012, were derived from four customers. Customers in any of the Company's target market sectors may experience unexpected reductions in demand for their products and consequently reduce their purchases from us, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. In addition, if any of these customers are unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to the Company.
- The Company utilizes third-party contract electronic manufacturers to manufacture, assemble, and test its products. As a result of current credit market conditions, if any of these third-parties were unable to obtain the necessary capital to operate their business, they may be unable to provide the Company with timely services or to make timely deliveries of products.
- Due to the continuing worldwide economic situation, coupled with the fact that the Company's Systems customers generally procure products that have been customized to meet their requirements, the Company has limited visibility into ultimate product demand, which makes sales forecasting more difficult. As a result, anticipated demand may not materialize, which could subject the Company to increased levels of excess and obsolete inventories.
- From time to time, the Company has experienced shortages or interruptions in supply for certain products or components used in the manufacture of the Company's products that have been or will be discontinued. In order to ensure an adequate supply of these items, the Company has occasionally purchased quantities of these items that are in excess of the Company's then current estimate of short-term requirements. For example, to ensure supply, the Company procured a substantial quantity of a certain component used in one of its Systems products. If the long-term requirements do not materialize as originally expected, or if the Company develops alternative solutions that no longer employ these items and the Company is not able to dispose of these excess products or components, the Company could be subject to increased levels of excess and obsolete inventories.

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Use of Estimates

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

Recently Issued Accounting Standards

In June 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-05, Comprehensive Income (ASC Topic 220) — Presentation of Comprehensive Income. The amendments from this update will result in more converged guidance on how comprehensive income is presented under U.S. GAAP and International Financial Reporting Standards ("IFRS"). With this update to ASC 220, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In either option, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The amendments in this update do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor do they affect how earnings per share is calculated or presented. The amended guidance also requires presentation of adjustments for items that are reclassified from other comprehensive income to net income in the statement where the components of net income and the components of other comprehensive income are presented. The amendments in this ASU should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. In December 2011, the FASB decided to defer the requirement to present reclassifications of other comprehensive income on the face of the income statement. The Company's adoption of this guidance as of January 1, 2012 did not have a material impact on its condensed consolidated financial position, results of operations or cash flows.

Revenue Recognition

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

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery to the customer's carrier (and acceptance, as applicable) has occurred, the sales price is fixed or determinable, collectability is probable, and there are no post-delivery obligations. For non-distributor hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of delivery to the customer's carrier. However, for arrangements that contain contractual acceptance provisions, revenue recognition may be delayed until acceptance by the customer or the acceptance provisions lapse unless the Company can objectively demonstrate that the contractual acceptance criteria have been satisfied, which is generally accomplished by establishing a history of acceptance for the same or similar products. For sales made to the Company's distributor partners, revenue recognition criteria are generally met at the time the distributor sells the products through to its end-use customer. Service revenue is recognized as the training services are performed, or ratably over the term of the support period.

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

The Company’s multiple deliverable revenue arrangements are primarily related to sales of its Systems products, which may include, within a single arrangement, electricity meters, data concentrators and related hardware (collectively, the “Hardware”); NES system software; Element Manager software; post-contract customer support (“PCS”) for the NES system

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and Element Manager software; extended warranties for the Hardware; and, occasionally, specified enhancements or upgrades to software used in the NES system. For arrangements originating or materially modified after December 31, 2009, with the exception of the NES system software, each of these deliverables is considered a separate unit of accounting. The NES system software functions together with an electricity meter to deliver its essential functionality and any related software license fee is charged for on a per meter basis. Therefore, the NES system software and an electricity meter are combined and considered a single unit of accounting. The Element Manager software is not considered to be part of an electricity meter's essential functionality and, therefore, Element Manager software and any related PCS continues to be accounted for under industry specific software revenue recognition guidance. However, all other NES system deliverables are no longer within the scope of industry specific software revenue recognition guidance.

The Company allocates revenue to each element in a multiple-element arrangement based upon their relative selling price. The Company determines the selling price for each deliverable using vendor specific objective evidence ("VSOE") of selling price or third party evidence ("TPE") of selling price, if it exists. If neither VSOE nor TPE of selling price exists for a deliverable, the Company uses its best estimated selling price ("BESP") for that deliverable. Since the use of the residual method is eliminated under the new accounting standards, any discounts offered by the Company are allocated to each of the deliverables. Revenue allocated to each element is then recognized when the basic revenue recognition criteria is met for the respective element.

Consistent with its methodology under previous accounting guidance, if available, the Company determines VSOE of fair value for each element based on historical stand-alone sales to third parties or from the stated renewal rate for the elements contained in the initial contractual arrangement. The Company currently estimates selling prices for its PCS and extended warranties based on VSOE of fair value.

In many instances, the Company is not currently able to obtain VSOE of fair value for all deliverables in an arrangement with multiple elements. This may be due to the Company infrequently selling each element separately or not pricing products within a narrow range. When VSOE cannot be established, the Company attempts to estimate the selling price of each element based on TPE. TPE would consist of competitor prices for similar deliverables when sold separately. Generally, the Company's offerings contain significant differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, the Company is unable to reliably determine the stand-alone selling prices for similar products of its competitors. Therefore, the Company is typically not able to obtain TPE of selling price.

When the Company is unable to establish a selling price using VSOE or TPE, which is generally the case for the Hardware and certain specified enhancements or upgrades to the Company's NES software, the Company uses its BESP in determining the allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. BESP is generally used for offerings that are not typically sold on a stand-alone basis or for new or highly customized offerings.

The Company establishes pricing for its products and services by considering multiple factors including, but not limited to, geographies, market conditions, competitive landscape, internal costs, gross margin objectives, and industry pricing practices. The determination of pricing also includes consultation with and formal approval by the Company's management, taking into consideration the Company's go-to-market strategy. These pricing practices apply to both the Company's Hardware and software products.

Based on an analysis of pricing stated in contractual arrangements for its Hardware products in historical multiple-element transactions and, to a lesser extent, historical standalone transactions, the Company has concluded that it typically prices its Hardware within a narrow range of discounts when compared to the price listed on the Company's standard pricing grid for similar deliverables (i.e., similar configuration, volume, geography, etc.). Therefore, the Company has determined that, for its current Hardware for which VSOE or TPE is not available, the Company's BESP is generally comprised of prices based on a narrow range of discounts from pricing stated in its pricing grid.

When establishing BESP for the Company's specified software enhancements or upgrades, the Company considers multiple factors including, but not limited to, the relative value of the features and functionality being delivered by the enhancement or upgrade as compared to the value of the software product to which the enhancement or upgrade relates, as well as the Company's pricing practices for NES system software PCS packages, which may include rights to the specified enhancements or upgrades.

The Company regularly reviews VSOE and has established a review process for TPE and BESP. The Company maintains internal controls over the establishment and updates of these estimates. There were no material impacts during the three and nine months ended September 30, 2012, resulting from changes in VSOE, TPE, or BESP, nor does the Company expect a material impact from such changes in the near term.

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For multiple element arrangements that were entered into prior to January 1, 2010 and that included NES system and/or Element Manager software, the Company deferred the recognition of all revenue until all software required under the arrangement had been delivered to the customer. Once the software was delivered, the Company recognized revenues for the Hardware and software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators was disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators was deferred until such time as additional deliveries of meters or data concentrators had occurred. Revenues for PCS on the NES system and Element Manager software, as well as for extended warranties on Systems Hardware products, were recognized ratably over the associated service period, which generally commenced upon the later of the delivery of all software, or the customer's acceptance of any given Hardware shipment.

As of September 30, 2012 and December 31, 2011, approximately $2.4 million and $9.4 million, respectively, of the Company's Systems revenue was deferred. This decrease in deferred revenues was primarily due to a change in the timing of revenue recognition for certain of the Company's Systems products, which resulted from the Company's ability to objectively demonstrate that the contractual acceptance criteria for these products was met at the time of delivery. All of the deferred revenue at September 30, 2012 and December 31, 2011 relates to revenue that is being accounted for under the revenue recognition guidance applicable to transactions entered into after December 31, 2009.

Deferred Revenue and Deferred Cost of Goods Sold

Deferred revenue consists substantially of amounts billed or payments received in advance of revenue recognition. Deferred cost of goods sold related to deferred product revenues includes direct product costs and applied overhead. Deferred cost of goods sold related to deferred service revenues includes direct labor costs and applied overhead. Once all revenue recognition criteria have been met, the deferred revenues and associated cost of goods sold are recognized.

2. Financial Instruments

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

On a recurring basis, the Company measures certain of its financial assets, namely its cash equivalents and available-for-sale investments, at fair value. The Company does not have any financial liabilities measured at fair value on a recurring basis. The fair value of the Company's financial assets measured at fair value on a recurring basis was determined using the following inputs at September 30, 2012 (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds [1]	$4,233	$4,233	$—	$—
U.S. government securities[2]	43,981	—	43,981	—

Total	$48,214	$4,233	$43,981	$—

The fair value of the Company’s financial assets measured at fair value on a recurring basis was determined using the following inputs at December 31, 2011 (in thousands):

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	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds [(1)]	$5,215	$5,215	$—	$—
U.S. government securities[(2)]	45,999	—	45,999	—
Total	$51,214	$5,215	$45,999	$—

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

(2) Represents our portfolio of available for sale securities and is included in either cash and cash equivalents or short-term investments in the Company's condensed consolidated balance sheets

Cash equivalents consist of either investments with remaining maturities of three months or less at the date of purchase, or money market funds for which the carrying amount is a reasonable estimate of fair value.

The Company's available-for-sale securities consist of U.S. government securities with a minimum and weighted average credit rating of A-1+. The Company values these securities based on pricing from pricing vendors, who may use quoted prices in active markets for identical assets (Level 1 inputs) or inputs other than quoted prices that are observable either directly or indirectly (Level 2 inputs) in determining fair value. However, the Company classifies all of its fixed income available-for-sale securities as having Level 2 inputs. The valuation techniques used to measure the fair value of the Company's financial instruments having Level 2 inputs were derived from non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models, such as discounted cash flow techniques. Our procedures include controls to ensure that appropriate fair values are recorded such as comparing prices obtained from multiple independent sources.

As of September 30, 2012, the Company's available-for-sale securities had contractual maturities from six to twelve months and an average remaining term to maturity of eight months. As of September 30, 2012, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses of the Company's short-term investments by major security type were as follows (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. government and agency securities	$43,977	$43,981	$4	$—

The amortized cost basis, aggregate fair value and gross unrealized holding gains and losses for the Company's available-for-sale short-term investments, by major security type, were as follows as of December 31, 2011 (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. government securities	$45,997	$45,999	$3	$1

Market values were determined for each individual security in the investment portfolio. Any decline in value of these investments is primarily related to changes in interest rates and is considered to be temporary in nature. The Company reviews its investments on a regular basis to evaluate whether or not any have experienced an other-than-temporary decline in fair value.

3. Earnings Per Share

The following is a reconciliation of the numerators and denominators of the basic and diluted net income (loss) per share computations for the three and nine months ended September 30, 2012 and 2011 (in thousands, except per share amounts):

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income (loss) (Numerator):				
Net income (loss), basic & diluted	$(4,264)	$655	$(8,713)	$(8,805)
Shares (Denominator):				
Weighted average common shares outstanding	42,806	42,232	42,564	42,040
Shares used in basic computation	42,806	42,232	42,564	42,040
Common shares issuable upon exercise of stock options (treasury stock method)	—	755	—	—
Shares used in diluted computation	42,806	42,987	42,564	42,040
Net income (loss) per share:				
Basic	$(0.10)	$0.02	$(0.20)	$(0.21)
Diluted	$(0.10)	$0.02	$(0.20)	$(0.21)

For the three and nine months ended September 30, 2012 and the nine months ended September 30,2011, 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. For the three months ended September 30, 2011, there were 755,000 potentially dilutive options that were considered in the diluted income per share calculation. The number of stock options, stock appreciation rights, restricted stock units (“RSUs”), and restricted stock awards (“RSAs”) excluded from this calculation for the three months ended September 30, 2012 and 2011 was 6,235,795 and 2,410,114, respectively, and for the nine months ended September 30, 2012 and 2011 was 6,235,795 and 6,129,039, respectively.

4. Stockholders’ Equity and Employee Stock Option Plans:

Stock-based Compensation Expense

The following table summarizes stock-based compensation expense for the three and nine months ended September 30, 2012 and 2011 and its allocation within the condensed consolidated statements of operations (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of revenues:				
Cost of product	$166	$221	$462	$627
Cost of service	31	29	82	62
Operating expenses:				
Product development	619	1,017	1,874	2,811
Sales and marketing	455	307	1,460	1,510
General and administrative	535	(403)	1,687	1,734
Total	$1,806	$1,171	$5,565	$6,744

Stock Award Activity

There were no options exercised for the three and nine month periods ended September 30, 2012. The total intrinsic value of options exercised during the three and nine months ended September 30, 2011 was approximately $86,000 and $1.2 million, respectively. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the options.

The total fair value of RSUs vested and released during the three and nine months ended September 30, 2012 was approximately $723,000 and $3.4 million, respectively. The total fair value of RSUs vested and released during the three and nine months ended September 30, 2011 was approximately $742,000 and $4.6 million, respectively. The fair value is calculated by multiplying the fair market value of the Company’s stock on the vesting date by the number of shares vested.

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Stock-based Compensation Expense for Awards with Financial-Based Performance Vesting Requirements

As of September 30, 2012, there were 230,000 unvested RSUs and RSAs that were subject to service-based vesting conditions as well as certain financial or other performance-based vesting requirements that must be achieved before vesting can occur.

Through September 30, 2012, cumulative compensation expense of $621,000 associated with these 230,000 unvested RSUs and RSAs has been recognized. From the date of grant through June 30, 2012, the Company had believed it was probable that the associated performance requirements would be achieved and therefore recognized expense on these awards. During the third quarter of 2012 and as of September 30, 2012, the Company believed that the performance condition is no longer probable of achievement. However, the Company has not yet determined that the performance condition is improbable of achievement. Therefore, beginning in the third quarter of 2012, that Company has discontinued the recognition of compensation costs related to these awards. If, prior to the expiration of the RSUs and RSAs, the Company determines that the performance condition is again probable, compensation expense will once again be recognized. Alternatively, if the Company determines that the performance condition is improbable of achievement, the cumulative compensation expense of $621,000 associated with these awards will be reversed.

5. Significant Customers:

The Company markets its products and services throughout the world to original equipment manufacturers (OEMs) and systems integrators in the building, industrial, transportation, utility/home, and other automation markets. During the three and nine months ended September 30, 2012 and 2011, the Company had four customers that accounted for a significant portion of its revenues: EBV Electronik GmbH and Avnet Europe Comm VA (“EBV/Avnet”), the Company’s primary distributors of its Sub-systems products in Europe, Duke Energy Corporation (“Duke”), a U.S. utility company; and Eltel Networks A/S (“Eltel”) and Telvent Energia y Medioambiente SA (“Telvent”), value added resellers of the Company’s Systems products. For the three and nine months ended September 30, 2012 and 2011, the percentage of the Company’s revenues attributable to sales made to these customers was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Telvent	22.0%	15.3%	29.5%	14.4%
Duke	9.6%	32.7%	16.4%	28.5%
Eltel	13.7%	10.3%	9.6%	12.6%
EBV/Avnet	8.4%	8.8%	7.4%	10.3%
Total	53.7%	67.1%	62.9%	65.8%

In April 2011, the Company’s distributor agreement with EBV was assigned from EBV to Avnet Europe Comm VA, a limited partnership organized under the laws of Belgium (“Avnet”). Each of EBV and Avnet are indirect subsidiaries of Avnet, Inc., a New York corporation, which is a distributor of electronic parts, enterprise computing and storage products and embedded subsystems. At the time of the assignment, the term of the distributor agreement was extended and will now expire in June 2014.

6. Commitments and Contingencies:

Legal Actions

In April 2009, the Company received notice that the receiver for two companies that filed for the Italian law equivalent of bankruptcy protection in May 2004, Finmek Manufacturing SpA and Finmek Access SpA (collectively, the “Finmek Companies”), had filed a lawsuit under an Italian “claw back” law in Padua, Italy against the Company, seeking the return of approximately $16.7 million in payments received by the Company in the ordinary course of business for components sold by the Company to the Finmek Companies prior to the bankruptcy filing. The Finmek Companies were among Enel’s third party meters manufacturers, and from time to time through January 2004, the

Company sold components to the Finmek Companies that were incorporated into the electricity meters that were manufactured by the Finmek Companies and sold to Enel SpA for the Enel Project. The Company believes that the Italian claw back law is not applicable to its transactions with the Finmek Companies, and the claims of the Finmek Companies' receiver are without merit, and it is defending the lawsuit. As such, no loss or range of loss associated with this action is considered probable or reasonably possible at this time.

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From time to time, in the ordinary course of business, the Company may be subject to other legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, 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, 2012, the amounts of which were immaterial, it is possible that the Company's results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

Line of Credit

The Company maintains a $10.0 million line of credit with its primary bank, which expires on July 1, 2013. The letter of credit contains certain financial covenants requiring the Company to maintain an overall minimum tangible net worth level and to maintain a minimum level of liquid assets. As of September 30, 2012, the Company was in compliance with these covenants. As of September 30, 2012, the Company's primary bank has issued, against the line of credit, one standby letter of credit totaling $113,000. Other than issuing standby letters of credit, the Company has never drawn against the line of credit, nor have amounts ever been drawn against the standby letters of credit issued by the bank.

7. Inventories:

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

	September 30, 2012	December 31, 2011
Purchased materials	$2,027	$2,346
Work in process	32	86
Finished goods	8,473	8,693
	$10,532	$11,125

8. Accrued Liabilities:

Accrued liabilities consist of the following (in thousands):

	September 30, 2012	December 31, 2011
Accrued payroll and related costs	$3,261	$5,673
Warranty reserve	329	823
Restructuring charges	164	49
Customer deposits	2	101
Accrued taxes	107	170
Other accrued liabilities	402	939
	$4,265	$7,755

9. Segment Disclosure:

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

The Company operates in one principal industry segment, its reportable segment: the design, manufacture and sale of products for the controls network industry, and markets its products primarily to the smart grid, smart cities and smart buildings

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markets. The Company's products provide the infrastructure and support required to implement and deploy open, interoperable, control network solutions. Most of the Company's products either incorporate or operate with the Neuron® Chip and/or the LONWORKS protocol. The Company also provides a range of services to its customers that consist of technical support, training courses covering its LONWORKS network technology and products, and custom software development. Any given customer purchases a small subset of products and services that are appropriate for that customer's application.

The Company operates in three main geographic areas: the Americas; Europe, Middle East and Africa ("EMEA"); and Asia Pacific / Japan ("APJ"). Each geographic area provides products and services to the Company's customers located in the respective region. The Company's long-lived assets include property and equipment, goodwill, 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, 2012 and December 31, 2011, long-lived assets of approximately $28.8 million and $33.2 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the condensed consolidated financial statements.

The Company has two primary product lines: Systems and Sub-systems. Systems revenue is primarily composed of sales of meters and data concentrators to system integrators or utilities. The Company previously referred to this as Utility revenue. Sub-systems revenue is principally composed of sales of components, software, and sub-system modules to utilities, building energy, or street lighting customers. This was previously reported as Commercial and Enel Project revenues. Summary revenue information by product line for the three and nine months ended September 30, 2012 and 2011 is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Systems	$17,806	$29,171	$74,526	$73,053
Sub-systems	11,258	14,656	35,693	42,899
Total	$29,064	$43,827	$110,219	$115,952

In North America, the Company sells its products primarily through a direct sales organization and select third-party electronics representatives. Outside North America, the Company sells its products through direct sales organizations in EMEA and APJ, value-added resellers, and local distributors. Revenues are attributed to geographic areas based on the country where the products are shipped to or the services are delivered. Summary revenue information by geography for the three and nine months ended September 30, 2012 and 2011 is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Americas	$6,322	$19,038	$31,098	$46,494
EMEA	18,723	20,704	68,203	58,730
APJ	4,019	4,085	10,918	10,728
Total	$29,064	$43,827	$110,219	$115,952

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

10. Income Taxes:

The provision for income taxes for the three months ended September 30, 2012 and 2011 was $57,000 and $114,000, respectively. The provision for income taxes for the nine months ended September 30, 2012 and 2011 was $148,000 and $229,000, respectively. The difference between the statutory rate and the Company's effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits.

As of September 30, 2012 and December 31, 2011, the Company had gross unrecognized tax benefits of approximately $3.8 million and $4.4 million, respectively, of which $735,000 and $755,000, respectively, if recognized, would impact the effective tax rate on income from continuing operations. The Company’s policy is to recognize interest and/or penalties related to unrecognized tax benefits in income tax expense. As of September 30, 2012 and December 31, 2011, the Company had accrued $158,000 and $201,000, respectively, for interest and penalties. The $540,000 reduction in gross unrecognized tax

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benefits during the nine months ended September 30, 2012 was primarily attributable to the expiration of the statute of limitations in certain foreign jurisdictions.

11. Related Parties:

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

In June 2000, the Company entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of its common stock for $130.7 million. The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To the Company's knowledge, Enel has disposed none of its 3.0 million shares. Under the terms of the stock purchase agreement, Enel has the right to nominate one member of the Company's board of directors. A representative of Enel served on the board until March 14, 2012; no Enel representative is presently on the board.

At the time the Company entered into the stock purchase agreement with Enel, it also entered into a research and development agreement with an affiliate of Enel (the "R&D Agreement"). Under the terms of the R&D Agreement, the Company cooperated with Enel to integrate its LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. The Company completed the sale of its components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, the Company supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, the Company entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from the Company. Under the software enhancement agreement, the Company provides software enhancements to Enel for use in its Contatore Elettronico system. The software enhancement agreement expires in December 2012 and the development and supply agreement expires in December 2013, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

For the three months ended September 30, 2012 and 2011, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $1.8 million and $2.0 million, respectively. For the nine months ended September 30, 2012 and 2011, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $3.5 million and $5.0 million, respectively. As of September 30, 2012, and December 31, 2011, none of the Company's total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

12. Restructuring

In December 2010, the Company recorded restructuring charges of approximately $1.2 million related to termination benefits, of which $49,000 remained accrued as of December 31, 2011. This remaining amount was paid to the remaining affected employee during the quarter ended June 30, 2012.

In May 2012, the Company undertook further cost cutting measures by initiating a headcount reduction of 42 full-time employees worldwide, to be terminated between May 2012 and March 2013. In connection with this restructuring plan, in 2012, the Company recorded restructuring charges of approximately $1.2 million related to termination benefits for these personnel.

The following table sets forth a summary of restructuring activities related to the Company's May 2012 restructuring program (in thousands):

	January 1, 2012	Costs Incurred	Cash Payments	September 30, 2012
Termination benefits	$—	$1,176	$1,012	$164

Accrued restructuring charges as of September 30, 2012 comprise the remaining liability balance and are reflected in accrued liabilities on the Company's Condensed Consolidated Balance Sheet as of September 30, 2012. The Company expects to pay these accrued termination benefits prior to September 30, 2013.

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13. Joint Venture

On March 23, 2012, the Company entered into an agreement with Holley Metering Limited (“Holley Metering”), a designer and manufacturer of energy meters in China, to create a joint venture, Zhejiang Echelon-Holley Technology Co., Ltd. (“Echelon-Holley”). The joint venture will focus on the development and sales of smart energy products for China and rest-of-world markets. The Company has a 51% ownership interest in the joint venture and exercises controlling influence. Therefore, Echelon-Holley’s accounts are included in the Company’s Condensed Consolidated Financial Statements as of September 30, 2012 and for the three months and nine months then ended. Holley Metering’s interests in Echelon-Holley’s net assets are reported in the noncontrolling interest in subsidiary on the Condensed Consolidated Balance Sheet as of September 30, 2012. Net loss attributable to the noncontrolling interest in Echelon-Holley was $156,000 during three months and nine months ended September 30, 2012.

As of September 30, 2012, Echelon and Holley Metering had contributed in cash a total of approximately $600,000 in Share Capital, as defined, to Echelon-Holley in proportion to their respective ownership interests.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business. These statements may be identified by the use of words such as "we believe," "expect," "anticipate," "intend," "plan," "goal," "continues," "may" and expressions. Forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. In particular, these statements include statements such as: our projections of Systems revenues; estimates of our future gross margins; statements regarding reinvesting a portion of our earnings from foreign operations; plans to use our cash reserves to strategically acquire other companies, products, or technologies; our projections of our combined cash, cash equivalent and short term investment balance; the sufficiency of our cash reserves to meet cash requirements; our expectations that our Sub-systems revenues will not fluctuate significantly from foreign currency sales; our forecasts regarding our sales and marketing expenses; and estimates of our interest income. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the "Factors That May Affect Future Results of Operations" section. Therefore, our actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to review or update publicly any forward-looking statements for any reason.

EXECUTIVE 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 eleven foreign countries throughout Europe and Asia. We develop, market, and sell energy control networking solutions, a critical element of incorporating action-oriented intelligence into the utility grid, buildings, streetlights, and other energy devices – all components of the evolving smart grid, which encompasses everything from the power plant to the plug. Echelon's products can be used to make the management of electricity over the smart grid cost effective, reliable, survivable and instantaneous. Our products enable everyday devices — such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves — to be made "smart" and inter-connected.

Our proven, open standard, multi-application energy control networking platform powers energy-savings applications for smart grid, smart cities and smart buildings that help customers save on their energy usage, reduce outage duration or prevent them from happening entirely, reduce carbon footprint and more. Today, we offer, directly and through our partners worldwide, a wide range of innovative, fully integrated products and services. We classify these products and services into two primary categories: Systems, such as our smart metering solutions, which are targeted for use by utilities and that we previously referred to as our Utility products and services; and Sub-systems that include our components, control nodes and development software, which are sold typically to OEMs who build them into their smart grid, smart cities and smart buildings solutions. Revenues from our Sub-systems products and services were previously referred to as Commercial and Enel Project revenues.

Our total revenues decreased by 33.7% during the third quarter of 2012 as compared to the same period in 2011, driven principally by decreased sales of our Systems products. Gross margins remained constant between the two periods, while overall operating expenses decreased by 8.3%. The net effect was a third quarter loss attributable to Echelon Corporation stockholders in 2012 that increased by $4.9 million as compared to the third quarter of 2011. For the nine months ended September 30, 2012, total revenues decreased by 4.9% as compared to the same period in 2011. Gross margins decreased by 3.1 percentage points between the two periods, while overall operating expenses decreased by 10.0%. The net effect was a loss attributable to Echelon Corporation stockholders for the first nine months in 2012 that decreased by $92,000 as compared to the first nine months of 2011.

The following tables provide an overview of key financial metrics for the three and nine months ended September 30, 2012 and 2011 that our management team focuses on in evaluating our financial condition and operating performance (in thousands, except percentages).

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	Three Months Ended September 30, 2012	2011	$ Change	% Change
Net revenues	$29,064	$43,827	$(14,763)	(33.7)%
Gross margin	40.9%	40.9%	---	0.0 ppt
Operating expenses	$15,742	$17,165	$(1,423)	(8.3)%
Net income (loss) attributable to Echelon Corporation Stockholders	$(4,264)	$655	$(4,919)	(751.0)%

	Nine months Ended September 30, 2012	2011	$ Change	% Change
Net revenues	$110,219	$115,952	$(5,733)	(4.9)%
Gross margin	41.1%	44.2%	---	(3.1) ppt
Operating expenses	$52,762	$58,596	$(5,834)	(10.0)%
Net loss attributable to Echelon Corporation Stockholders	$(8,713)	$(8,805)	$92	(1.0)%

	Balance as of September 30, 2012	December 31, 2011	$ Change	% Change
Cash, cash equivalents, and short-term investments	$62,667	$58,656	$4,011	6.8%

- Net revenues: Our total revenues decreased by 33.7% during the third quarter of 2012 as compared to the same period in 2011, driven primarily by a $11.4 million, or 39%, decrease in sales of our Systems products and services and a $3.4 million or 23% decrease in net revenues from our Sub-systems products. The decrease in our Systems revenues was primarily due to an overall decrease in the level of large-scale deployments in the United States of our NES system products. With respect to our Sub-systems product line, the decrease in revenues during the third quarter of 2012 was due to decrease in sales to our American and European Sub-system customers other than Enel, reflecting depressed economic conditions and ongoing market share loss. Many of our Sub-systems customers produce products used in commercial or industrial buildings. The markets for these products were adversely affected by the recession that started in 2008. These markets have yet to recover to their pre-recession levels. Our total revenues decreased during the nine months ended September 30, 2012 as compared to the same period in 2011 by 4.9%. This was due mainly to decreased sales of Sub-systems products to European customers, including Enel, partially offset by increased shipments of our Systems products for projects in Finland and increases due to a change in the timing of revenue recognition for certain of our Systems products. These increases were partially offset by a reduction in Systems products shipped for our projects in United States.
- Gross margin: Our gross margin remained constant for the three months ended September 30, 2012 as compared to the same period in 2011, and decreased by 3.1 percentage points during the nine month period ended September 30, 2012 as compared to the same period in 2011. The decrease during the nine month period was primarily due to increased manufacturing costs for our Systems products, as well as a change in the mix of products sold. This decline in gross margins was partially offset by reductions in indirect manufacturing expenses mainly due to reduced compensation expenses.
- Operating expenses: Our operating expenses decreased by 8.3% and 10.0% during the three and nine month periods ended September 30, 2012, respectively, as compared to the same periods in 2011. The decreases in the three month period ended September 30, 2012, compared to the same period in 2011, were driven primarily by decreases in compensation costs (primarily due to reduced headcount and other employee related costs) as well as reduced travel costs. Along with the reasons noted above, also contributing to the decrease in operating expenses for the nine month period ended September 30, 2012, compared to the same period in 2011, was the impact of the reduction of stock compensation expense of $800,000 reflecting the retirement of our former CFO as well as the restructuring action during the second quarter of 2012 and the related restructuring charge of approximately $1.2 million that we took

during 2012. This was partially offset by reduced stock compensation expense of $1 million resulting from the passing of our former Executive Chairman, Ken Oshman, in 2011. Also contributing to the decrease in operating expenses for the nine month period were the reduced fees paid to third party service providers.

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- Net loss attributable to Echelon Corporation Stockholders: We generated a net loss of $4.3 million during the third quarter of 2012 compared to net income of $655,000 during the same period in 2011. This reduction in net income was directly attributable to the $14.8 million quarter-over-quarter decrease in net revenues, partly offset by reduced operating expenses. Excluding the impact of non-cash stock-compensation charges, our net income decreased by approximately $4.3 million in the third quarter of 2012 as compared to the same period in 2011. Our net loss decreased by $92,000 during the nine months ended September 30, 2012 as compared to the same period in 2011. This marginal decrease was attributable to the reduced operating expenses offset by the reduction in revenues. Excluding the impact of non-cash stock-compensation charges and restructuring charges incurred in the first half of 2012, our net loss decreased by approximately $89,000 in the first nine months of 2012 as compared to the same period in 2011.
- Cash, cash equivalents, and short-term investments: During the first nine months of 2012, our cash, cash equivalents, and short-term investment balance increased by 6.8%, from $58.7 million at December 31, 2011 to $62.7 million at September 30, 2012. This increase was primarily the result of cash provided by operations of $7.2 million due mainly to reduction in working capital (increased A/R collections of $18.2 million being the primary driver), partly offset by cash used for taxes paid on stock awards released during the year and principal payments on our lease financing obligations.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. Note 1, “Significant Accounting Policies” of Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2011, which we filed with the Securities and Exchange Commission in March 2012, describes the significant accounting policies and methods used in the preparation of our consolidated financial statements. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our revenues, stock-based compensation, allowance for doubtful accounts, inventories, and commitments and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

During the three and nine months ended September 30, 2012, there were no material changes to our critical accounting policies or in the matters for which we make critical accounting estimates in the preparation of our condensed consolidated financial statements as compared to those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011.

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RESULTS OF OPERATIONS

The following table reflects the percentage of total revenues represented by each item in our Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2012 and 2011:

	Three Months Ended September 30, 2012	2011	Nine months Ended September 30, 2012	2011
Revenues:				
Product	96.5 %	98.1 %	97.4 %	97.6 %
Service	3.5	1.9	2.6	2.4
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
Cost of product	57.4	58.0	57.4	54.4
Cost of service	1.7	1.1	1.5	1.4
Total cost of revenues	59.1	59.1	58.9	55.8
Gross profit	40.9	40.9	41.1	44.2
Operating expenses:				
Product development	25.0	17.2	21.3	22.4
Sales and marketing	16.5	13.4	15.0	16.5
General and administrative	12.6	8.6	10.5	11.6
Restructuring charges	—	—	1.1	—
Total operating expenses	54.1	39.2	47.9	50.5
Income (loss) from operations	(13.2)	1.7	(6.8)	(6.3)
Interest and other income (expense), net	(0.6)	0.9	(0.2)	(0.1)
Interest expense on lease financing obligations	(1.2)	(0.8)	(0.9)	(1.0)
Income (loss) before provision for income taxes	(15.0)	1.8	(7.9)	(7.4)
Income tax expense	0.2	0.3	0.1	0.2
Net income (loss)	(15.2)%	1.5 %	(8.0)%	(7.6)%
Net loss attributable to non controlling interest	0.5 %	— %	0.1 %	— %
Net income (loss) attributable to Echelon Corporation stockholders	(14.7)%	1.5 %	(7.9)%	(7.6)%

Revenues

Total revenues

	Three Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
(Dollars in thousands)				
Total revenues	$ 29,064	$ 43,827	$ (14,763)	(33.7)%

	Nine Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
(Dollars in thousands)				
Total revenues	$ 110,219	$ 115,952	$ (5,733)	(4.9)%

The $14.8 million decrease in total revenues for the quarter ended September 30, 2012 as compared to the same period in 2011 was primarily due to an $11.4 million, or 39.0%, decrease in sales of our Systems products and services and a

$3.4 million, or 23.2%, decrease in net revenues from our Sub-systems products. The $5.7 million decrease in total revenues for the

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nine months ended September 30, 2012 as compared to the same period in 2011 was primarily the result of a $7.2 million decrease in Sub-systems revenues, which was partially offset by a $1.5 million increase in Systems revenues.

As we look forward to the remainder of 2012, the smart energy market continues to be in the midst of a challenging time. Macro conditions remain tentative amidst the European financial crisis, and competition is heightened as the industry faces slow growth and ongoing consolidation. New tender activity for smart–metering deployments is down and pricing pressures are increasing. In addition, the Sub-system business is still being negatively impacted by worldwide macro economic conditions, as well as ongoing market share loss, particularly in the buildings market. In this challenging environment, we expect our revenues in the fourth quarter of 2012 will be lower than those generated in the first three quarters of the year.

Systems revenues

	Three Months Ended			
(Dollars in thousands)	September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Systems revenues	$ 17,806	$ 29,171	$ (11,365)	(39.0)%

	Nine Months Ended			
(Dollars in thousands)	September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Systems revenues	$ 74,526	$ 73,053	$ 1,473	2.0 %

During the three and nine months ended September 30, 2012 and 2011, our Systems revenues were derived primarily from a relatively small number of customers who have undertaken large-scale deployments of our NES System products. These deployments generally come to fruition after an extended and complex sales process, and each is relatively substantial in terms of its revenue potential. They vary significantly from one another in terms of, among other things, the overall size of the deployment, the duration of time over which the products will be sold, the mix of products being sold, the timing of delivery of those products, and the ability to modify the timing or size of those projects. This relative uniqueness among each deployment results in significant variability and unpredictability in our Systems revenues.

Systems revenues decreased during the quarter ended September 30, 2012 as compared to the same period in 2011. This was primarily due to an overall decrease in the level of large-scale deployments in the United States of our NES system products, partly offset by a one time price increase for products sold in the first half of 2012 to one of our customers. Systems revenues increased during the nine months ended September 30, 2012 as compared to the same period in 2011. This was due to increased shipments of our Systems products for projects in Finland. These increases were partially offset by a reduction in products shipped for our projects in Denmark and the United States.

Our ability to recognize revenue for our Systems products depends on several factors, including, but not limited to, the impact on delivery dates of any modifications to existing shipment schedules included in the contracts that have been awarded to us thus far, and in some cases, certain contractual provisions, such as customer acceptance. For arrangements that contain contractual acceptance provisions, revenue recognition may be delayed until acceptance by the customer or the acceptance provisions lapse unless we can objectively demonstrate that the contractual acceptance criteria have been satisfied, which is generally accomplished by establishing a history of acceptance for the same or similar products. In the future, we will continue to evaluate historical acceptance rates for our Systems products and, when the data supports it, will recognize revenue at the point of delivery to the customer’s carrier for those particular products (once all other revenue recognition criteria have been met), which could increase our Systems revenue in the period in which this determination is made. In addition, the revenue recognition rules relating to products such as our

NES System may require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period.

Our Systems revenues have historically been concentrated with a relatively few customers. During the years ended December 31, 2011, 2010, and 2009, approximately 94.2%, 85.4%, and 82.5%, respectively, of our Systems revenues were attributable to four customers. While our Systems customers will change over time, given the nature of the Systems market, we expect our future Systems revenues will continue to be concentrated among a limited number of customers.

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Sub-systems revenues

(Dollars in thousands)	Three Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Sub-systems revenues	$11,258	$ 14,656	$(3,398)	(23.2)%

(Dollars in thousands)	Nine Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Sub-systems revenues	$35,693	$ 42,899	$(7,206)	(16.8)%

Our Sub-systems revenues are primarily comprised of sales of our hardware products, and to a lesser extent, revenues we generate from sales of our software products and from our customer support and training offerings. Included in these totals are products and services sold to Enel.

Excluding sales of products and services to Enel, which are discussed more fully below, our Sub-systems revenues decreased by $3.2 million, or 25.0% during the three months ended September 30, 2012, and by $5.8 million, or 15.2% during the nine months ended September 30, 2012, as compared to the same periods in 2011. For the three month period, this decrease was primarily due to a decrease in revenues in the EMEA and Americas regions and ongoing market share loss. For the nine month period, this decrease was primarily due to a decrease in revenues in the EMEA region. These decreases were attributable, we believe, to generally poor macroeconomic conditions in Europe and the depressed Sub-systems market in Americas during 2012 and ongoing market share loss. Within the Sub-systems family of products, the year-over-year decrease was driven primarily from decreased sales of our control and connectivity products, partially offset by an increase in sales of our SmartServer products.

Our future Sub-systems revenues will also be subject to further fluctuations in the exchange rates between the United States dollar and the foreign currencies in which we sell these products and services. In general, if the dollar were to weaken against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would increase. Conversely, if the dollar were to strengthen against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would decrease. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in these currencies and the magnitude of the exchange rate fluctuation from year to year. The portion of our Sub-systems revenues conducted in currencies other than the United States dollar, principally the Japanese Yen, was about 8.3% for the nine months ended September 30, 2012 and 6.9% for the same period in 2011. To date, we have not hedged any of these foreign currency risks. We do not currently expect that, during 2012, the amount of our Sub-systems revenues conducted in these foreign currencies will fluctuate significantly from prior year levels. Given the historical and expected future level of sales made in foreign currencies, we do not currently plan to hedge against these currency rate fluctuations. However, if the portion of our 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 (included in Sub-systems)

(Dollars in thousands)	Three Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Enel project revenues	$1,768	$ 2,001	$(233)	(11.6)%

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(Dollars in thousands)	Nine Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Enel project revenues	$3,527	$ 4,969	$(1,442)	(29.0)%

In October 2006, we entered into two agreements with Enel, a development and supply agreement and a software enhancement agreement. Under the development and supply agreement, Enel is purchasing additional metering kit and data concentrator products from us. Under the software enhancement agreement, we are providing software enhancements to Enel for use in its Contatore Elettronico system. Enel Project revenues recognized during the three and nine month periods ended September 30, 2012 and 2011, respectively, related primarily to shipments under the development and supply agreement, and to a lesser extent, from revenues attributable to the software enhancement agreement. The software enhancement agreement expires in December 2012 and the development and supply agreement expires in December 2013.

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.

Gross Profit and Gross Margin

(Dollars in thousands)	Three Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Gross Profit	$11,899	$17,907	$(6,008)	(33.6)%
Gross Margin	40.9%	40.9%	N/A	—

(Dollars in thousands)	Nine Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Gross Profit	$45,266	$51,254	$(5,988)	(11.7)%
Gross Margin	41.1%	44.2%	N/A	(3.1)

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

Gross margin remained constant for the three months ended September 30, 2012 as compared to the same period in 2011. Our gross margins for the three months ended September 30, 2012 were impacted by non routine items such as a one time price increase for products sold in the first half of 2012 to one of our customers offset by charges for excess inventory and some production equipment that we don’t expect to use, which were the result of lower volume expectations. On balance these items reduced our gross margins by approximately 120 basis points. Gross margin decreased by approximately 3.1 percentage points during the nine month period ended September 30, 2012, respectively, as compared to the same period in 2011.The decrease during the nine month period was primarily due to increased manufacturing costs for our Systems products, and the change in mix of Systems and Sub- systems products sold. This decline in gross margins was partially offset by some reductions in operations expenses mainly due to reduced compensation expenses.

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In June 2011, Jabil, one of our primary CEMs, notified us that they intended to increase the prices they charge us for manufacturing our Systems products. The new pricing became effective July 1, 2011, and was based on increased fees for Jabil's overhead and profit, cost increases for commodities contained in our products, and higher labor rates for Jabil's production personnel. The impact of these cost increases began to phase in during the third quarter of 2011 and became fully effective at the beginning of the fourth quarter. In an effort to mitigate the effects of these price increases and thus improve our gross margins within the foreseeable future, we are working on certain design modifications for these products intended to reduce their cost to manufacture. We continue to work closely with Jabil to identify other opportunities to reduce their manufacturing costs associated with our products.

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

Operating Expenses

Product Development

	Three Months Ended			
(Dollars in thousands)	September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Product Development	$ 7,256	$ 7,533	$ (277)	(3.7)%

	Nine Months Ended			
(Dollars in thousands)	September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Product Development	$ 23,450	$ 26,005	$ (2,555)	(9.8)%

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

During the first nine months of 2011, our product development expenses were impacted by a contractual arrangement whereby a third party was making payments to us in connection with certain design and development activities we were performing. During the three and nine months ended September 30, 2011, we completed efforts worth $1.2 million and $1.5 million, respectively. These amounts were used to offset our product development expenses in these periods. Excluding the impact of these offsetting payments, our product development expenses decreased by $1.5 million and $4.1 million during the three and nine months ended September 30, 2012 as compared to the same periods in 2011. These decreases were primarily due to reduced compensation costs, including share based compensation expenses (as mentioned in the executive overview above), which were down primarily due to lower headcount in our product development organization in 2012. These compensation cost reductions were partially offset by increased outside services and contractor costs.

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Sales and Marketing

(Dollars in thousands)	Three Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Sales and Marketing	$4,807	$ 5,885	$(1,078)	(18.3)%

(Dollars in thousands)	Nine Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Sales and Marketing	$16,512	$ 19,183	$(2,671)	(13.9)%

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

The decrease in sales and marketing expenses during the three and nine months ended September 30, 2012 as compared to the same periods in 2011 was driven primarily by lower compensation (including commission expenses and bonus expenses), lower travel and entertainment expenses and reduced fees paid to consultants and other third party service providers.

General and Administrative

(Dollars in thousands)	Three Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
General and Administrative	$3,679	$ 3,747	$(68)	(1.8)%

(Dollars in thousands)	Nine Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
General and Administrative	$11,624	$ 13,408	$(1,784)	(13.3)%

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

General and administrative expenses remained fairly constant for the three months ended September 30, 2012 as compared to the same period in 2011. The decrease in general and administrative expenses during the nine months ended September 30, 2012 as compared to the same period in 2011 was primarily attributable to a decrease in compensation expenses (including bonus expenses) and a decrease in fees paid to third party service providers.

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Restructuring Charges

(Dollars in thousands)	Three Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Restructuring Charges	$—	$ —	$—	—

(Dollars in thousands)	Nine Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Restructuring Charges	$ 1,176	$ —	$ 1,176	—

In May 2012, we undertook further cost cutting measures by initiating a headcount reduction of 42 full-time employees worldwide, to be terminated between May 2012 and March 2013. In connection with this restructuring plan, in 2012, we recorded restructuring charges of approximately $1.2 million related to termination benefits for these personnel.

With the exception of $164,000 that remains accrued and reflected in accrued liabilities on our Condensed Consolidated Balance Sheets as of September 30, 2012, the restructuring charges of a total of $1.2 million were paid out by the third quarter of 2012. We expect to pay the remaining $164,000 of accrued termination benefits through the first two quarters of 2013.

Interest and Other Income (Expense), Net

(Dollars in thousands)	Three Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Interest and Other Income (Expense), Net	$ (184)	$ 390	$ (574)	(147.2)%

(Dollars in thousands)	Nine Months Ended September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Interest and Other Income (Expense), Net	$ (194)	$ (123)	$ (71)	57.7 %

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

Interest and other expense, net increased by $574,000 during the quarter ended September 30, 2012 as compared to the same period in 2011. This increase was primarily attributable to the fact that, during the third quarter of 2012, we recognized approximately $186,000 of foreign currency translation losses, whereas in the third quarter of 2011, we recognized foreign currency translation gains of approximately $436,000. Interest and other expense, net increased by $71,000 during the nine months ended September 30, 2012 as compared to the same period in 2011. This increase was primarily attributable to the fact that, during the first nine months of 2012, we recognized approximately $206,000 of foreign currency translation losses, whereas for the same period in 2011, we recognized foreign currency translation losses of approximately $108,000. These fluctuations are attributable to our foreign currency denominated short-term intercompany balances. We account for translation gains and losses associated with these balances by reflecting these amounts as either other income or loss in our consolidated statements of operations. During periods when the U.S. dollar weakens in value against these foreign currencies, the associated translation losses negatively impact other income. Conversely, when the U.S. dollar strengthens as it did during the first nine months of 2012, the resulting translation gains favorably impact other income.

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We do not currently anticipate interest income on our investment portfolio will improve during 2012 as we expect interest rates to remain historically low. Future gains or losses associated with translating our foreign currency denominated short-term intercompany balances will depend on exchange rates in effect at the time of translation.

Interest Expense on Lease Financing Obligations

	Three Months Ended			
(Dollars in thousands)	September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Interest Expense on Lease Financing Obligations	$ 336	$ 363	$ (27)	(7.4)%

	Nine Months Ended			
(Dollars in thousands)	September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Interest Expense on Lease Financing Obligations	$ 1,031	$ 1,111	$ (80)	(7.2)%

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

Interest expense on lease financing obligations decreased by $27,000 and $80,000 during the three and nine month periods ended September 30, 2012 as compared to the same periods in 2011, which were a result of the nature of this expense. As with any amortizing fixed rate loan, payments made earlier in the term of the loan are comprised primarily of interest expense with little being allocated to principal repayment. Payments made later in the term of the loan, however, have an increasing proportion of principal repayment, with less being attributable to interest expense. Accordingly, as we continue to make payments in accordance with our lease obligation, we expect a higher proportion of the payments we make in the future will be allocated to principal repayment and less will be allocated to interest expense.

Income Tax Expense

	Three Months Ended			
(Dollars in thousands)	September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Income Tax Expense	$ 57	$ 114	$ (57)	(50.0)%

	Nine Months Ended			
(Dollars in thousands)	September 30, 2012	September 30, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Income Tax Expense	$ 148	$ 229	$ (81)	(35.4)%

The income tax expense for the quarters ended September 30, 2012 and 2011 was $57,000 and $114,000, respectively. The income tax expense for the nine month periods ended September 30, 2012 and 2011 was $148,000 and $229,000, respectively. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits.

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OFF-BALANCE-SHEET ARRANGEMENTS AND OTHER CONTRACTUAL OBLIGATIONS

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

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

Effective June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately $48.9 million. Both leases permit us to exercise an option to extend the respective lease for two sequential five-year terms.

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

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

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

In March 2012, we announced the formation of a joint venture in Hangzhou, China with Holley Metering, a Chinese company with which we have been developing smart energy products for the Chinese and rest-of-world markets. The joint venture will require us to provide capital contributions of approximately $2.0 million, of which we had contributed $306,000 as of September 30, 2012. We expect to contribute the remaining $1.7 million by December 31, 2012.

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

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

Royalties. We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which was recorded as cost of products revenue in our condensed consolidated statements of income, was approximately $103,000 during the quarter ended September 30, 2012, and $130,000 for the same period in 2011, and $384,000 for the nine months ended September 30, 2012, and $398,000 for the same period in 2011.

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

Taxes. We conduct our operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on Echelon's operations in that particular location. While we strive to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with generally accepted accounting principles, we make a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and we believe that, as of September 30, 2012, we have adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

Legal Actions. In April 2009, the Company received notice that the receiver for two companies that filed for the Italian law equivalent of bankruptcy protection in May 2004, Finmek Manufacturing SpA and Finmek Access SpA (collectively, the "Finmek Companies"), had filed a lawsuit under an Italian "claw back" law in Padua, Italy against Echelon, seeking the return of approximately $16.7 million in payments received by Echelon in the ordinary course of business for components we sold to the Finmek Companies prior to the bankruptcy filing. The Finmek Companies were among Enel's third party meters manufacturers, and from time to time through January 2004, we sold components to the Finmek Companies that were incorporated into the electricity meters that were manufactured by the Finmek Companies and sold to Enel SpA for the Enel Project. We believe that the Italian claw back law is not applicable to our transactions with the Finmek Companies, and the claims of the Finmek Companies' receiver are without merit and we are defending the lawsuit. As such, no loss associated with this action is considered probable or reasonably possible at this time.

From time to time, in the ordinary course of business, we are subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While we believe we have adequately provided for such contingencies as of September 30, 2012, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

LIQUIDITY AND CAPITAL RESOURCES

Since our inception, we have financed our operations and met our capital expenditure requirements primarily from the sale of preferred stock and common stock, although during the years 2002 through 2004, we were also able to finance our operations through operating cash flow. From inception through September 30, 2012, we raised $295.0 million from the sale of preferred stock and common stock, including the exercise of stock options and warrants from our employees and directors.

The following table presents selected financial information as of September 30, 2012, and for each of the last three fiscal years (dollars in thousands):

	September 30,	December 31,		
	2012	2011	2010	2009
Cash, cash equivalents, and short-term investments	$62,667	$58,656	$64,632	$80,116
Trade accounts receivable, net	16,942	35,215	25,102	21,496
Working capital	73,424	74,922	77,259	96,357
Stockholders' equity	84,693	89,108	93,989	115,898

As of September 30, 2012, we had $62.7 million in cash, cash equivalents, and short-term investments, an increase of $4.0 million as compared to December 31, 2011. Historically, our primary source of cash, other than stock sales, has been receipts from revenue, and to a lesser extent, proceeds from the exercise of stock options and warrants by our employees and directors. Our primary uses of cash have been cost of product revenue, payroll (salaries, commissions, bonuses, and benefits), general operating expenses (costs associated with our offices such as rent, utilities, and maintenance; fees paid to third party service providers such as consultants, accountants, and attorneys; travel and entertainment; equipment and supplies;

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advertising; and other miscellaneous expenses), acquisitions, capital expenditures, and purchases under our stock repurchase programs.

Cash flows from operating activities. Cash flows from operating activities have historically been driven by net income (loss) levels; adjustments for non-cash charges such as stock-based compensation; depreciation and amortization; changes in accrued investment income; and fluctuations in operating asset and liability balances. Net cash provided by operating activities was $7.2 million for the nine months ended September 30, 2012, an increase in cash inflows of approximately $6.7 million as compared to the same period in 2011. During the nine months ended September 30, 2012, net cash provided by operating activities was primarily the result of stock-based compensation expenses of $5.6 million and depreciation and amortization expense of $5.3 million and changes in operating assets and liabilities of $5.2 million, partially offset by our net loss of $8.9 million. The primary components of the $5.2 million net change in our operating assets and liabilities were a $18.2 million decrease in accounts receivable, a $5.6 million decrease in deferred cost of goods sold, a $587,000 decrease in inventories partially offset by a $9.3 million decrease in accounts payable, a $7.3 million decrease in deferred revenues and a $3.6 million decrease in accrued liabilities. Accounts receivable decreased primarily as a result of the timing of collections and revenues in the first nine months of 2012 as compared to the same period in 2011. Also contributing to the decrease in accounts receivable was a general improvement in the days sales outstanding for our Systems related receivables. Deferred cost of goods sold decreased in conjunction with a decrease in deferred revenues. Inventories decreased primarily in anticipation of the reduced revenues in the near term. Accounts payable decreased due to an overall reduction in the level of purchasing activity and timing of expenditures during the first nine months of 2012. Deferred revenues decreased due primarily to our ability to objectively demonstrate that the contractual acceptance criteria for much of the Systems products we shipped during the year was satisfied at the time of delivery, as against prior year where revenues were deferred until customer acceptance was received. Accrued liabilities decreased primarily due to the payment of bonuses and commissions during the first quarter of 2012 that were accrued as of December 31, 2011 in accordance with our 2011 compensation arrangements.

During the nine months ended September 30, 2011, net cash provided by operating activities was $562,000, an increase in cash inflows of approximately $2.2 million as compared to the same period in 2010. During the nine months ended September 30, 2011, net cash provided by operating activities was primarily the result of stock-based compensation expenses of $6.7 million and depreciation and amortization expense of $4.5 million, partially offset by our net loss of $8.8 million and changes in our operating assets and liabilities of $2.0 million. The primary components of the $2.0 million net change in our operating assets and liabilities were a $2.0 million decrease in deferred revenues; a $1.9 million increase in accounts receivable; a $1.6 million increase in inventories; and a $1.1 million increase in other current assets; the impact of which was partially offset by a $3.0 million increase in accounts payable; an $892,000 increase in accrued liabilities; and a $762,000 decrease in deferred cost of goods sold. Deferred revenues decreased due primarily to the timing of products shipped. Accounts receivable increased primarily as a result of increased revenues during the third quarter of 2011 as compared to the fourth quarter of 2010. During the quarter ended September 30, 2011, total revenues were $43.8 million compared to $38.8 million during the quarter ended December 31, 2010. Inventories increased primarily to an increase in finished goods levels required for anticipated increased product shipments in the fourth quarter of 2011 as compared to the first quarter of 2011, and to a lesser extent due to the timing of customer shipments during the latter part of the third quarter that had not yet reached their destination. During the third quarter of 2011, the amount of product shipped in the latter part of the quarter for which customer acceptance had not yet been received was higher than what was observed in the fourth quarter of 2010. Other current assets increased primarily due to an increase in unbilled receivables. Accounts payable increased due to an overall increase in the level of purchasing activity due to higher revenues in the third quarter of 2011 as compared to the fourth quarter of 2010, as well as the timing of expenditures during the third quarter of 2011. Accrued liabilities increased primarily due to amounts accrued for our 2011 management bonus program, amounts accrued for commissions, and increased provisions for warranty expenses, partially offset by the payment of termination benefits that were accrued as part of our restructuring program in the fourth quarter of 2010. Deferred cost of goods sold decreased in conjunction with a decrease in deferred revenues.

Cash flows from investing activities. Cash flows from investing activities have historically been driven by transactions involving our short-term investment portfolio, capital expenditures, changes in our long-term assets, and acquisitions. Net cash used in investing activities was $3.8 million for the nine months ended September 30, 2012, a decrease in cash inflows of $21.7 million from the same period in 2011. During the nine months ended September 30, 2012, net cash used in investing activities was primarily the result of the purchases of available-for-sale short-term investments of $66.9 million and capital expenditures of $814,000, partially offset by proceeds from maturities and sales of available-for-sale short-term investments of $64.0 million. During the nine months ended September 30, 2011, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of $58.9 million, partially offset by purchases of available-for-sale short-term investments of $39.0 million and capital expenditures of $2.0 million.

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Cash flows from financing activities. Cash flows from financing activities have historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase programs and principal payments on our lease financing obligations. Net cash used in financing activities was $2.4 million for the nine months ended September 30, 2012, consistent with our cash outflows as compared to the same period in 2011. During the nine months ended September 30, 2012, net cash used in financing activities was primarily the result of $1.2 million worth of shares repurchased from employees for payment of employee taxes on vesting of performance shares and upon exercise of stock options and $1.5 million in principal payments on our building lease financing obligations, partly offset by cash received for the capital infusion of $294,000 by Holley Metering in our joint venture in China. During the nine months ended September 30, 2011, net cash used in financing activities was $2.4 million, a $55,000 decrease in cash outflows as compared to the same period in 2010. During the nine months ended September 30, 2011, net cash used in financing activities was primarily the result of $2.1 million worth of shares repurchased from employees for payment of employee taxes on vesting of performance shares and upon exercise of stock options and $1.3 million in principal payments on our building lease financing obligations, partially offset by proceeds of $945,000 from the exercise of stock options by our employees.

As noted above, our cash and investments totaled $62.7 million as of September 30, 2012. Of this amount, approximately 2% was held by our foreign subsidiaries. Our intent is to permanently reinvest a significant portion of our earnings from foreign operations, and current plans do not anticipate that we will need funds generated from foreign operations to fund our domestic operations. In the event funds from foreign operations are needed to fund operations in the United States and if U.S. tax has not already been previously provided, we would provide for and pay any additional U.S. taxes due in connection with repatriating these funds.

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

We maintain a $10.0 million line of credit with our primary bank, which expires on July 1, 2013. The letter of credit contains certain financial covenants requiring us to maintain an overall minimum tangible net worth level and to maintain a minimum level of liquid assets. As of September 30, 2012, we were in compliance with these covenants. As of September 30, 2012, our primary bank has issued, against the line of credit, one standby letter of credit totaling $113,000. Other than issuing standby letters of credit, we have never drawn against the line of credit, nor have amounts ever been drawn against the standby letters of credit issued by the bank.

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

Based on our current business plan and revenue prospects, we believe that our existing cash reserves will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. However, we currently expect that our combined cash, cash equivalent, and short-term investment balance will decline during 2012. In the event that we require additional financing, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

RELATED PARTY TRANSACTIONS

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

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for $130.7 million. The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our knowledge, Enel has not disposed of any of its 3.0 million shares. Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. A representative of Enel served on our board until March 14, 2012; no Enel representative is presently serving on our board.

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At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the "R&D Agreement"). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from us. Under the software enhancement agreement, we provide software enhancements to Enel for use in its Contatore Elettronico system. The software enhancement agreement expires in December 2012 and the development and supply agreement expires in December 2013, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

For the three months ended September 30, 2012 and 2011, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $1.8 million and $2.0 million, respectively. For the nine months ended September 30, 2012 and 2011, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $3.5 million and $5.0 million, respectively. As of September 30, 2012, and December 31, 2011, none of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

RECENTLY ISSUED ACCOUNTING STANDARDS

There have been no new recent accounting pronouncements or changes in accounting pronouncements during the nine months ended September 30, 2012, that are of significance, or potential significance, to our company.

FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS

Interested persons should carefully consider the risks described below in evaluating our company. Additional risks and uncertainties not presently known to us, or that we currently consider immaterial, may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock would likely decline. Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described in this section. This section should be read in conjunction with the condensed consolidated financial statements and accompanying notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q.

Our Systems revenues may not meet expectations, which could cause volatility in the price of our stock.

We and our partners sell our smart metering and distribution automation products to utilities. For several reasons, sales cycles with utility companies can be extended and unpredictable. Utilities generally have complex budgeting, purchasing, and regulatory processes that govern their capital spending, and their spending is likely to be adversely impacted by continuation of challenging economic conditions. In addition, in many instances, a utility may require one or more field trials of a smart grid system (such as one based on our NES Smart Grid System or our smart grid subsystem products) before moving to a volume deployment. There is also generally an extended development and integration effort required in order to incorporate a new technology into a utility's existing infrastructure. A number of other factors may also need to be addressed before the utility decides to engage in a full-scale deployment of our NES Smart Grid System, including:

- economic factors affecting the utility, in particular, and the area in which it operates, in general;
- regulatory factors, including public utility commission or similar approvals, the outcome and timing of which may be affected by matters unrelated to smart grid deployment; standards compliance; or internal utility requirements that may affect the smart metering system or the timing of its deployment;
- the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments;
- the deployment schedule for projects undertaken by our utility or systems integrator customers; and
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delays in installing, operating, and evaluating the results of a smart grid field trial that is based on our NES Smart Grid System.

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As a result, we can often spend up to two years working either directly or through a reseller to make a sale to a utility. At the end of that lengthy sales process, particularly in view of increasing competition in the Smart Grid market and continuing economic challenges, there is no guarantee that we will be selected by the utility.

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

Once a utility decides to move forward with a large-scale deployment of a smart grid project that is based on our NES Smart Grid System, the timing of and our ability to recognize revenue on our Systems product shipments will depend on several factors. These factors, some of which may not be under our control, include shipment schedules that may be delayed or subject to modification, other contractual provisions, such as customer acceptance of all or any part of the NES Smart Grid System, our ability to manufacture and deliver quality products according to expected schedules, and customer cancellation rights. For example, in October 2011, Duke Energy cancelled certain orders for our products that we anticipated would have been delivered in late 2012 and beyond.

In addition, the revenue recognition rules relating to products such as our NES Smart Grid System may also require us to defer some of our Systems revenues until certain conditions are met in a future period. For example, beginning in the third quarter of 2011, we began shipping hardware products to a customer for which we had not yet delivered a final version of the related firmware. As a result, we were not able to recognize the revenue associated with that hardware until the first quarter of 2012, when the firmware was delivered because payment for the hardware was contingent upon delivery of the firmware.

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

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

If we are unable to receive orders for, ship, and recognize revenue for our products in a timely manner and in line with our targets (and often in the same year), our financial results will be harmed. We have invested and intend to continue to invest significant resources in the development and sales of our products, particularly our Systems products, such as our Smart Grid portfolio of products. Our long-term financial goals include expectations for a reasonable return on these investments, particularly for our Systems products. To date the revenues generated from sales of these Systems products have not yielded gross margins in line with our long term goals for this product line, although our operating expenses have increased significantly. Our Systems products are also experiencing continuing downward pricing pressures due to intense competition. In addition, as we sell more Sub-systems products for the Smart Grid, we may also experience downward pricing pressures that would reduce our gross margins for those products.

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

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