

ECHELON CORP  
Form 10-Q/A  
May 16, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, DC 20549**

**FORM 10-Q/A**  
**AMENDMENT NO. 1**

(Mark one)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 31, 2007

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

000-29748

(Commission file number)

**ECHELON CORPORATION**

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(Exact name of registrant as specified in its charter)

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

**77-0203595**  
(IRS Employer

Identification Number)

**550 Meridian Avenue**

**San Jose, CA 95126**

(Address of principal executive office and zip code)

**(408) 938-5200**

(Registrant's telephone number, including area code)

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

Yes  No

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

Yes  No

As of April 30, 2007, 39,432,584 shares of the registrant's common stock were outstanding.

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**ECHELON CORPORATION**

**FORM 10-Q/A**

**AMENDMENT NO. 1**

**FOR THE QUARTER ENDED MARCH 31, 2007**

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In this Quarterly Report on Form 10-Q/A we are restating our condensed consolidated balance sheets as of March 31, 2007 and December 31, 2006, and our related condensed consolidated statements of operations and cash flows for each of the quarters ended March 31, 2007 and 2006. As reported on April 22, 2008, during the preparation of our financial results for the quarter ended March 31, 2008, we identified an error in our previously reported equity compensation expense. On April 30, 2008, we reported that we had also inappropriately accounted for the 1999 and 2001 leases of our San Jose, California corporate headquarters facilities.

The effects of all restatement adjustments on our condensed consolidated balance sheets as of March 31, 2007 and December 31, 2007 and 2006 are as follows:

	March 31, 2007	December 31, 2007	December 31, 2006
Increase in total assets	\$ 14.3 million	\$ 12.3 million	\$ 15.0 million
Increase in total liabilities	\$ 17.2 million	\$ 15.2 million	\$ 17.9 million
Increase in additional paid-in-capital	\$ 1.0 million	\$ 2.0 million	\$ 0.8 million
Increase in accumulated deficit	\$ 3.9 million	\$ 4.9 million	\$ 3.7 million

The effects of all restatement adjustments on our condensed consolidated statements of operations for the quarters ended March 31, 2007 and 2006 are as follows:

	Quarter Ended March 31, 2007	Quarter Ended March 31, 2006
Decrease in rent expense	\$ 1.0 million	\$ 1.0 million
Increase in depreciation expense	\$ 0.7 million	\$ 0.7 million
Increase in stock-based compensation expense	\$ 0.2 million	\$ 0.1 million
Increase in interest expense	\$ 0.3 million	\$ 0.4 million
Increase in net loss	\$ 0.2 million	\$ 0.2 million

Included in Note 2 of Notes to Condensed Consolidated Financial Statements in this Report are tables that present the effects of all restatement adjustments on the condensed consolidated financial statements reconciling the previously reported data to the as restated data for the Condensed Consolidated Balance Sheets as of March 31, 2007 and December 31, 2006, and the Condensed Consolidated Statements of Operations and Cash Flows for the quarters ended March 31, 2007 and 2006. The restatements are further discussed below.

***Restatement of stock-based compensation expense:*** During the preparation of our financial results for the quarter ended March 31, 2008, we identified an error in our previously reported stock-based compensation expense for the years ended December 31, 2007, 2006 and 2005, and each of the quarterly periods in 2007 and 2006. The error was isolated to share awards and does not affect the other forms of our equity compensation awards, namely stock options and stock-settled stock appreciation rights. While the grant date fair value of the share awards was determined correctly in accordance with Statement of Financial Accounting Standard ( SFAS ) No. 123R (revised 2004), *Share-Based Payment*, the amount of expense associated with these awards that was recognized in 2007, 2006 and 2005 was not correct. The error was caused by a misapplication of the widely-used equity compensation software application we use to manage and account for our equity compensation awards. This misapplication caused the expense associated with these share awards to be calculated using the straight-line, single-option method rather than the accelerated, multiple-option method, which we had elected to use for all of our equity compensation awards. Use of the straight-line, single-option method resulted in understatements of stock-based compensation expense in 2007, 2006 and 2005 of \$1.2 million, \$535,000 and \$263,000, respectively. For the quarters ended March 31, 2007 and 2006, stock-based compensation expense was understated by \$153,000 and \$145,000, respectively.

***Restatement related to the leases of our San Jose, California headquarters facilities:*** In connection with the restatement of stock-based compensation expense, KPMG LLP, our independent registered public accounting firm, brought to our attention that we had inappropriately accounted for the leases of our corporate headquarters facilities that were entered into in 1999 and 2001. Under the guidance in Emerging Issues Task Force Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction* ( EITF 97-10 ), and SFAS No. 98, *Accounting for Leases: Sale-Leaseback transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; Initial Direct Costs of Direct Financing Leases; an amendment of FASB Statements No. 13, 66, and 91*



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and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11 ( SFAS 98 ), we should have reflected an asset on our balance sheet for the costs paid by the lessor to construct our headquarters facilities, as well as a corresponding liability, because we were the deemed owner of the headquarters facilities for accounting purposes during the construction periods. Upon completion of construction, we did not meet the sale-leaseback criteria under SFAS 98 and therefore should have treated the leases as financing obligations and the assets and corresponding liabilities would not be derecognized. We had historically accounted for these leases as operating leases under SFAS No. 13, *Accounting for Leases* ( SFAS 13 ), whereby the total minimum lease payment obligations under the leases were recognized as monthly rent expense on a straight-line basis over the terms of the leases. The restatement adjustments do not affect the total cash payments we have made or are obligated to make under the lease agreements, nor do they change the total expense to be recognized over the lease terms. However, the timing and nature of expenses in the statement of operations is different under this treatment as compared to operating lease treatment. Specifically, we should have recognized land lease expense, depreciation expense on the assets we are deemed to own and interest expense on the associated lease financing obligations. For a more detailed description of the effects on our condensed consolidated financial statements see Note 2 of Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this Report.

Our management and the Audit Committee of our Board of Directors have concluded that these errors in our Condensed Consolidated Financial Statements were unintentional, and no misdeed or fraud was involved in any respect. The Audit Committee also determined that the error in stock-based compensation expense was in no way caused by any backdating of or similar improper activity involving stock option grants. In conjunction with the Audit Committee, we have determined that the errors are a result of material weaknesses in our internal control over financial reporting, as such term is defined by Securities and Exchange Commission Rule 1-02(a)(4) of Regulation S-X. See further explanation of the material weaknesses and remediation plans in Part I, Item 4 Controls and Procedures (as restated) of this Report.

Except for the matters related to the aforementioned restatements and material weaknesses, this Amendment No. 1 does not modify or update other disclosures in the originally filed Form 10-Q.

The Company will also file amendments to its 2007 Form 10-K and Forms 10-Q for each of the quarters ended June 30, and September 30, 2007. The amended 2007 filings will include restated information for periods affected by these restatements.

This Form 10-Q/A also reflects the restatement of related information contained in (i) Management's Discussion and Analysis of Financial Condition and Results of Operations in Part I, Item 2.

**FORWARD-LOOKING INFORMATION**

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

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

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

	<b>March 31, 2007 (As Restated)<sup>1</sup></b>	<b>December 31, 2006 (As Restated)<sup>1</sup></b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 35,870	\$ 37,412
Short-term investments	85,684	86,745
Accounts receivable, net	17,520	13,918
Inventories	11,075	11,359
Deferred cost of goods sold	6,432	19,060
Other current assets	2,011	2,138
<b>Total current assets</b>	<b>158,592</b>	<b>170,632</b>
Property and equipment, net	29,611	30,405
Goodwill	8,312	8,278
Other long-term assets	1,956	1,957
<b>Total assets</b>	<b>\$ 198,471</b>	<b>\$ 211,272</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 6,420	\$ 6,893
Accrued liabilities	8,502	4,796
Current portion lease financing obligations	2,657	2,579
Deferred revenues	15,066	26,843
<b>Total current liabilities</b>	<b>32,645</b>	<b>41,111</b>
<b>LONG-TERM LIABILITIES:</b>		
Lease financing obligations, net of current portion	15,361	16,052
Deferred rent, net of current portion	429	446
<b>Total long-term liabilities</b>	<b>15,790</b>	<b>16,498</b>
<b>STOCKHOLDERS EQUITY:</b>		
Common stock	418	416
Additional paid-in capital	285,526	283,728
Treasury stock	(19,259)	(19,259)

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Accumulated other comprehensive income	1,121	997
Accumulated deficit	(117,770)	(112,219)
Total stockholders' equity	150,036	153,663
Total liabilities and stockholders' equity	\$ 198,471	\$ 211,272

<sup>1</sup> See Note 2 of Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.  
*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 March 31,	
	2007 (As Restated) <sup>1</sup>	2006 (As Restated) <sup>1</sup>
<b>REVENUES:</b>		
Product	\$ 39,077	\$ 10,574
Service	192	171
Total revenues	39,269	10,745
<b>COST OF REVENUES:</b>		
Cost of product <sup>2</sup>	28,634	4,565
Cost of service <sup>2</sup>	483	436
Total cost of revenues	29,117	5,001
Gross profit	10,152	5,744
<b>OPERATING EXPENSES:</b>		
Product development <sup>2</sup>	7,778	6,959
Sales and marketing <sup>2</sup>	5,427	5,162
General and administrative <sup>2</sup>	3,568	3,265
Total operating expenses	16,773	15,386
Loss from operations	(6,621)	(9,642)
Interest and other income, net	1,497	1,394
Interest expense on lease financing obligations	(319)	(360)
Loss before provision for income taxes	(5,443)	(8,608)
Provision for income taxes	108	80
NET LOSS	\$ (5,551)	\$ (8,688)
Net loss per share:		
Basic	\$ (0.14)	\$ (0.22)
Diluted	\$ (0.14)	\$ (0.22)
Shares used in computing net loss per share:		
Basic	39,227	39,767
Diluted	39,227	39,767

<sup>1</sup> See Note 2 of Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

<sup>2</sup> Amounts include stock-based compensation costs as follows (as restated)<sup>1</sup>:

Cost of product	\$	147	\$	127
Cost of service		16		16
Product development		482		669
Sales and marketing		316		398
General and administrative		372		341

*See accompanying notes to condensed consolidated financial statements.*

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	<b>Three Months Ended March 31,</b>	
	<b>2007 (As Restated)<sup>1</sup></b>	<b>2006 (As Restated)<sup>1</sup></b>
<b>CASH FLOWS USED IN OPERATING ACTIVITIES:</b>		
Net loss	\$ (5,551)	\$ (8,688)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,778	1,713
Loss on disposal of fixed assets	2	
Increase in (reduction of) allowance for doubtful accounts	7	(94)
Reduction of (increase in) accrued investment income	114	(3)
Stock-based compensation	1,333	1,551
Change in operating assets and liabilities:		
Accounts receivable	(3,607)	4,945
Inventories	290	(204)
Deferred cost of goods sold	12,627	(1,078)
Other current assets	136	(646)
Accounts payable	(479)	361
Accrued liabilities	3,713	(2,872)
Deferred revenues	(11,779)	4,495
Deferred rent	(32)	(25)
Net cash used in operating activities	(1,448)	(545)
<b>CASH FLOWS PROVIDED BY INVESTING ACTIVITIES:</b>		
Purchases of available-for-sale short-term investments	(31,783)	(12,842)
Proceeds from maturities and sales of available-for-sale short-term investments	32,768	22,195
Change in other long-term assets	6	17
Capital expenditures	(983)	(1,031)
Net cash provided by investing activities	8	8,339
<b>CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:</b>		
Principal payments of lease financing obligations	(613)	(544)
Proceeds from exercise of stock options	845	
Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options	(377)	
Repurchase of common stock under stock repurchase program	&#1	