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

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 June 30, 2009

OR

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

For the transition period from to

000-29748

(Commission file number)

ECHELON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**77-0203595**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**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 ¨

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

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

Large accelerated filer	¨	Accelerated filer	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 ¨ No x

As of July 31, 2009, 40,705,965 shares of the registrant s common stock were outstanding.

Table of Contents

ECHELON CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2009

INDEX

FORWARD-LOOKING INFORMATION

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

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ECHELON CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

	June 30, 2009	December 31, 2008
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 11,536	$ 37,669
Short-term investments	70,953	49,647
Accounts receivable, net (1)	13,285	23,480
Inventories	19,382	16,513
Deferred cost of goods sold	2,571	2,482
Other current assets	3,233	4,707
Total current assets	120,960	134,498
Property and equipment, net	38,114	40,574
Goodwill	8,436	8,417
Other long-term assets	992	2,028
Total assets	$ 168,502	$ 185,517
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 7,172	$ 10,675
Accrued liabilities	4,738	5,053
Current portion lease financing obligations	1,519	1,439
Deferred revenues	8,351	8,520
Total current liabilities	21,780	25,687
LONG-TERM LIABILITIES:		
Lease financing obligations, net of current portion	24,603	25,350
Other long-term liabilities	1,570	1,909
Total long-term liabilities	26,173	27,259
STOCKHOLDERS EQUITY:		
Common stock	439	437
Additional paid-in capital	321,402	313,549

Treasury stock	(28,130)	(28,130)
Accumulated other comprehensive income	996	784
Accumulated deficit	(174,158)	(154,069)
Total stockholders equity	120,549	132,571
Total liabilities and stockholders equity	$ 168,502	$ 185,517

(1) Includes related party amounts of $643 as of June 30, 2009 and $4,970 as of December 31, 2008. See Note 11 for additional information on related party transactions.

See accompanying notes to condensed consolidated financial statements.

3

Table of Contents

ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Revenues:				
Product	$ 21,836	$ 31,466	$ 39,225	$ 66,133
Service	810	691	1,604	1,619
Total revenues[2]	22,646	32,157	40,829	67,752
Cost of revenues:				
Cost of product [1]	12,259	18,751	21,899	41,283
Cost of service [1]	601	675	1,249	1,388
Total cost of revenues	12,860	19,426	23,148	42,671
Gross profit	9,786	12,731	17,681	25,081
Operating expenses:				
Product development [1]	8,642	9,402	17,733	18,438
Sales and marketing [1]	5,655	6,162	11,377	12,167
General and administrative [1]	4,086	4,721	7,873	9,236
Total operating expenses	18,383	20,285	36,983	39,841
Loss from operations	(8,597)	(7,554)	(19,302)	(14,760)
Interest and other income (expense), net	(377)	519	(67)	1,178
Interest expense on lease financing obligations	(419)	(265)	(844)	(539)
Loss before provision for income taxes	(9,393)	(7,300)	(20,213)	(14,121)
Income tax (benefit) expense	131	74	(124)	94
Net loss	$ (9,524)	$ (7,374)	$ (20,089)	$ (14,215)
Net loss per share:				
Basic	$ (0.23)	$ (0.18)	$ (0.50)	$ (0.35)
Diluted	$ (0.23)	$ (0.18)	$ (0.50)	$ (0.35)
Shares used in computing net loss per share:				
Basic	40,658	40,774	40,583	40,781
Diluted	40,658	40,774	40,583	40,781

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

Cost of product	$ 348	$ 390	$ 680	$ 753
Cost of service	41	47	93	94
Product development	1,513	1,532	2,777	2,701
Sales and marketing	880	746	1,657	1,443
General and administrative	1,258	1,102	1,876	2,118
Total	$ 4,040	$ 3,817	$ 7,083	$ 7,109

(2) Includes related party amounts of $1,702 and $1,598 for the three months ended June 30, 2009 and 2008, respectively, and $2,991 and $2,915 for the six months ended June 30, 2009 and 2008, respectively. See Note 11 for additional information on related party transactions.

See accompanying notes to condensed consolidated financial statements.

4

Table of Contents

ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net loss	$ (20,089)	$ (14,215)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	3,201	4,255
Reduction of allowance for doubtful accounts	(17)	(44)
Loss on disposal of fixed assets	2	
Reduction of (increase in) accrued investment income	(2)	650
Stock-based compensation	7,083	7,109
Change in operating assets and liabilities:		
Accounts receivable	10,197	18,279
Inventories	(2,889)	(4,600)
Deferred cost of goods sold	(90)	2,291
Other current assets	1,487	(1,986)
Accounts payable	(3,129)	(3,189)
Accrued liabilities	(622)	576
Deferred revenues	(214)	(4,844)
Deferred rent	9	(14)
Net cash provided by (used in) operating activities	(5,073)	4,268
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchases of available-for-sale short-term investments	(64,857)	(30,507)
Proceeds from maturities and sales of available-for-sale short-term investments	43,504	33,104
Change in other long-term assets	1,026	(22)
Capital expenditures	(1,069)	(2,038)
Net cash provided by (used in) investing activities	(21,396)	537
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Principal payments of lease financing obligations	(711)	(1,118)
Proceeds from exercise of stock options	1,018	1,209
Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options	(229)	(717)
Repurchase of common stock under stock repurchase program		(2,634)
Net cash provided by (used in) financing activities	78	(3,260)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	258	270
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(26,133)	1,815

CASH AND CASH EQUIVALENTS:		
Beginning of period	37,669	76,062
End of period	$ 11,536	$ 77,877
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest on lease financing obligations	$ 840	$ 606
Cash paid for income taxes	$ 226	$ 422
Noncash investing and financing information Increase in property and equipment and related lease financing obligation due to lease extension	$	$ 12,526

See accompanying notes to condensed consolidated financial statements.

5

Table of Contents

ECHELON CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

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

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

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

Risks and Uncertainties

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

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

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

Due to the continuing current worldwide economic crisis, coupled with the fact that the Company s NES customers 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.

Use of Estimates

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

Table of Contents

Revenue Recognition

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

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

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

The Company currently sells a limited number of its LonWorks® Infrastructure products that are considered multiple element arrangements under SOP 97-2. Revenue for the software license element is recognized at the time of delivery of the applicable product to the end-user. The only undelivered element at the time of sale consists of post-contract customer support (PCS). The VSOE for this PCS is based on prices paid by the Company s customers for stand-alone purchases of PCS. Revenue for the PCS element is deferred and recognized ratably over the PCS service period. The costs of providing these PCS services are expensed when incurred.

In most instances involving large-scale deployments, the Company s Networked Energy Services (NES) system products are sold as part of multiple element arrangements, which may include electricity meters and data concentrators (collectively, the Hardware); NES system software, for which a royalty is charged on a per-meter basis; PCS for the NES system software; and extended warranties for the Hardware. These arrangements may require the Company to deliver Hardware over an extended period of time. In accordance with SOP 97-2, when the multiple element arrangement includes NES system software, the Company defers the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, the Company recognizes revenues for the Hardware and NES system software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. The Company has established VSOE for the PCS on the NES system software, as well as for extended warranties on its NES Hardware products, based on stated renewal rates. These revenues are recognized ratably over the associated service period, which generally commences upon the later of the delivery of all software, or the customer s acceptance of any given Hardware shipment.

In arrangements which include significant customization or modification of software, the Company recognizes revenue using the percentage-of-completion method, as described in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, if the Company believes it is able to make reasonably dependable estimates of the extent of progress toward completion. The Company measures progress toward completion using an input method based on the ratio of costs incurred, principally labor, to date to total estimated costs of the project. These estimates are assessed continually during the term of the contract, and revisions are reflected when the changed conditions become known. Revenues from these types of arrangements are included in service revenues in the condensed consolidated statement of operations.

The Company accounts for the rights of return, price protection, rebates, and other sales incentives offered to its distributors in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, *Revenue Recognition When Right of Return Exists,* and EITF Issue No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products).*

Table of Contents

Deferred Revenue and Deferred Cost of Goods Sold

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

Recently Issued Accounting Standards

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

On January 1, 2009, the Company adopted the provisions of Statement of Financial Accounting Standards Board (FASB) No. 157 (SFAS 157), *Fair Value Measurements,* for nonfinancial assets and nonfinancial liabilities measured at fair value on a non-recurring basis. These nonfinancial items include goodwill and other long-lived assets measured at fair value for purposes of conducting impairment tests. On April 1, 2009, the Company adopted the provisions of FASB Staff Positions (FSP) FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability has Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4). FSP FAS 157-4 provides additional guidance for estimating fair value in accordance with SFAS No. 157, *Fair Value Measurements*, when the volume and level of activity for the asset or liability have significantly decreased. The adoption of SFAS 157 and FSP FAS 157-4 did not have a material impact on the Company s financial position, results of operations, or cash flows.

On April 1, 2009, the Company adopted the provisions of FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* and FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. FSP FAS 115-2 and FAS 124-2 modifies the requirements for recognizing other-than-temporary impairments of debt securities, changes the existing impairment model for those securities, and modifies the presentation and frequency of related disclosures. FSP FAS 107-1 and APB 28-1 amends FASB No. 107, *Disclosures about Fair Value of Financial Instruments,* to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements and also amends APB Opinion No. 28, *Interim Financial Reporting,* to require those disclosures in summarized financial information at interim reporting periods. The adoption of these FSPs did not have a material impact on the Company s financial position, results of operations, or cash flows.

In May 2009 the FASB issued and the Company adopted SFAS No. 165 (SFAS 165), *Subsequent Events*. SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS 165 requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether the date represents the date the financial statements were issued or were available to be issued. The adoption of SFAS 165 did not have a material impact on the Company s financial position, results of operations, or cash flows.

In June 2009, the FASB issued SFAS No. 168 (SFAS 168), *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162*. SFAS 168 establishes the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in accordance with GAAP. All guidance included in the Codification will be considered authoritative at that time, even guidance that comes from what is currently deemed to be a non-authoritative section of a standard. Once the Codification becomes effective, all non-grandfathered, non-SEC accounting literature not included in the Codification will become non-authoritative. SFAS No. 168 is applicable for interim and annual periods ending after September 15, 2009. This pronouncement will have no effect on the Company s financial position, results of operations, or cash flows. However, upon adoption, all current references to FASB accounting standards will be replaced with references to the applicable codification sections.

2. Financial Instruments

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

On a recurring basis, the Company measures certain of its financial assets, namely its cash equivalents and available-for-sale investments, at fair value in accordance with SFAS 157. 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 June 30, 2009 (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]	$ 5,549	$ 5,549	$	$
Fixed income available-for-sale securities [2]	70,953		70,953	
Total	$ 76,502	$ 5,549	$ 70,953	$

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

		Fair Value Measurements at Reporting Date Using		
	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]	$ 2,399	$ 2,399	$	$
Fixed income available-for-sale securities [2]	82,641		82,641	
Total	$ 85,040	$ 2,399	$ 82,641	$

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

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

All of the $71.0 million of fixed income available-for-sale securities at June 30, 2009 are classified as short-term investments. Of the $82.6 million of fixed income available-for-sale securities at December 31, 2008, approximately $33.0 million are classified as cash equivalents, while the remaining $49.6 million are classified as short-term investments. Cash equivalents consist of either investments with remaining maturities of three months or less at the date of purchase, or money market funds for which the carrying amount is a reasonable estimate of fair value.

Table of Contents

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

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. corporate commercial paper	$ 5,000	$ 5,000	$	$
U.S. government and agency securities	65,927	65,953	26	
Total investments in debt securities	$ 70,927	$ 70,953	$ 26	$

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

3. Earnings Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net loss (Numerator):				
Net loss, basic & diluted	$ (9,524)	$ (7,374)	$ (20,089)	$ (14,215)
Shares (Denominator):				
Weighted average common shares outstanding	40,658	40,774	40,583	40,781
Shares used in basic computation	40,658	40,774	40,583	40,781
Common shares issuable upon exercise of stock options (treasury stock method)				
Shares used in diluted computation	40,658	40,774	40,583	40,781
Net loss per share:				
Basic	$ (0.23)	$ (0.18)	$ (0.50)	$ (0.35)
Diluted	$ (0.23)	$ (0.18)	$ (0.50)	$ (0.35)

For the three and six months ended June 30, 2009 and 2008, the diluted net loss per share calculation is equivalent to the basic net loss per share calculation as there were no potentially dilutive stock options due to the Company s net loss position. The number of stock options, stock appreciation rights, and restricted stock units excluded from this calculation for the three and six months ended June 30, 2009 and 2008 was 7,561,629 and 8,431,216, respectively.

4. Stockholders Equity and Employee Stock Option Plans

Common Stock

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

Table of Contents

Comprehensive Loss

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net loss	$ (9,524)	$ (7,374)	$ (20,089)	$ (14,215)
Other comprehensive income/(loss), net of tax:				
Foreign currency translation adjustment	680	(184)	261	506
Unrealized holding loss on available-for-sale securities	(17)	(44)	(49)	(110)
Comprehensive loss	$ (8,861)	$ (7,602)	$ (19,877)	$ (13,819)

Stock Award Activity

The total intrinsic value of options exercised during the three and six months ended June 30, 2009 was approximately $18,000 and $209,000, respectively. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the awards.

The total fair value of performance shares vested and released during the three and six months ended June 30, 2009 was approximately $706,000 and $807,000, respectively. The fair value is calculated by multiplying the fair market value of the Company s stock on the vesting date by the number of shares vested.

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

As of June 30, 2009, there were 245,337 non-vested share awards (with a grant date fair value of approximately $2.0 million) that were subject to certain financial-based performance requirements that must be achieved before vesting can occur. Of these 245,337 non-vested share awards, 31,250 (that were issued in October 2006 with a grant date fair value of approximately $263,000) contain financial-based performance conditions that must be achieved by October 2010; 87,898 (that were issued in February 2007 with a grant date fair value of approximately $778,000) contain financial-based performance conditions that must be achieved by February 2010; and the remaining 126,189 share awards (that were issued in May 2009 with a grant date fair value of approximately $943,000) contain financial-based performance conditions that must be achieved by May 2014.

Through June 30, 2009, cumulative compensation expense of $220,000 and $60,000 associated with the 31,250 share awards granted in October 2006 and the 126,189 share awards granted in May 2009, respectively, has been recognized assuming that the associated financial performance requirements will be achieved. If such requirements are not met, no compensation cost will be recognized and any recognized compensation cost will be reversed. No compensation expense has been recognized associated with the remaining 87,898 share awards granted in February 2007 as management does not currently expect the financial performance requirements for these awards will be met. During the six months ended June 30, 2009, previously recognized compensation expense of $503,000 associated with these 87,898 share awards was 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 six months ended June 30, 2009 and 2008, the Company had seven customers that accounted for a majority of its revenues: EBV Electronik GmbH (EBV), the Company s primary distributor of its LonWorks® Infrastructure products in Europe; Enel S.p.A. (Enel), an Italian utility company (including Enel s third party meter manufacturers); Duke Energy Corporation (Duke), a U.S. utility company; and Eltel Networks A/S (Eltel), Telvent Energia y Medioambiente SA (Telvent), Limited Liability Company Engineering Center ENERGOAUDITCONTROL (EAC), and ES Elektrosandberg AB (ES), value added resellers of the Company s NES products. For the three and six months ended June 30, 2009 and 2008, the percentage of the Company s revenues attributable to sales made to these customers was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Eltel	23.1%	0.1%	22.4%	0.5%
EBV	15.1%	17.2%	18.7%	16.2%
Enel	7.3%	4.1%	6.4%	3.8%
EAC	5.3%	14.6%	2.9%	8.0%
Telvent	2.9%	5.6%	2.1%	15.3%
ES	1.2%	23.1%	2.1%	24.7%
Duke	0.6%	5.9%	0.8%	3.6%
Total	55.5%	70.6%	55.4%	72.1%

Table of Contents

Of the percentage of sales made to EBV, approximately 0.2% and 0.9% for the three and six months ended June 30, 2009, respectively, and approximately 0.9% and 0.5% for the three and six months ended June 30, 2008, respectively, related to sales of components the Company sold to EBV, which EBV in turn sold to one of Enel s third party meter manufacturers. Elsewhere in this document, those sales are reported as Enel Project revenues. The Company s contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2009. Please refer to Note 11, Related Parties, for additional information regarding the Company s agreements with Enel.

6. Commitments and Contingencies

Legal Actions

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

From time to time, in the ordinary course of business, the Company may be subject to other legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, 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 June 30, 2009, the amounts of which were immaterial, it is possible that the Company s results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

Line of Credit

The Company maintains a $10.0 million line of credit with its primary bank. As of June 30, 2009, the Company s primary bank has issued, against the line of credit, a standby letter of credit totaling $35,000. Other than causing to have issued standby letters of credit, the Company has never drawn against the line of credit, nor have amounts ever been drawn against standby letters of credit issued by the bank.

Table of Contents

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):

	June 30, 2009	December 31, 2008
Purchased materials	$ 5,752	$ 6,844
Work-in-process	46	89
Finished goods	13,584	9,580
	$ 19,382	$ 16,513

8. Accrued Liabilities

Accrued liabilities consist of the following (in thousands):