ECHELON CORP
Form 10-K/A
May 16, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

AMENDMENT NO. 1

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 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 ________.

Commission file number: 000-29748

ECHELON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**77-0203595**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

550 Meridian Avenue

San Jose, California 95126

(Address of principal executive office and zip code)

(408) 938-5200

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, par value $0.01	The NASDAQ Stock Market LLC (The Nasdaq Global Market)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No x

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 such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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 June 30, 2007, the last business day of the registrant s most recently completed second fiscal quarter, there were 39,672,418 shares of the registrant s common stock outstanding, and the aggregate market value of such shares held by non-affiliates of the registrant (based on the per share closing sale price of $15.63 of such shares on the Nasdaq Global Market on June 29, 2007) was approximately $426.8 million. Shares of the registrant s common stock held by each executive officer and director and by each entity that owns 5% or more of the registrant s outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 29, 2008, 40,810,133 shares of the registrant s common stock, $.01 par value per share, were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Document	**Parts Into Which Incorporated**
Proxy Statement for the Annual Meeting of Stockholders to be held May 27, 2008 (Proxy Statement)	Part III

Table of Contents

ECHELON CORPORATION

FORM 10-K/A

AMENDMENT NO. 1

FOR THE YEAR ENDED DECEMBER 31, 2007

INDEX

		Page
	PART I	5
Item 1.	Business	5
Item 1A.	Risk Factors	12
Item 1B.	Unresolved Staff Comments	20
Item 2.	Properties	20
Item 3.	Legal Proceedings	20
Item 4.	Submission of Matters to a Vote of Security Holders	20
	PART II	20
Item 5.	Market for the Registrant s Common Equity and Related Stockholder Matters	20
Item 6.	Selected Financial Data	22
Item 7.	Management s Discussion and Analysis of Financial Condition and Results of Operations	25
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	41
Item 8.	Financial Statements and Supplementary Data	41
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	41
Item 9A.	Controls and Procedures	42
Item 9B.	Other Information	43
	PART III	44
Item 10.	Directors, Executive Officers and Corporate Governance Matters	44
Item 11.	Executive Compensation	44
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	44
Item 13.	Certain Relationships and Related Transactions and Director Independence	44
Item 14.	Principal Accountant Fees and Services	44
	PART IV	44
Item 15.	Exhibits, Financial Statement Schedule	44
SIGNATURES		83
EXHIBIT INDEX		84

EXPLANATORY NOTE

In this Annual Report on Form 10-K/A we are restating our consolidated balance sheets as of December 31, 2007 and 2006, and our consolidated statements of operations, stockholders equity, comprehensive income (loss), and cash flows for each of the years ended December 31, 2007, 2006 and 2005. In addition, we are restating Part II, Item 6 Selected Financial Data , for each of the years in the 5-year period ended December 31, 2007. 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 consolidated balance sheets as of December 31, 2007 and 2006 are as follows:

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

The effects of all restatement adjustments on our consolidated statements of operations for the years ended December 31, 2007, 2006 and 2005 are as follows:

	Year Ended December 31,		
	2007	2006	2005
Decrease in rent expense	$ 3.9 million	$ 3.9 million	$ 3.9 million
Increase in depreciation expense	$ 2.7 million	$ 2.7 million	$ 2.7 million
Increase in stock-based compensation expense	$ 1.2 million	$ 0.5 million	$ 0.3 million
Increase in interest expense	$ 1.2 million	$ 1.4 million	$ 1.5 million
Increase in net loss	$ 1.2 million	$ 0.7 million	$ 0.6 million

See Note 2 of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Report for further explanation of the effects on our statements of stockholders equity, cash flows and comprehensive income. 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* (SFAS 123R), 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.

Restatement related to the leases of our San Jose, California headquarters facilities: During the reviews of our historical financial statements 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 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

Table of Contents

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 term. 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 consolidated financial statements see Note 2 of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Report.

Our management and the Audit Committee of our Board of Directors have concluded that these errors in our 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 II, Item 9A Controls and Procedures (as restated) of this Report.

Except for 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-K.

The Company will also file amendments to its Forms 10-Q for each of the quarterly periods ended March 31, June 30, and September 30, 2007. The amended 2007 quarterly filings will include restated 2007 and 2006 quarterly information affected by these restatements. See also Note 13 Selected Quarterly Financial Data (Unaudited) (as restated) of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Report for information on the effects of the restatement on the previously reported quarterly data.

This Form 10-K/A also reflects the restatement of related information contained in (i) Business in Part I, Item 1, (ii) Properties in Part I, Item 2, and (iii) Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 for the years ended December 31, 2007, 2006 and 2005.

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 or strategies regarding the future that are forward-looking. These statements include those discussed in Item 1, Business, including General, Markets, Products and Services, Product Development, Marketing, Competition, and Government Regulation in Item 1A, Risk Factors, in Item 2, Properties, in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, including Critical Accounting Policies, Results of Operations, Off-Balance-Sheet Arrangements and Other Contractual Obligations, Liquidity and Capital Resources, Related Party Transactions, Recently Issued Accounting Standards, and elsewhere in this report. In this report, the words anticipate, believe, expect, intend, future, moving toward and 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 factors including, but not limited to, those set forth in the section entitled Risk Factors and elsewhere in this report. 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

ITEM 1. BUSINESS
General

Echelon was incorporated in California in 1988 and reincorporated in Delaware in 1989. We are an ISO 9001 certified company that develops, markets, and sells system and network infrastructure products that enable everyday devices such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves to be made smart and inter-connected. Working together, products and systems equipped with our technology can monitor and save energy, lower costs, improve productivity and enhance service, quality, safety and convenience.

In the building, home, industrial, transportation, and other automation markets, we sell a suite of network infrastructure products to original equipment manufacturers (OEMs). OEMs design in, or embed, our products into their products and systems in order to give their products local intelligence and networking capability. We call the products that we sell to OEMs our LonWorks® Infrastructure, or LWI , product line. Our LWI products include transceivers, control modules, routers, network interfaces, development tools, and software tools and toolkits. Representative customers include BOC Edwards, EnerNOC, Fuji Electric, Fujitsu General, Groupe Schneider, Honeywell, Johnson Controls, NTT Data, Samsung, Schindler Elevator, Siemens, and Trane. By using our LWI products, we believe OEMs can reduce their development time and expense and bring higher quality, more functional products to market than previously possible or than would be possible using alternative development approaches. Additionally, we believe the resulting products can also be energy aware and save energy, and are also lower cost for end-users to install, maintain and operate.

For the electric utility industry we have developed an advanced metering infrastructure system that we call the Networked Energy Services (NES) system. The NES system provides a two-way information and control path between the utility and its customer, which we believe enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. Our primary channel to market for the NES system is through value-added resellers (VARs). Examples of NES VARs and partners include ES Elektrosandberg AB, ES Mätteknik, EVB, Görlitz, Limited Liability Company Engineering Center ENERGOAUDITCONTROL, and Telvent. These VARs in turn add application software, project management, and other value-added services to provide utilities with complete advanced metering systems offerings. Representative end-use customers include Vattenfall and E.ON in Sweden, Nuon in the Netherlands, Integral Energy in Australia, and Duke Energy in the United States.

For system integrators serving the street lighting, remote facility monitoring, and energy management markets, we have developed the *i*.LON® Internet server family of products, which provides a low-cost, robust Internet interface and local control capability for remote devices and systems. We believe that the *i*.LON product family provides a compelling platform for applications that can monitor and substantially reduce energy consumption, lower maintenance costs, and enhance safety and convenience. Representative resellers of *i*.LON based, managed street lighting solutions include EnerNOC, Streetlight Vision, Device Insight, and Intron. Representative end-use customers include the City of Oslo, Norway and the City of Bremen, Germany.

In quick-service restaurants, our LonWorks technology and i.LON Internet Server are being used to monitor and control kitchen equipment and key building systems (including HVAC and lighting) through a single network, in an effort to manage energy use and improve efficiency. For example, the fast-food giant McDonald s is encouraging its kitchen equipment manufacturers to incorporate our LonWorks technology into new equipment as a way to lower operating costs and improve operations. The potential savings for quick-service restaurants is considerable since the average restaurant, operating without an effective control system, spends thousands of dollars a year in energy costs.

We view our system infrastructure and network infrastructure product lines as two complementary sides of the same coin, tied together by a common theme of energy management. We believe that, while each offering has substantial value on its own, together they bring a more comprehensive and valuable solution to the end user and that, over time, our success in system infrastructure applications helps drive success in the network infrastructure applications and vice-versa. For example, we believe that utilities that adopt our NES system become better prospects for *i*.LON-based street lighting systems and for in-home and in-building energy management applications based on our LWI products. We believe the same synergy is present for utilities that first adopt an *i*.LON-based street lighting system. Likewise we believe that because our system products are built on our LWI products, the availability of home and commercial devices based on our LWI products represents an opportunity for utilities to extend the reach of energy management into homes and buildings.

5

Table of Contents

Markets

We market our products and services primarily in North and South America, Europe, Japan, China and other selected Asia Pacific countries. Our principal target markets include the following:

Electric Utilities

We believe the worldwide electric metering industry is transitioning from stand-alone meters or limited-function automatic metering reading (AMR) systems to advanced metering infrastructure (AMI), or smart grid systems. These advanced systems offer two-way communication and multiple services over a common infrastructure to utilities and their customers, and provide the ability to add new functionality over time to future proof the system. While the timing and speed of the transition varies by geography, and even within a given geography by utility, we believe that two principal factors will drive this change: market deregulation, which motivates utilities to increase service quality and flexibility while lowering their cost-to-serve; and growing availability and sustainability concerns, which drive regulators and utilities toward time-of-use pricing, demand response, load shifting, and other programs to reduce both energy consumption and peak-load demand.

To capitalize on this opportunity, Echelon developed the NES system. With a strategy of selling the NES system through our VAR partners, we launched the NES VAR channel and shipped the first release of our NES system products for use in trials in December 2003. We, or more often our VARs or other partners, have installations that are underway or completed in Australia, Austria, Denmark, the Netherlands, Russia, Sweden, and the United States. To date, we have shipped over one million NES meters to customers around the world. We believe that the NES system serves a worldwide market opportunity arising from the need to save energy and reduce carbon emissions. In addition to announced installations, Echelon, or more often our VARs, are participating in many trial and pilot projects.

In June 2000, we began working with the Italian utility Enel to incorporate our technology into Enel s Contatore Elettronico project. Under this project, Enel replaced its existing stand-alone electricity meters with advanced, networked electricity meters at about 27 million of its customers locations in Italy. We completed our scheduled deliveries under this project in 2005. 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 the Contatore Elettronico system. Both the development and supply agreement and the software enhancement agreement expire in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances. Sales to Enel and its meter manufacturers accounted for 10.3% of our total revenues in 2007, 12.4% in 2006, and 36.2% in 2005.

Building Automation

Our LWI product line is used by companies worldwide in most areas of the building automation industry, including access control; automatic doors; elevators; energy management; fire/life/safety; heating, ventilation, and air conditioning (HVAC); lighting; metering; security; and automated window blinds. We believe that our products are widely accepted because they lower installed system cost, reduce ongoing life-cycle costs, and increase functionality. We also believe that an increased global interest in reducing energy consumption both to reduce cost and minimize impact to the environment has become a driving force behind the adoption of our LWI and *i*.LON Internet server products. For example, using a LonWorks building management system to integrate and optimize HVAC, lighting, security, and other subsystems, the Crown Estate headquarters building in London was able to achieve 33% less carbon dioxide emissions than that of a comparable building and was awarded the highest rating possible by BREEAM, a U.K. assessment method that rates the environmental performance of new and existing buildings. Our OEM customers in the building automation market include Groupe Schneider, Honeywell, Johnson Controls, Philips Lighting, Schindler Elevator, Siemens, and Yamatake. Sales to Honeywell, both direct and through distribution, accounted for approximately 4.3% of our total revenues in 2007 and 11.0% of our total revenues in 2006.

Industrial Automation

Our LWI products are used in a wide range of industrial automation applications, including semiconductor fabrication plants, gas compressor stations, gasoline tank farms, oil pumping stations, water pumping stations, textile dyeing machinery, pulp and paper processing equipment, automated conveyor systems, and many other industrial environments. In such industrial installations, among other advantages, our control networks can replace complex wiring harnesses, reduce installation costs, eliminate expensive programmable logic controllers and distribute control among sensors, actuators and other devices, thereby reducing system costs, improving control and eliminating the problem of a single point of failure. For example, BOC Edwards, a leading supplier of vacuum pumping systems to the semiconductor industry, uses our products within certain vacuum pump products to replace complex wiring used to connect various motors, sensors, actuators, and displays. In addition to BOC Edwards, our OEM customers in the industrial automation market include Fuji Electric, Hitachi, Meissner & Wurst, and

Yokagawa.

Table of Contents

Demand Response

Echelon s products, including the i.LON Internet Server and SmartServer, are being used by several energy management companies to implement automated demand response solutions, that help business customers manage energy use and control energy costs during peak electricity periods.

Street Lighting

We believe that the street lighting market, which we estimate contains about 740 million street light poles worldwide, represents a large market opportunity for our LWI and *i*.LON Internet server products. Through the combination of our power line smart transceiver product built into ballasts to provide local intelligence, control, and reliable networking, and our *i*.LON Internet server, which provides local control and remote Internet connectivity, LonWorks based street lighting systems can reduce energy consumption and cut maintenance costs through remote diagnostics and predictive failure reporting while enhancing safety and lighting quality. For example, the City of Oslo, Norway is in the process of replacing ballasts in 55,000 streetlights with electronic ballasts that communicate over existing power lines using Echelon s power line technology. Preliminary results have demonstrated energy reduction of over 50% and cost reductions on the order of 30%. Our OEM customers and reseller partners in the street lighting market include Luminext, Device Insight, Kongsberg Analogic, Philips Lighting Control, SELC, and Streetlight Vision.

Home Control

While the market for home automation and control is still in its infancy, we believe that product innovations we have made to simplify the installation of such devices, coupled with a growing consumer demand for green products that can help devices manage and reduce and control their energy costs, has created a new opportunity in the market for networked home control products. In response to this opportunity, in November 2006 we launched the Digital Home® Alliance. The Digital Home Alliance is designed to bring together a collection of companies that market networked home control products based upon Echelon s LonWorks control networking technology and promote to consumers the value of the Digital Home Alliance logo as a mark of products that network together, are easy to install, and add value to consumers lives.

Transportation

Our products are used in important transportation applications, including railcars, light rail, buses, motor coaches, fire trucks, naval vessels, and aircraft. Our control networks can be used in these transportation systems to improve efficiency, reduce maintenance costs, and increase safety and comfort. LonWorks technology is one of the standards required by the New York City Transit Authority when evaluating replacement alternatives for its subway cars. Key OEMs in the transportation market include Bombardier, Kawasaki, New York Air Brake, and Siemens.

Products & Services

We offer a wide-ranging set of products and services. These products help our customers maximize development efficiency, minimize product cost, and maximize the opportunity to integrate across product lines and industry segments. Our products are built on a common technology base with sharing between products wherever possible.

Our LWI network infrastructure products include *transceivers*, *control modules*, *routers*, *network interfaces*, *development tools*, and *software tools and toolkits*. *Transceivers* and *control modules* are products that our OEM customers use to embed networking and intelligence into their products. In 2005, we announced a new embedded control networking platform, called Pyxos and in late 2006 we began deliveries of the first products based on this platform, which includes development tools and the Pyxos FT chip, which is designed to be built into the sensors and actuators embedded inside a machine. Sales of transceivers and control modules generated approximately 25.4% of our revenues during 2007, 53.5% of our revenues during 2006, and 38.1% of our revenues during 2005. *Routers* are used to control and partition network traffic, increasing the total throughput and speed of the system or to provide transparent support for multiple media, which makes it possible to signal between different types of media, such as twisted pair, power line, radio frequency, and optical fiber. *Network interfaces* are products that can be used to connect computers and controllers to a LonWorks network. Our Mini EVK and NodeBuilder® *development tools* are designed to make it easy for OEMs to design our transceivers and control modules into their products and systems. Our *software tools and toolkits* include our LNS® network operating system, which provides a client-server platform for installing, maintaining, monitoring, and interfacing with LonWorks networks, and the LNS based LonMaker® Integration Tool, which built on the Microsoft Visio technical drawing package to give users a graphical, drag and drop environment for designing their network s control system.

Our system infrastructure products include the *i*.LON family of Internet servers and the NES system. Our *i*.LON products provide cost-effective, secure LAN, WAN, and Internet connectivity to everyday devices in control networks. The *i*.LON 100 Internet server also includes a number of

capabilities specifically designed to simplify the implementation and increase the functionality of LonWorks-based street lighting and remote facility monitoring and energy management applications. Our NES system is designed to provide the core networking infrastructure necessary to build and deploy an advanced metering system. It includes a family of

digital electricity meters, a family of data concentrators, and the NES system software. NES electricity meters are designed to meet the needs of residential and light commercial users. Since electricity meters are measurement devices used to bill consumers many, but not all, countries require that meters be certified (or homologated) by a recognized authority to verify their accuracy. As of December 31, 2007, NES meters had been homologated in 17 countries. However, each new version of one of our meters will generally require re-homologation. The mechanical form-factor and characteristics also vary by country. Our initial set of NES meters conformed to the IEC standards used throughout most of Europe and parts of Asia. In 2006 we added additional products that meet the BS standards used in the UK and many former British Colonies, the AS standards used in Australia, and meters that conform to the ANSI form-factor used throughout the United States and Canada. NES data concentrators are designed to reduce system cost by enabling all of the electricity on a given low voltage transformer to share a single wide area connection. Data concentrators are offered in different configurations based upon the number of meters that they are designed to manage. Data concentrators connect to the wide area network using an industry standard modem interface and communicate using Internet standard TCP/IP, allowing our resellers and their utility customers to select a wide variety of available connectivity options including GPRS (general packet radio service), GSM (Global System for Mobile communications), PSTN (public switched telephone networks), BPL (broadband over power line), WiFi, WiMax, Fiber Optic, Ethernet and others. The NES system software is enterprise software designed to allow our customers to quickly integrate the NES system into a utility s business processes and systems. Through the NES system software, the NES system, in effect, looks like a collection of web services and events, allowing a wide range of industry standard tools and operating environments to be used. The NES system software is designed to scale from low cost, single server implementations for small pilots, to large scale systems distributed physically and geographically across multiple servers to support millions of meters with high reliability, availability, and scalability requirements.

We also offer a variety of technical training courses covering our products and technology. These courses are designed to provide hands-on, in-depth and practical experience that can be used immediately by our customers to build products and systems based on our products. In some instances these classes are also licensed to third-parties in foreign markets who present them in the local language. Additionally, we offer a variety of computer-based training courses that can be taken over the Internet. We also offer telephone, e-mail, and on-site technical support to our customers on an annual contract or per-incident basis. The goal of these support services to resolve customers technical problems on a timely basis, ensure that our products will be used properly, and shorten the time required for our customers to develop products that use our technology.

Product Development

Our future success depends in large part on our ability to enhance existing products, reduce product cost, and develop new products that maintain technological competitiveness. We have made and intend to continue to make substantial investments in product development. We obtain extensive product development input from customers and by monitoring end-user needs and changes in the marketplace. We continue to make significant engineering investments in developing and enhancing our products and broadening the markets they serve.

Our total expenses for product development were $32.6 million for 2007 (as restated), $28.2 million for 2006 (as restated), and $24.9 million for 2005 (as restated). Included in these totals were stock-based compensation expenses of $2.8 million (as restated), $2.1 million (as restated), and $246,000 (as restated), for the years ended December 31, 2007, 2006, and 2005, respectively. In addition, of the $24.9 million of product development expenses incurred in 2005, approximately $37,000 related to amortization charges for intangible assets acquired in prior years. We anticipate that we will continue to commit substantial resources to product development in the future and, as a result, product development expenses may continue to increase over historical levels. To date, we have not recorded any capitalized software development costs from our development efforts.

Marketing

Our marketing efforts focus on creating awareness of our brand, the products and solutions that we offer, and the capabilities and benefits that they bring. We conduct an integrated marketing program comprised of press releases, brochures, published papers, case studies, participation in industry trade shows, speaking at industry conferences, webinars, advertising, direct mail, newsletters, our global website, and the LonWorld® industry exhibition and conference. We have also formed and actively participate in two associations directly focused on the adoption of our products, LonMark® International and the Digital Home Alliance, and participate in other relevant industry organizations.

Sales and Distribution

In most regions of the world we market and sell our products and services using our direct sales organization, distributors, value-added resellers, and integration partners. We rely solely on distributors in certain markets in the Asia Pacific and Latin America regions. During the three years ended December 31, 2007, the Company had five 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), and Telvent Energia y Medioambiente SA (Telvent), Limited Liability Company Engineering Center ENERGOAUDITCONTROL (EAC), and ES

Table of Contents

Elektrosandberg AB (ES), value added resellers of the Company s NES products. For the years ended December 31, 2007, 2006, and 2005, the percentages of the Company s revenues attributable to sales made to these customers were as follows:

	Year Ended December 31,		
	2007	2006	2005
Telvent	28.2%	%	%
EBV	12.8%	27.1%	21.0%
ES	11.4%	0.1%	%
Enel	10.3%	12.4%	36.2%
EAC	7.2%	%	%
Total	69.9%	39.6%	57.2%

We support our worldwide sales personnel with application engineers and technical and industry experts working in our headquarters. Outside the United States, direct sales, applications engineering, and customer support are conducted through our offices in China, France, Germany, Hong Kong, Italy, Japan, the Netherlands, South Korea, and the United Kingdom. Each of these offices is staffed primarily with local employees.

Our international sales include both export sales and sales by international subsidiaries and accounted for 86.6% of our total revenues for 2007, 65.5% of our total revenues for 2006, and 77.1% of our total revenues for 2005.

Manufacturing

Our manufacturing strategy is to outsource production to third parties where it reduces our costs and to limit our internal manufacturing to such tasks as quality inspection, system integration, custom configuration, testing, and order fulfillment. We maintain manufacturing agreements with Cypress and Toshiba related to the Neuron® Chip. We also maintain manufacturing agreements with STMicroelectronics for production of our power line transceiver, with Cypress for production of our free topology transceiver, and with Cypress, On Semiconductor, and AMI Semiconductor for the production of certain other components we sell.

For most of our products requiring assembly, we use contract electronic manufacturers including WKK Technology, TYCO, Jabil, and Flextronics. These contract electronic manufacturers procure material and assemble, test, and inspect the final products to our specifications.

Working Capital

As of December 31, 2007, we had working capital, defined as current assets less current liabilities, of $126.7 million (as restated), which was a decrease of approximately $2.8 million compared to working capital of $129.5 million (as restated) as of December 31, 2006.

As of December 31, 2007, we had cash, cash equivalents, and short-term investments of $107.2 million, which was a decrease of approximately $17.0 million compared to a balance of $124.2 million as of December 31, 2006. Cash used in operating activities in 2007 of $13.1 million (as restated) was primarily the result of our net loss of $15.7 million (as restated) and a net increase in our operating assets and liabilities of $13.2 million (as restated), all of which was partially offset by non-cash charges for stock-based compensation expenses of $7.8 million (as restated), depreciation and amortization expenses of $7.4 million (as restated), and a decrease in accrued investment income of $436,000.

Competition

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, and changes in customer requirements. To maintain and improve our competitive position, we must keep pace with the evolving needs of our customers and continue to develop and introduce new products, features and services in a timely and efficient manner. The principal competitive factors that affect the markets for our products include:

our ability to anticipate changes in customer requirements and to develop new or improved products that meet these requirements in a timely manner;

the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;

our product reputation, quality, performance, and conformance with established industry standards;

Table of Contents

- our customer service and support;
- warranties, indemnities, and other contractual terms; and
- customer relationships and market awareness.

In each of our markets, our competitors include both small companies as well as some of the largest companies in the electronics industry operating either alone or together with trade associations and partners. Our key competitors include companies such as Siemens in the building industry; Allen-Bradley (a subsidiary of Rockwell Automation), Groupe Schneider and Siemens in the industrial automation industry; the Bayard Capital group of companies, DCSI, Elster, Enel, GE, IBM, Iskraemeco, Itron/Actaris, and Siemens in the utility industry; Siemens in the transportation industry; and Zensys in the home control market. Key industry standard and trade group competitors include BACnet, Konnex, and DALI in the buildings industry; Profibus, HART, and DeviceNet in the industrial control market; DLMS in the utility industry; Zigbee and the ZWave alliance in the home control market; and the Train Control Network (TCN) in the rail transportation market. Each of these standards and/or alliances is backed by one or more competitors. For example, the Zigbee alliance includes over 150 member companies with promoter members such as Eaton, Freescale, Motorola, Texas Instruments, STMicroelectronics, Ember, Siemens, Honeywell, Mitsubishi Electric, Samsung, Schneider Electric, Tendril, Huawei Technologies, and Philips.

Additionally, while our product implementations are proprietary to Echelon and often protected by unique, patented implementations, LonWorks technology is open, meaning that many of our basic control networking patents are broadly licensed without royalties or license fees. For instance, all of the network management commands required to develop software that competes with our LNS software are published. As a result, our customers are capable of developing hardware and software solutions that compete with many of our products.

Government Regulation

Many of our products and the industries in which they are used are subject to U.S. and foreign regulation as well as local, industry-specific codes and requirements. While we believe that changes in environmental regulations can benefit our sales due to the demonstrated ability of our products to reduce and better manage energy consumption, government regulatory action could also greatly reduce the market for our products or cause us to undertake significant development efforts to make our products compliant, as was the case with the Restriction of Hazardous Substances (RoHS) regulations that went into effect in Europe in 2006. Some of our competitors have also attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their products. We have resisted these efforts and will continue to oppose competitors efforts to use regulation to impede competition in the markets for our products.

Proprietary Rights

We own numerous patents, trademarks, and logos. As of February 29, 2008, we had received 100 United States patents, and had 5 patent applications pending. Some of these patents have also been granted in selected foreign countries. Many of the specific patents that are fundamental to LonWorks technology have been licensed to our customers with no license fee or royalties. At present, the principal value of the remaining patents relates to our specific implementation of our products and designs.

We hold several trademarks in the United States, many of which are registered, including Echelon, LonBuilder®, LonMark, LonTalk®, LonWorks, Neuron, LON, LonPoint®, LonUsers®, LonMaker, 3120®, 3150®, LNS, LonManager®, Digital Home, and NodeBuilder. We have also registered some of our trademarks and logos in foreign countries.

Employees

As of February 29, 2008, we had 319 employees worldwide, of which 148 were in product development, 67 were in sales and marketing, 53 were in general and administrative, 39 were in operations, and 12 were in customer support and training. About 212 employees are located at our headquarters in California and 45 employees are located in other offices throughout the United States. Our remaining employees are located in ten countries worldwide, with the largest concentrations in Germany, Japan, the Netherlands, the United Kingdom, and Hong Kong. None of our employees is represented by a labor union. We have not experienced any work stoppages and we believe relations with our employees are good.

Where to Find More Information

We make our public filings with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all exhibits and amendments to these reports, available free of charge at our website, www.echelon.com, as soon as reasonably practicable after we file such material with the SEC. These materials

Table of Contents

are located in the Investor Relations portion of our Web site under the link SEC Filings. The inclusion of our Web site address in this report does not include or incorporate by reference into this report any information on our Web site. Copies of our public filings may also be obtained from the SEC Web site at www.sec.gov.

Executive Officers of the Registrant

M. Kenneth Oshman, age 67, has been our Chairman and Chief Executive Officer since December 1988. He also served as our President from 1988 to 2001. Prior to joining Echelon, Mr. Oshman, with three associates, founded ROLM Corporation, a telecommunications equipment company, in 1969. He was Chief Executive Officer, President, and a director of ROLM from its founding until its merger with IBM in 1984. Following the merger, he became a Vice President of IBM and a member of the Corporate Management Board. He remained in that position until 1986. Prior to founding ROLM, Mr. Oshman was a member of the technical staff at Sylvania Electric Products from 1963 to 1969. In addition to his responsibilities at our company, Mr. Oshman serves as a director of Sun Microsystems. Mr. Oshman earned B.A. and B.S.E.E. degrees from Rice University and M.S. and Ph.D. degrees in Electrical Engineering from Stanford University.

Beatrice Yormark, age 63, has been our President and Chief Operating Officer since September 2001. She served as our Vice President of Marketing and Sales from January 1990 to August 2001. Ms. Yormark joined our company from Connect, Inc., an on-line information services company, where she was the Chief Operating Officer. Before joining Connect, Ms. Yormark held a variety of positions, including Executive Director of Systems Engineering for Telaction Corporation, Director in the role of Partner at Coopers & Lybrand, Vice President of Sales at INTERACTIVE Systems Corporation, and various staff positions at the Rand Corporation. In addition to her responsibilities at our company, Ms. Yormark serves as a director of ID Systems, (NASDAQ: IDSY). Ms. Yormark holds a B.S. degree in Mathematics from City College of New York and a M.S. degree in Computer Science from Purdue University.

Oliver R. Stanfield, age 58, has been our Executive Vice President & Chief Financial Officer since September 2001. He served as our Vice President and Chief Financial Officer from March 1989 to August 2001. Mr. Stanfield joined our company from ROLM, where he served in several positions since 1980, including: Director of Pricing; Vice President, Plans and Controls; Vice President, Business Planning; Vice President, Financial Planning and Analysis; Treasurer; and Controller, Mil Spec Division. Prior to joining ROLM, Mr. Stanfield worked for ITEL Corporation, Computer Automation and Rockwell International. Mr. Stanfield began his business career with Ford Motor Company in 1969 in various accounting positions while completing a B.S. degree in Business Administration and an M.B.A. degree from the University of Southern California.

Anders B. Axelsson, age 48, has been our Senior Vice President of Sales & Marketing since June 2003. Prior to joining our company, he was Chief Executive Officer of PowerFile, Inc. From 1999 to 2001, he was President/General Manager of Snap Appliances, Inc. Between 1992 and 1999, he worked for Measurex, which was later acquired by Honeywell, and served in several positions, including Vice President of Engineering and Marketing and President/Managing Director for Europe. Mr. Axelsson started his career with ABB in 1981 where he worked for 11 years in various sales, marketing, and engineering management positions. He holds a B.S. in Electrical Engineering from ED Technical Institute in Jonkpoing, Sweden and is a graduate of the Executive Program at the University of Michigan.

Kathleen Bloch, age 51, has been our Senior Vice President and General Counsel since February 2003. Prior to joining our company, Ms. Bloch was a partner in the law firm of Wilson Sonsini Goodrich & Rosati, P.C., where she practiced from 1996 to 2003. Prior to joining Wilson Sonsini Goodrich & Rosati, she was a partner with the San Francisco and Los Angeles offices of Sheppard Mullin Richter & Hampton. Ms. Bloch received a B.S. degree in Business Administration from the University of Southern California and her law degree from Stanford Law School.

Frederik Bruggink, age 52, has been our Senior Vice President and General Manager of our Service Provider Group since July 2002. He served as our Senior Vice President of Sales and Marketing from September 2001 to June 2002, and as our Vice President, Europe, Middle East and Africa, from April 1996 to August 2001. Mr. Bruggink joined our company in 1996 from Banyan Systems, where he was Vice President, Europe. From 1985 to 1993, Mr. Bruggink held several positions at Stratus Computer, including General Manager for Holland, Benelux, and Northern Europe. His last position at Stratus was Vice President, Northern Europe. Prior to joining Stratus, he held sales positions at Burroughs Computers. Mr. Bruggink attended the University of Leiden.

Russell Harris, age 46, joined us in September 2001 as our Senior Vice President of Operations. Mr. Harris also manages our hardware engineering organization. Prior to joining our company, he served as the Vice President of Operations for NetDynamics from 1996 until its acquisition by Sun Microsystems in 1998. From 1998 to 1999, Mr. Harris served in a management transition role for Sun Microsystems. From 1991 to 1996, Mr. Harris was the Director of Operations at Silicon Graphics, Inc. From 1985 through 1991, he held various positions at Convergent Technologies and Unisys Corporation. His last position at Unisys was as Director of IT for Worldwide Operations. Mr. Harris earned B.S. and M.S. degrees in Industrial Engineering from Stanford University.

ITEM 1A. RISK FACTORS

Interested persons should carefully consider the risks described below in evaluating our company. Additional risks and uncertainties not presently known to us, or that we currently consider immaterial, may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock would likely decline.

Our NES revenues may not be predictable.

We and our partners sell our NES system to utilities. For several reasons, sales cycles with utility companies are generally extended and unpredictable. Utilities generally have complex budgeting, purchasing, and regulatory processes that govern their capital spending. In addition, in many instances, a utility may require one or more field trials of automated meter infrastructure (AMI) projects that is based on our NES system before moving to a volume deployment. There is also generally an extended development and integration effort required in order to incorporate a new technology into a utility s existing infrastructure. A number of other factors may also need to be addressed before the utility decides to engage in a full-scale deployment of our NES system, including:

- the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments;
- the deployment schedule for projects undertaken by our utility or systems integrator customers; and
- delays in installing, operating, and evaluating the results of an AMI field trial that is based on our NES system.

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

Once a utility decides to move forward with a large-scale deployment of an AMI project that is based on our NES system, the timing of and our ability to recognize revenue on our NES system product shipments will depend on several factors. These factors, some of which may not be under our control, include shipment schedules that may be delayed or subject to modification, other contractual provisions, such as customer acceptance of all or any part of the AMI system, and our ability to manufacture and deliver quality products according to expected schedules. In addition, the complex revenue recognition rules relating to products such as our NES system may also require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period. As a consequence, our ability to predict the amount of NES revenues that we may expect to recognize in any given fiscal quarter is likely to be limited. As NES revenues account for an increasing percentage of our overall revenues, we and our investors may have increasing difficulty in projecting our financial results.

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

We have invested and intend to continue to invest significant resources in the development and sales of our NES system. Our long-term financial goals include expectations for a reasonable return on these investments. However, to date the revenues generated from sales of our NES system products have not yielded gross margins in line with our long term goals for this product line, while our NES related operating expenses have increased significantly.

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

- Increase market acceptance of our NES system products in order to increase revenues;

- Increase gross margin from our NES revenues by continuing to reduce the cost of manufacturing our NES system products;
- Manage the manufacturing transition to reduced-cost NES products; and
- Manage our operating expenses to a reasonable percentage of revenues.

We cannot assure you that we will meet any or all of these objectives to the extent necessary to achieve our financial goals.

Table of Contents

We depend on a limited number of key suppliers.

Our future success will depend significantly on our ability to timely manufacture our products cost-effectively, in sufficient volumes, and in accordance with quality standards. For most of our products requiring assembly, we rely on a limited number of contract electronic manufacturers (CEMs), principally WKK Technology (WKK), TYCO, Jabil, and Flextronics. These CEMs procure material and assemble, test, and inspect the final products to our specifications. This strategy involves certain risks, including reduced control over quality, costs, delivery schedules, availability of materials, components, and finished products, and manufacturing yields. In addition, CEMs can experience turnover and instability, exposing us to additional risks as well as missed commitments to our customers.

We also maintain manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products, including those used in our NES system. The Neuron Chip, which is an important component that we and our customers use in control network devices, is currently manufactured and distributed by two providers, Toshiba and Cypress Semiconductor. Another semiconductor supplier, STMicroelectronics, manufactures our power line smart transceiver products, for which we have no alternative source. In addition, we currently purchase several key products and components from sole or limited source suppliers with which we do not maintain signed agreements that would obligate them to supply to us on negotiated terms.

We may elect to change any of these key suppliers. For example, we are currently in the process of ending our relationship with WKK and moving the production of products WKK builds for us to alternative CEMs. This transition will require us to purchase inventory from WKK that WKK procured in anticipation of our production requirements. In addition, we currently have capital equipment located at WKK that must be relocated to the new CEMs in order to continue manufacturing our products there. In addition, if any of our key suppliers were to stop manufacturing our products or supplying us with our key components, it could be expensive and time consuming to find a replacement. Also, as our NES business grows, we will be required to expand our business with our key suppliers or find additional sources of supply, as we have recently done with Flextronics and Jabil. There is no guarantee that we would be able to find acceptable alternative or additional sources. Additional risks that we face if we must transition between CEMs include:

- moving raw material, in-process inventory, and capital equipment between locations, some of which may be in different parts of the world;
- reestablishing acceptable manufacturing processes with a new work force; and
- exposure to excess or obsolete inventory held by contract manufacturers for use in our products.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with our product, assembly and test specifications could adversely affect our revenues and gross profit, and could result in claims against us by our customers, which could harm our results of operations and financial position.

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

In the event of late deliveries, late or improper installations or operations, failure to meet product specifications or other product failures, failure to achieve performance specifications, indemnities or other compliance issues, the agreements governing the sales of the NES system may expose us to penalties, damages and other liabilities. Even in the absence of such contractual provisions, we may agree to assume certain liabilities for the benefit of our customers. Any such liabilities would have an adverse effect on our financial condition and operating results.

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

We may be vulnerable to price increases for products, components, or materials, such as copper and cobalt. In addition, in the past we have occasionally experienced shortages or interruptions in supply for certain of these items, including products or components that have been or will be discontinued, which caused us to delay shipments beyond targeted or announced dates. To help address these issues, we may decide to purchase quantities of these items that are in excess of our estimated requirements. As a result, we could be forced to increase our excess and obsolete inventory reserves to provide for these excess quantities, which could harm our operating results.

If we experience any shortage of products or components of acceptable quality, or any interruption in the supply of these products or components, or if we are not able to procure them from alternate sources at acceptable prices and within a reasonable period of time, our revenues, gross profits or both could decrease. In addition, under the terms of some of our contracts with our customers, we may also be subject to penalties if we fail to deliver our products on time.

Table of Contents

The markets for our products are highly competitive.

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, rapid changes in customer requirements, and localized market requirements. In each of our markets, we compete with a wide array of manufacturers, vendors, strategic alliances, systems developers and other businesses.

The principal competitive factors that affect the markets for our products include the following:

- our ability to anticipate changes in customer requirements and to develop or improve our products to meet these requirements in a timely manner;
- the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;
- our product reputation, quality, performance, and conformance with established industry standards;
- our ability to meet a customer s required delivery schedules;
- our customer service and support;
- warranties, indemnities, and other contractual terms; and
- customer relationships and market awareness.

Competitors for our NES system products include the Bayard Capital group of companies, DCSI, Elster, Enel, General Electric, Iskraemeco, Itron/Actaris, Kamstrup, Sensus, and Siemens, which directly or through IT integrators such as IBM or telecommunications companies such as Telenor, offer metering systems that compete with our NES system offering.

For our LWI products, our competitors include some of the largest companies in the electronics industry, operating either alone or together with trade associations and partners. Key company competitors include companies such as Siemens in the building industry; Allen-Bradley (a subsidiary of Rockwell Automation), Groupe Schneider and Siemens in the industrial automation industry; Siemens in the transportation industry; and Zensys in the home control market. Key industry standard and trade group competitors include BACnet, DALI, and Konnex in the buildings industry; DeviceNet, HART, and Profibus in the industrial control market; DLMS in the utility industry; Echonet, Zigbee and the Z-Wave alliance in the home control market; and the Train Control Network (TCN) in the rail transportation market. Each of these standards and/or alliances is backed by one or more competitors. For example, the Zigbee alliance includes over 150 member companies with promoter members such as Eaton, Freescale, Motorola, Texas Instruments, STMicroelectronics, Ember, Siemens, Honeywell, Mitsubishi Electric, Samsung, Schneider Electric, Tendril, Huawei Technologies, and Philips.

Many of our competitors, alone or together with their trade associations and partners, have significantly greater financial, technical, marketing, service and other resources, significantly greater name recognition, and broader product offerings. In addition, the utility metering market is experiencing a trend towards consolidation. As a result, these competitors may be able to devote greater resources to the development, marketing, and sale of their products, and may be able to respond more quickly to changes in customer requirements or product technology. If we are unable to compete effectively in any of the markets we serve, our revenues, results of operations, and financial position would be harmed.

Liabilities resulting from defects in or misuse of our products, whether or not covered by insurance, may delay our revenues and increase our liabilities and expenses.

Our products may contain undetected errors or failures when first introduced, as new versions are released, or as a result of the manufacturing or shipping process. In addition, our customers or their installation partners may improperly install or implement our products, which could delay completion of a deployment or hinder our ability to win a subsequent award. Furthermore, because of the low cost and interoperable nature of our products, LONWORKS technology could be used in a manner for which it was not intended.

If errors or failures are found in our products, we may not be able to successfully correct them in a timely manner, or at all. Such errors or failures could delay our product shipments and divert our engineering resources while we attempt to correct them. In addition, we could decide to extend the warranty period, or incur other costs outside of our normal warranty coverage, to help address any known errors or failures in our products and mitigate the impact on our customers. This could delay our revenues and increase our expenses.

To address these issues, the agreements we maintain with our customers may contain provisions intended to limit our exposure to potential errors and omissions claims as well as any liabilities arising from them. In certain very limited instances, these agreements require that we be named as an additional insured on our customers insurance policies. However, our customer contracts and additional insured coverage may not effectively protect us against the liabilities and expenses associated with errors or failures attributable to our products.

Defects in our products may also cause us to be liable for losses in the event of property damage, harm or death to persons, claims against our directors or officers, and the like. Such liabilities could harm our reputation, expose our company to liability, and adversely affect our operating results and financial position.

To help reduce our exposure to these types of liabilities, we currently maintain property, general commercial liability, errors and omissions, directors and officers, and other lines of insurance. However, it is possible that such insurance may not be available in the future or, if available, may be insufficient in amount to cover any particular claim, or we might not carry insurance that covers a specific claim. In addition, we believe that the premiums for the types of insurance we carry will continue to fluctuate from period to period. Significant cost increases could also result in increased premiums or reduced coverage limits. Consequently, if we elect to reduce our coverage, or if we do not carry insurance for a particular type of claim, we will face increased exposure to these types of claims.

If we do not maintain adequate distribution channels, our revenues will be harmed.

We market our NES system products directly, as well as through selected VARs and integration partners. We believe that a significant portion of our NES system sales will be made through our VARs and integration partners, rather than directly by our company. To date, our VARs and integration partners have greater experience in overseeing projects for utilities. As a result, if our relationships with our VARs and integration partners are not successful, or if we are not able to create similar distribution channels for our NES system products with other companies in various geographic areas, revenues from sales of our NES system products may not meet our financial targets, which will harm our operating results and financial condition.

Currently, significant portions of our LWI revenues are derived from sales to distributors, including EBV, the primary independent distributor of our products to OEMs in Europe. Historically, sales to EBV, as well as sales to our other distributor partners, have accounted for a substantial portion of our total LWI revenues. Agreements with our distributor partners are generally renewed on an annual basis. If any of these agreements are not renewed, we would be required to locate another distributor or add our own distribution capability to meet the needs of our end-use customers. Any replacement distribution channel could prove less effective than our current arrangements. In addition, if any of our distributor partners fail to dedicate sufficient resources to market and sell our products, our revenues would suffer. Furthermore, if they significantly reduce their inventory levels for our products, service levels to our end-use customers could decrease.

We face financial and operational risks associated with international operations.

We have operations located in ten countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 86.6%, 65.5%, and 77.1% of our total net revenues for the years ended December 31, 2007, 2006, and 2005, respectively. We expect that international sales will continue to constitute a significant portion of our total net revenues.

Changes in the value of currencies in which we conduct our business relative to the U.S. dollar could cause fluctuations in our reported financial results. The three primary areas where we are exposed to foreign currency fluctuations are revenues, cost of goods sold, and operating expenses.

With respect to revenues generated in foreign currencies, our historical foreign currency exposure has been related primarily to the Japanese Yen and has not been material to our consolidated results of operations. However, in the future, we expect that some foreign utilities may require us to price our NES system in the utility s local currency, which will increase our exposure to foreign currency risk. In addition, we have agreed with EBV, our European distributor, that upon notice from EBV, we will sell our products to EBV in European Euros rather than U.S. dollars. If EBV were to exercise this right, our revenue exposure to foreign currency fluctuations would increase.

For our cost of goods sold, the majority of our products are assembled by CEMs in China, and to a lesser extent, in the European Union, although our transactions with these vendors have historically been denominated in U.S. dollars. These vendors may require us to pay in their local currency, or demand a U.S. dollar price adjustment or other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases.

15

Table of Contents

We use the local currency to pay for our operating expenses in the various countries where we have operations. If the value of the U.S. dollar declines as compared to the local currency where the expenses are incurred, our expenses, when translated back into U.S. dollars, will increase.

To date, we have not hedged any of our foreign currency exposures and currently do not maintain any hedges to mitigate our foreign currency risks. Consequently, any resulting adverse foreign currency fluctuations could significantly harm our revenues, cost of goods sold, or operating expenses.

Additional risks inherent in our international business activities include the following:

- timing of and costs associated with localizing products for foreign countries and lack of acceptance of non-local products in foreign countries;
- inherent challenges in managing international operations;
- the burdens of complying with a wide variety of foreign laws and unexpected changes in regulatory requirements, tariffs, and other trade barriers;
- economic and political conditions in the countries where we do business;
- differing vacation and holiday patterns in other countries, particularly in Europe;
- labor actions generally affecting individual countries, regions, or any of our customers, which could result in reduced demand for, or could delay delivery or acceptance of, our products;
- international terrorism and anti-American sentiment; and
- potentially adverse tax consequences, including restrictions on repatriation of earnings.

Any of these factors could have a material adverse effect on our revenues, results of operations, and our financial condition.

The sales cycle for our LWI products is lengthy and unpredictable.

The sales cycle between initial LWI customer contact and execution of a contract or license agreement with a customer or purchase of our products, can vary widely. Initially, we must educate our customers about the potential applications of and cost savings associated with our products. If we are successful in this effort, OEMs typically conduct extensive and lengthy product evaluations before making a decision to design our products into their offerings. Once the OEM decides to incorporate our products, volume purchases of our products are generally delayed until the OEM s product development, system integration, and product introduction periods have been completed. In addition, changes in our customer s budgets, or the priority they assign to control network development, could also affect the sales cycle.

We generally have little or no control over these factors, any of which could prevent or substantially delay our ability to complete a transaction and could adversely affect the timing of our revenues and results of operations.

If we sell our NES system products directly to a utility, we will face additional risks.

If we sell our NES system products to a utility directly, we may be required to assume responsibility for installing the NES system in the utility s territory, integrating the NES system into the utility s operating and billing system, overseeing management of the combined system, and undertaking other activities. To date, we do not have any significant experience with providing these types of services. As a result, if we sold directly to a utility, it may be necessary for us to contract with third parties to satisfy these obligations. We cannot assure you that we would find appropriate third parties to provide these services on reasonable terms, or at all. Assuming responsibility for these or other services would add to the costs and risks associated with NES system installations, and could also negatively affect the timing of our revenues and cash flows related to these transactions.

Fluctuations in our operating results may cause our stock price to decline.

Our quarterly and annual results have varied significantly from period to period, and we have sometimes failed to meet securities analysts expectations. Moreover, we have a history of losses and cannot assure you that we will achieve sustained profitability in the future. Our future operating results will depend on many factors, many of which are outside of our control, including the following:

- the mix of products and services that we sell may change to a less profitable mix;

- shipment, payment schedules, and product acceptance may be delayed;
- the complex revenue recognition rules relating to products such as our NES system could require us to defer some or all of the revenue associated with NES product shipments until certain conditions, such as delivery and acceptance criteria, are met in a future period;
- our contract electronic manufacturers may not be able to provide quality products on a timely basis, especially during periods where capacity in the CEM market is limited;
- our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;
- our products may not be accepted by utilities, OEMs, systems integrators, service providers and end-users at the levels we project;
- downturns in any customer s or potential customer s business, or declines in general economic conditions, could cause significant reductions in capital spending, thereby reducing the levels of orders from our customers;
- recording of expense relating to equity compensation as required under SFAS No. 123R will decrease our earnings;
- we may incur costs associated with any future business acquisitions; and
- results of impairment tests for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, and SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, with respect to goodwill and other identified intangible assets that we acquired in the past or that we may acquire in the future may negatively affect our earnings and financial condition.

Any of the above factors could, individually or in the aggregate, have a material adverse effect on our results of operations and our financial condition, which could cause our stock price to decline.

We may be unable to promote and expand acceptance of our open, interoperable control systems over competing protocols, standards, or technologies.

LONWORKS technology is open, meaning that many of our technology patents are broadly licensed without royalties or license fees. As a result, our customers are able to develop hardware and software solutions that compete with some of our products. Because some of our customers are OEMs that develop and market their own control systems, these customers in particular could develop competing products based on our open technology. For instance, we have published all of the network management commands required to develop software that competes with our LNS software.

In addition, many of our competitors are dedicated to promoting closed or proprietary systems, technologies, software and network protocols or product standards that differ from or are incompatible with ours. We also face strong competition from large trade associations that promote alternative technologies and standards for particular vertical applications or for use in specific countries. These include BACnet, DALI, and KNX in the buildings market; DeviceNet, HART, and ProfiBus in the industrial controls market; TCN in the rail transportation market, DLMS in the metering market, and Echonet, Zigbee, and Z-Wave in the home control market.

Our technologies, protocols, or standards may not be successful or we may not be able to compete with new or enhanced products or standards introduced by our competitors, which would have a material adverse affect on our revenues, results of operations, and financial condition.

Our business may suffer if it is alleged or found that our products infringe the intellectual property rights of others.

We may be contractually obligated to indemnify our customers or other third parties that use our products in the event our products are alleged to infringe a third party s intellectual property rights. From time to time, we may also receive notice that a third party believes that our products may be infringing patents or other intellectual property rights of that third party. Responding to those claims, regardless of their merit, can be time consuming, result in costly litigation, divert management s attention and resources, and cause us to incur significant expenses.

As the result of such a claim, we may elect or be required to redesign our products, some of our product offerings could be delayed, or we could be required to cease distributing some of our products. In the alternative, we could seek a license to the third party s intellectual property. Even if our products do not infringe, we may elect to take a license or settle to avoid incurring litigation costs. However, it is possible that we would not be able to obtain such a license or settle on reasonable terms, or at all.

Lastly, our customers may not purchase our products if they are concerned our products may infringe third party intellectual property rights. This could reduce the market opportunity for the sale of our products and services.

Any of the foregoing risks could have a material adverse affect on our revenues, results of operations, and financial condition.

We have limited ability to protect our intellectual property rights.

Our success depends significantly upon our intellectual property rights. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements and other contractual provisions to establish, maintain and protect these intellectual property rights, all of which afford only limited protection. If any of our patents fail to protect our technology, or if we do not obtain patents in certain countries, our competitors may find it easier to offer equivalent or superior technology.

We have also registered or applied for registration for certain trademarks, and will continue to evaluate the registration of additional trademarks as appropriate. If we fail to properly register or maintain our trademarks or to otherwise take all necessary steps to protect our trademarks, the value associated with the trademarks may diminish. In addition, if we fail to protect our trade secrets or other intellectual property rights, we may not be able to compete as effectively in our markets.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services or use information that we regard as proprietary, or it may not be economically feasible to enforce them. Any of our patents, trademarks, copyrights or intellectual property rights could be challenged, invalidated or circumvented. In addition, we cannot assure you that we have taken or will take all necessary steps to protect our intellectual property rights. Third parties may also independently develop similar technology without breach of our trade secrets or other proprietary rights. In addition, the laws of some foreign countries, including several in which we operate or sell our products, do not protect proprietary rights to as great an extent as do the laws of the United States and it may take longer to receive a remedy from a court outside of the United States. Also, some of our products are licensed under shrink-wrap license agreements that are not signed by licensees and therefore may not be binding under the laws of certain jurisdictions.

From time to time, litigation may be necessary to defend and enforce our proprietary rights. As a result, we could incur substantial costs and divert management resources, which could harm our business, regardless of the final outcome. Despite our efforts to safeguard and maintain our proprietary rights both in the United States and abroad, we may be unsuccessful in doing so. Also, the steps that we take to safeguard and maintain our proprietary rights may be inadequate to deter third parties from infringing, misusing, misappropriating, or independently developing our technology or intellectual property rights, or to prevent an unauthorized third party from misappropriating our products or technology.

Our executive officers and technical personnel are critical to our business.

Our company s success depends substantially on the performance of our executive officers and key employees. Due to the specialized technical nature of our business, we are particularly dependent on our Chief Executive Officer, our President and Chief Operating Officer, and our technical personnel. Our future success will depend on our ability to attract, integrate, motivate and retain qualified technical, sales, operations, and managerial personnel, as well as our ability to successfully implement a plan for management succession.

Competition for qualified personnel in our business areas is intense, and we may not be able to continue to attract and retain qualified executive officers and key personnel. Our product development and marketing functions are largely based in Silicon Valley, which is a highly competitive marketplace. It may be particularly difficult to recruit, relocate and retain qualified personnel in this geographic area. Moreover, the cost of living, including the cost of housing, in Silicon Valley is known to be high. Because we are legally prohibited from making loans to executive officers, we will not be able to assist potential key personnel as they acquire housing or incur other costs that might be associated with joining our company. In addition, if we lose the services of any of our key personnel and are not able to find suitable replacements in a timely manner, our business could be disrupted, other key personnel may decide to leave, and we may incur increased operating expenses in finding and compensating their replacements.

The trading price of our stock has been volatile, and may fluctuate due to factors beyond our control.

The trading price of our common stock is subject to significant fluctuations in response to numerous factors, including the following:

significant stockholders may sell some or all of their holdings of our stock;

- investors may be concerned about our ability to develop additional customers for our products and services; and

- volatility in our stock price may be unrelated or disproportionate to our operating performance.

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

Voluntary standards and governmental regulatory actions in our markets could limit our ability to sell our products.

Standards bodies, which are formal and informal associations that attempt to set voluntary, non-governmental product standards, are influential in many of our target markets. We participate in many voluntary standards organizations around the world in order to both help prevent the adoption of exclusionary standards and to promote voluntary standards for our products. However, we do not have the resources to participate in all voluntary standards processes that may affect our markets.

In addition, many of our products and the industries in which they are used are subject to U.S. and foreign regulation. For example, the power line medium, which is the communications medium used by some of our products, is subject to special regulations in North America, Europe and Japan. In general, these regulations limit the ability of companies to use power lines as a communication medium. In addition, some of our competitors have attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their own products.

The adoption of voluntary standards or the passage of governmental regulations that are incompatible with our products or technology could limit the market opportunity for our products, which could harm our revenues, results of operations, and financial condition.

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

As of February 29, 2008, our directors and executive officers, together with certain entities affiliated with them (including, for this purpose, Enel, which has the right to nominate a director to our board of directors), beneficially owned 33.0% of our outstanding stock.

When we sold 3.0 million newly issued shares of our common stock to Enel on September 11, 2000, we granted Enel the right to nominate a director to our board of directors, although a nominee of Enel does not currently sit on our board. In connection with the stock sale, our directors and our Chief Financial Officer agreed to enter into a voting agreement with Enel in which each of them agreed to vote in favor of Enel s nominee to our board of directors. In addition, Enel agreed to vote for our board s recommendations for the election of directors, approval of accountants, approval of Echelon s equity compensation plans, and certain other matters. As a result, our directors and executive officers, together with certain entities affiliated with them, may be able to control substantially all matters requiring approval by our stockholders, including the election of all directors and approval of certain other corporate matters.

Natural disasters, power outages, and other factors outside of our control such as widespread pandemics could disrupt our business.

We must protect our business and our network infrastructure against damage from earthquake, flood, hurricane and similar events, as well as from power outages. A natural disaster, power outage, or other unanticipated problem could also adversely affect our business by, among other things, harming our primary data center or other internal operations, limiting our ability to communicate with our customers, and limiting our ability to sell our products. We do not insure against several natural disasters, including earthquakes.

Any outbreak of a widespread communicable disease pandemic could similarly impact our operations. Such impact could include, among other things, the inability for our sales and operations personnel located in affected regions to travel and conduct business freely, the impact any such disease may have on one or more of the distributors for our products in those regions, and increased supply chain costs. Additionally, any future health-related disruptions at our third-party contract manufacturers or other key suppliers could affect our ability to supply our customers with products in a timely manner, which would harm our results of operations.

Table of Contents

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES (As Restated)

At our corporate headquarters in San Jose, California, we lease two buildings, each of which contains approximately 75,000 square feet of useable space. We moved to this location in October 2001. The lease for the first building, which began in October 2001, requires minimum rental payments for ten years totaling approximately $20.6 million. The lease for the second building, which began in May 2003, also requires minimum rental payments for ten years totaling approximately $23.4 million. For accounting purposes only, we are the deemed owner of these buildings; see Notes 2, 3 and 8 of Notes to Consolidated Financial Statements in Part II, Item 8 of this report for further explanation of the accounting treatment and associated restatement.

We also lease office space for some of our sales and marketing employees in China, France, Germany, Hong Kong, India, Italy, Japan, the Netherlands, South Korea, and the United Kingdom and for some of our research and development employees in Fargo, North Dakota, and Germany. The leases for these offices expire at various dates through 2018. As of December 31, 2007, the future minimum rental payments for all of our leased office space, including those for our corporate headquarters facilities, totaled approximately $24.4 million. For the year ended December 31, 2007, the aggregate rental expense for all leased office space was approximately $5.4 million.

We believe that our facilities will be adequate for at least the next 12 months. For additional information regarding our obligations under property leases, please see Notes 2 and 8 of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Report.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of our fiscal year ended December 31, 2007.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock is traded on the Nasdaq Global Market under the symbol ELON. We began trading on NASDAQ on July 28, 1998, the date of our initial public offering. The following table sets forth, for the quarter indicated, the high and low sales price per share of our common stock as reported on the Nasdaq Global Market.

	Price Range	
Year Ended December 31, 2007	**High**	**Low**
Fourth quarter	$ 30.66	$ 14.70
Third quarter	32.49	14.93
Second quarter	18.75	10.50
First quarter	10.68	7.19
Year Ended December 31, 2006	**High**	**Low**
Fourth quarter	$ 9.04	$ 7.70
Third quarter	8.99	6.92
Second quarter	9.49	7.32

First quarter	9.50	7.58

20

As of February 29, 2008, there were approximately 438 stockholders of record. Because brokers and other institutions hold many shares on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders.

Dividend Policy

We have never paid dividends on our capital stock and do not currently expect to pay any dividends in the foreseeable future. We intend to retain future earnings, if any, for use in our business.

Equity Compensation Plan Summary Information

For information on our equity compensation plans, please refer to Note 4 to our accompanying consolidated financial statements.

Recent Sales of Unregistered Securities

There were no sales of unregistered securities during the fourth quarter of our fiscal year ended December 31, 2007.

Stock Price Performance Graph

The graph below compares the cumulative total stockholder return on our common stock (assuming reinvestment of dividends) with the cumulative total return on the S&P 500 Index and the S&P 500 Information Technology Index (which is comprised of those companies in the information technology sector of the S&P 500 Index). The graph assumes that $100 was invested in our common stock on December 31, 2002 and in the S&P 500 Index and the S&P 500 Information Technology Index. Historic stock price performance is not necessarily indicative of future stock performance.

Table of Contents

ITEM 6. SELECTED FINANCIAL DATA (As Restated)

The following selected consolidated financial data have been restated. Consolidated statement of operations data for the years ended December 31, 2007, 2006 and 2005, and the consolidated balance sheet data as of December 31, 2007 and 2006, have been derived from the audited consolidated financial statements (as restated). The consolidated statement of operations data for the years ended December 31, 2004 and 2003, and the consolidated balance sheet data as of December 31, 2005, 2004 and 2003, have been derived from unaudited consolidated financial statements (as restated). See further explanation of the restatements in Note 2 of Notes to Consolidated Financial Statements contained in Part II, Item 8 of this Report. The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations (as restated) and the Consolidated Financial Statements and Notes (as restated) in Item 8 of this Form 10-K/A in order to fully understand factors that may affect the comparability of the information presented below.

	Year Ended December 31,				
	2007 (As Restated)[1]	2006 (As Restated)[1]	2005 (As Restated)[1]	2004 (As Restated)[1]	2003 (As Restated)[1]
	(in thousands, except per share data)				
Consolidated Statement of Operations Data:					
Net revenues:					
Product	$ 135,405	$ 56,515	$ 73,563	$ 108,947	$ 117,153
Service	2,172	761	865	974	1,000
Total revenues	137,577	57,276	74,428	109,921	118,153
Cost of revenues:					
Cost of product	85,035	22,039	30,928	46,059	49,356
Cost of service	2,360	1,877	2,081	1,957	2,604
Total cost of revenues	87,395	23,916	33,009	48,016	51,960
Gross profit	50,182	33,360	41,419	61,905	66,193
Operating expenses:					
Product development	32,644	28,221	24,853	24,914	34,765
Sales and marketing	21,181	20,408	20,994	19,347	18,504
General and administrative	16,083	13,949	19,401	12,702	11,817
Total operating expenses	69,908	62,578	65,248	56,963	65,086
Operating income (loss)	(19,726)	(29,218)	(23,829)	4,942	1,107
Interest and other income, net	5,717	5,817	5,225	2,140	2,219
Interest expense on lease financing obligations	(1,211)	(1,379)	(1,530)	(1,666)	(1,483)
Income (loss) before provision for income taxes	(15,220)	(24,780)	(20,134)	5,416	1,843
Provision for income taxes	452	350	154	586	600
Net income (loss)	$ (15,672)	$ (25,130)	$ (20,288)	$ 4,830	$ 1,243
Income (loss) per share [2]:					
Basic	$ (0.39)	$ (0.64)	$ (0.50)	$ 0.12	$ 0.03
Diluted	$ (0.39)	$ (0.64)	$ (0.50)	$ 0.12	$ 0.03
Shares used in per share calculation [2]:					
Basic	39,891	39,487	40,377	40,918	40,070

Diluted	39,891	39,487	40,377	41,007	40,792
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$ 107,190	$ 124,157	$ 154,480	$ 160,364	$ 144,923
Working capital	126,711	129,521	154,869	171,032	158,609
Total assets	204,707	211,272	213,671	244,384	237,331
Total stockholders equity	153,211	153,663	178,551	208,611	198,915

[1] See Note 2 of Notes to Consolidated Financial Statements for an explanation of the restatement.

[2] See Note 1 of Notes to Consolidated Financial Statements for an explanation of shares used in computing basic net income (loss) per share, and diluted net income (loss) per share.

Table of Contents

The following tables present the effects of the restatement of Selected Financial Data for each of the years in the five year period ended December 31, 2007. See Note 2 of Notes to Consolidated Financial Statements for further explanation of the restatements.

	Year Ended December 31,								
	2007			2006			2005		
(in thousands, except per share data)	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated
Consolidated Statement of Operations Data:									
Net revenues:									
Product	$ 135,405	$	$ 135,405	$ 56,515	$	$ 56,515	$ 73,563	$	$ 73,563
Service	2,172		2,172	761		761	865		865
Total revenues	137,577		137,577	57,276		57,276	74,428		74,428
Cost of revenues:									
Cost of product	84,934	101	85,035	22,032	7	22,039	30,955	(27)	30,928
Cost of service	2,389	(29)	2,360	1,917	(40)	1,877	2,124	(43)	2,081
Total cost of revenues	87,323	72	87,395	23,949	(33)	23,916	33,079	(70)	33,009
Gross profit	50,254	(72)	50,182	33,327	33	33,360	41,349	70	41,419
Operating expenses:									
Product development	32,511	133	32,644	28,357	(136)	28,221	25,098	(245)	24,853
Sales and marketing	21,030	151	21,181	20,372	36	20,408	21,023	(29)	20,994
General and administrative	16,490	(407)	16,083	14,505	(556)	13,949	20,018	(617)	19,401
Total operating expenses	70,031	(123)	69,908	63,234	(656)	62,578	66,139	(891)	65,248
Operating loss	(19,777)	51	(19,726)	(29,907)	689	(29,218)	(24,790)	961	(23,829)
Interest and other income, net	5,717		5,717	5,817		5,817	5,225		5,225
Interest expense on lease financing obligations		(1,211)	(1,211)		(1,379)	(1,379)		(1,530)	(1,530)
Loss before provision for income taxes	(14,060)	(1,160)	(15,220)	(24,090)	(690)	(24,780)	(19,565)	(569)	(20,134)
Provision for income taxes	452		452	350		350	154		154
Net loss	$ (14,512)	$ (1,160)	$ (15,672)	$ (24,440)	$ (690)	$ (25,130)	$ (19,719)	$ (569)	$ (20,288)
Loss per share:									
Basic	$ (0.36)	$ (0.03)	$ (0.39)	$ (0.62)	$ (0.02)	$ (0.64)	$ (0.49)	$ (0.01)	$ (0.50)
Diluted	$ (0.36)	$ (0.03)	$ (0.39)	$ (0.62)	$ (0.02)	$ (0.64)	$ (0.49)	$ (0.01)	$ (0.50)
Shares used in per share calculation:									
Basic	39,891		39,891	39,487		39,487	40,377		40,377

Diluted	39,891		39,891	39,487		39,487	40,377		40,377
Consolidated Balance Sheet Data:									
Cash, cash equivalents and short-term investments	$ 107,190	$	$ 107,190	$ 124,157	$	$ 124,157	$ 154,480	$	$ 154,480
Working capital	129,882	(3,171)	126,711	132,420	(2,899)	129,521	157,474	(2,605)	154,869
Total assets	192,450	12,257	204,707	196,276	14,996	211,272	195,938	17,733	213,671
Total stockholders equity	156,110	(2,899)	153,211	156,575	(2,912)	153,663	181,308	(2,757)	178,551

Table of Contents

	Year Ended December 31,					
	2004			2003		
(in thousands, except per share data)	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated
Consolidated Statement of Operations Data:						
Net revenues:						
Product	$ 108,947	$	$ 108,947	$ 117,153	$	$ 117,153
Service	974		974	1,000		1,000
Total revenues	109,921		109,921	118,153		118,153
Cost of revenues:						
Cost of product	46,110	(51)	46,059	49,407	(51)	49,356
Cost of service	2,003	(46)	1,957	2,650	(46)	2,604
Total cost of revenues	48,113	(97)	48,016	52,057	(97)	51,960
Gross profit	61,808	97	61,905	66,096	97	66,193
Operating expenses:						
Product development	25,262	(348)	24,914	35,113	(348)	34,765
Sales and marketing	19,440	(93)	19,347	18,597	(93)	18,504
General and administrative	13,388	(686)	12,702	12,108	(291)	11,817
Total operating expenses	58,090	(1,127)	56,963	65,818	(732)	65,086
Operating income	3,718	1,224	4,942	278	829	1,107
Interest and other income, net	2,140		2,140	2,219		2,219
Interest expense on lease financing obligations		(1,666)	(1,666)		(1,483)	(1,483)
Income before provision for income taxes	5,858	(442)	5,416	2,497	(654)	1,843
Provision for income taxes	586		586	600		600
Net income	$ 5,272	$ (442)	$ 4,830	$ 1,897	$ (654)	$ 1,243
Income per share:						
Basic	$ 0.13	$ (0.01)	$ 0.12	$ 0.05	$ (0.02)	$ 0.03
Diluted	$ 0.13	$ (0.01)	$ 0.12	$ 0.05	$ (0.02)	$ 0.03
Shares used in per share calculation:						
Basic	40,918		40,918	40,070		40,070
Diluted	41,007		41,007	40,792		40,792
Consolidated Balance Sheet Data:						
Cash, cash equivalents and short-term investments	$ 160,364	$	$ 160,364	$ 144,923	$	$ 144,923
Working capital	173,391	(2,359)	171,032	160,745	(2,136)	158,609
Total assets	223,916	20,468	244,384	214,128	23,203	237,331
Total stockholders equity	211,062	(2,451)	208,611	200,924	(2,009)	198,915

Table of Contents

ITEM 7. 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 Annual Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business. These statements may be identified by the use of words such as we believe, expect, anticipate, intend, plan, goal, continues, may and similar expressions. In addition, forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the Business and Risk Factors sections. Our actual results may differ materially.

Certain information below affected by stock-based compensation expense and expenses, assets and liabilities related to the leases of our San Jose, California headquarters facilities has been adjusted to reflect the restatements of our financial results as more fully described in Note 2 of Notes to Consolidated Financial Statements in Part II, Item 8 of this Report.

RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS

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 and determined we had inappropriately accounted for the 1999 and 2001 leases of our San Jose, California corporate headquarters facilities.

Restatement of stock-based compensation expense: 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* (SFAS 123R), 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.

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 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.

Our management and the Audit Committee of our Board of Directors have concluded that these errors in our 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.

Table of Contents

Therefore we have restated our consolidated balance sheets as of December 31, 2007 and 2006, and our consolidated statements of operations, stockholders equity, cash flows and comprehensive income (loss) for each of the years in the three-year period ended December 31, 2007 and each of the quarters in 2007 and 2006, to reflect the restatement adjustments applicable to those periods. We will also file amendments to our Forms 10-Q for each of the quarters ended March 31, June 30, and September 30, 2007. The amended 2007 quarterly filings will include restated 2007 and 2006 quarterly information affected by these restatements. See also Note 13, *Selected Quarterly Financial Data (Unaudited) (As Restated)*, of Notes to Consolidated Financial Statements in Item 8 of this Report for information on the effects of the restatement on the previously reported quarterly data. In addition, we have restated Item 6 Selected Financial Data in this Report for each of the years in the five-year period ended December 31, 2007.

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

	December 31,	
	2007	**2006**
Increase in total assets	$ 12.3 million	$ 15.0 million
Increase in total liabilities	$ 15.2 million	$ 17.9 million
Increase in additional paid-in-capital	$ 2.0 million	$ 0.8 million
Increase in accumulated deficit	$ 4.9 million	$ 3.7 million

The effects of all restatement adjustments on our consolidated statements of operations for the years ended December 31, 2007, 2006 and 2005 are as follows:

	Year Ended December 31,		
	2007	**2006**	**2005**
Decrease in rent expense	$ 3.9 million	$ 3.9 million	$ 3.9 million
Increase in depreciation expense	$ 2.7 million	$ 2.7 million	$ 2.7 million
Increase in stock-based compensation expense	$ 1.2 million	$ 0.5 million	$ 0.3 million
Increase in interest expense	$ 1.2 million	$ 1.4 million	$ 1.5 million
Increase in net loss	$ 1.2 million	$ 0.7 million	$ 0.6 million

The correction of the accounting for our San Jose, California headquarters facilities leases required us to calculate the adjustments by year beginning with the year ended December 31, 2000. The cumulative effect of the restatement adjustments related to the lease accounting errors for the years 2000 through 2004 is reported as a $2.5 million increase to the 2005 beginning accumulated deficit balance in our Consolidated Statement of Stockholders Equity in Item 8 of this Report. The financial statement effects of all restatement adjustments by year are summarized in the following table (in thousands):

		Adjustments related to errors in lease accounting			
Fiscal Year	**Increase in stock-based compensation expense**	**Net increase (decrease) in rent expense**	**Increase in depreciation expense**	**Increase in interest expense**	**Net increase in expense**
2000	$	$ 281	$	$	$ 281
2001		31	301	199	531
2002		(1,606)	1,204	945	543
2003		(3,173)	2,344	1,483	654
2004		(3,948)	2,724	1,666	442
Cumulative effect of restatement on prior periods		(8,415)	6,573	4,293	$ 2,451
2005	263	(3,947)	2,723	1,530	569
2006	535	(3,948)	2,724	1,379	690
2007	1,173	(3,948)	2,724	1,211	1,160
	$ 1,971	$ (20,258)	$ 14,744	$ 8,413	$ 4,870

Included in Note 2 of Notes to Consolidated Financial Statements in Item 8 of this Report are tables that present the effects of all restatement adjustments on the consolidated financial statements reconciling the previously reported data to the as restated data for the Consolidated Balance Sheets as of December 31, 2007 and 2006, and the Consolidated Statements of Operations and Cash Flows for each of the years in the three-year period ended December 31, 2007. Other than the cumulative effect of restatement adjustments to beginning accumulated deficit as of January 1, 2005, shown in the table above, the effects of the restatement adjustments on the

Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss) for each of the years in the three-year period ended December 31, 2007 relate solely to the change in our net loss resulting from the restatements and therefore have not been specifically reconciled.

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 ten foreign countries throughout Europe and Asia. We develop, market, and sell system and network infrastructure products that enable everyday devices such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves to be made smart and inter-connected. Working together, products and systems equipped with our technology can monitor and save energy, lower costs, improve productivity and enhance service, quality, safety and convenience. We offer these hardware and software products and related services to OEMs and systems integrators in the building, industrial, transportation, utility/home, and other automation markets.

We have been investing in products for use by electricity utilities for use in management of electricity distribution. We began to receive modest amounts of revenue resulting from these investments in 2004, which grew to approximately $883,000 in 2005, decreased slightly to $791,000 in 2006, and grew substantially to $70.6 million in 2007. We refer to this revenue as networked energy services, or NES, revenue. We sell certain of our products to Enel and certain suppliers of Enel for use in Enel s Contatore Elettronico electricity meter management project in Italy. We refer to Echelon s revenue derived from sales to Enel and Enel s designated manufacturers as Enel Project revenue. We refer to all other revenue as LonWorks Infrastructure, or LWI, revenue. We also provide a variety of technical training courses related to our products and the underlying technology. Some of our customers also rely on us to provide customer support on a per-incident or term contract basis.

During the first and second quarters of 2006, we revised our revenue recognition methodology for sales made to the distributors of our LWI products. Under the revised methodology, we now defer revenue, as well as cost of goods sold, on items shipped to these distributors that remain in their inventories at quarter-end. The revision significantly reduced our first and second quarter 2006 revenues, but did not have an impact on cash flows from operations or require any changes to our historical financial statements. A more thorough explanation of this revision can be found later in this report in the LonWorks Infrastructure revenues and EBV revenues sections of our discussion on Results of Operations.

We have a history of losses and, although we achieved profitability in past fiscal periods, including the fourth quarter of 2007, we incurred a loss for the years ended December 31, 2007, 2006, and 2005. We also expect to incur an operating loss in 2008. This expectation is due primarily to the fact that, effective January 1, 2006, we began recording compensation expense associated with stock options and other forms of equity compensation as required under SFAS 123R. For the years ended December 31, 2006 and 2007, we recorded approximately $5.5 million (as restated) and $7.8 million (as restated), respectively, of stock-based compensation expense. We expect stock-based compensation expense in 2008 will be significantly higher than that charged in 2007.

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 this Form 10-K/A 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 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.

We believe the following critical accounting policies and estimates relate to those policies that are most important to the presentation of our consolidated financial statements and require the most difficult, subjective and complex judgments.

Revenue Recognition. Our revenues are derived from the sale and license of our products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to our 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.

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectibility is probable, and there are no post-delivery obligations. For hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For sales made to our 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.

In most instances involving large-scale deployments, our Networked Energy Services (NES) System products are sold as part of multiple element arrangements as that term is defined under AICPA Statement of Position 97-2 (SOP 97-2), *Software Revenue Recognition*, as amended. These arrangements may include electricity meters and data concentrators (collectively, the Hardware); NES System software, for which a royalty is charged on a per-meter basis; post-contract customer support (PCS) for the NES System software; and extended warranties for the Hardware. These arrangements may require us to deliver Hardware over an extended period of time. In accordance with SOP 97-2, when the multiple element arrangement includes NES System software, we defer the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, we recognize 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. We have established vendor specific objective evidence for the PCS on the NES System software, as well as for the warranties on our NES Hardware products, based on stated renewal rates. These revenues are recognized ratably over the associated service period, which generally commences upon the latter of the delivery of all software, or the customer s acceptance of any given Hardware shipment.

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

Stock-Based Compensation. Effective January 1, 2006, we adopted the provisions of and account for stock-based compensation in accordance with SFAS 123R. We elected the modified-prospective method, under which prior periods are not revised for comparative purposes. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the estimated fair value of the award and is recognized as expense ratably over the requisite service period, which is the vesting period.

We currently use the Black-Scholes-Merton (BSM) option-pricing model to estimate the fair value of stock options. The estimation of fair value of share-based payment awards on the date of grant using the BSM option-pricing model is affected by the fair market value of our stock on the date of grant, as well as a number of highly complex and subjective variables. These variables include the expected term of the option, the expected volatility of our stock price over the expected term of the option, risk-free interest rates, and expected dividends.

We estimate the expected term of options granted using the simplified method as illustrated in SEC Staff Accounting Bulletin No. 107 (SAB 107). Under the simplified method, the expected term is calculated by taking the average of the vesting term and the contractual term of the option. The expected volatility is based primarily on the historical volatility of our common stock over the most recent period commensurate with the expected term of the option, and to a lesser extent is based on implied volatility calculated from the market traded options on our common stock. We base the risk-free interest rate that we use in the BSM option-pricing model on U.S. Treasury issues in effect at the time of option grant that have remaining terms similar to the expected term of the option. We have never paid cash dividends on our common stock, and do not anticipate paying cash dividends in the foreseeable future. Therefore, we use an expected dividend yield of zero in the BSM option-pricing model.

SFAS 123R also requires us to record compensation expense for stock-based compensation net of estimated forfeitures, and to revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All share-based payment awards are amortized using the multiple option method over their requisite service period, which is generally the vesting period.

There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and may materially affect the estimated fair value of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods, and assumptions. The BSM option-pricing model was developed for use in estimating the fair value of traded options that have no vesting or hedging restrictions and that are fully transferable, characteristics that are not present in our option grants.

28

Table of Contents

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods, or if we decide to use a different option-pricing model, stock-based compensation expense in those future periods may differ significantly from what we have recorded in the current period and could materially affect our operating results.

Allowance for Doubtful Accounts. We typically sell our products and services to customers with net 30-day payment terms. In certain instances, payment terms may extend to as much as approximately net 90 days. For a customer whose credit worthiness does not meet our minimum criteria, we may require partial or full payment prior to shipment. Alternatively, customers may be required to provide us with an irrevocable letter of credit prior to shipment.

We evaluate the collectibility of our accounts receivable based on a combination of factors. In circumstances where we are aware of a specific customer s inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected. These determinations are made based on several sources of information, including, but not limited to, a specific customer s payment history, recent discussions we have had with the customer, updated financial information for the customer, and publicly available news related to that customer. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, the current business environment, the credit worthiness of our overall customer base, changes in our customers payment patterns, and our historical experience. If the financial condition of our customers were to deteriorate, or if general economic conditions worsened, additional allowances may be required in the future, which could materially impact our results of operations and financial condition. Our allowance for doubtful accounts was $330,000 as of December 31, 2007, and $250,000 as of December 31, 2006.

Inventory Valuation. At each balance sheet date, we evaluate our ending inventories for excess quantities and obsolescence. This evaluation includes analyses of sales levels by product and projections of future demand. Inventories on hand in excess of one year s forecasted demand are not valued. In addition, we write off inventories that we consider obsolete. We consider a product to be obsolete when one of several factors exists. These factors include, but are not limited to, our decision to discontinue selling an existing product, the product has been re-designed and we are unable to rework our existing inventory to update it to the new version, or our competitors introduce new products that make our products obsolete. We adjust remaining inventory balances to approximate the lower of our cost or market value. If future demand or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales in the period the revision is made.

Warranty Reserves. We evaluate our reserve for warranty costs based on a combination of factors. In circumstances where we are aware of a specific warranty related problem, for example a product recall, we reserve an estimate of the total out-of-pocket costs we expect to incur to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. When evaluating the need for any additional reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical warranty-related return rates, historical costs of repair, and knowledge of new products introduced. If any of these factors were to change materially in the future, we may be required to increase our warranty reserve, which could have a material negative impact on our results of operations and our financial condition. Our reserve for warranty costs was $301,000 as of December 31, 2007, and $224,000 as of December 31, 2006.

Table of Contents

Results of Operations

The following table reflects the percentage of total revenues represented by each item in our Consolidated Statements of Operations for the years ended December 31, 2007, 2006, and 2005:

	Year Ended December 31,		
	2007 (As Restated)[1]	2006 (As Restated)[1]	2005 (As Restated)[1]
Revenues:			
Product	98.4 %	98.7 %	98.8 %
Service	1.6	1.3	1.2
Total revenues	100.0	100.0	100.0
Cost of revenues:			
Cost of product	61.8	38.5	41.5
Cost of service	1.7	3.3	2.8
Total cost of revenues	63.5	41.8	44.3
Gross profit	36.5	58.2	55.7
Operating expenses:			
Product development	23.7	49.3	33.4
Sales and marketing	15.4	35.6	28.2
General and administrative	11.7	24.4	26.1
Total operating expenses	50.8	109.3	87.7
Loss from operations	(14.3)	(51.1)	(32.0)
Interest and other income, net	4.1	10.1	7.0
Interest expense on lease financing obligations	(0.9)	(2.3)	(2.1)
Loss before provision for income taxes	(11.1)	(43.3)	(27.1)
Provision for income taxes	0.3	0.6	0.2
Net loss	(11.4)%	(43.9)%	(27.3)%

[1] See Note 2 of Notes to Consolidated Financial Statements for an explanation of the restatements.

Revenues

Total revenues

(Dollars in thousands)	Year Ended December 31, 2007	2006	2005	2007 over 2006 $ Change	2006 over 2005 $ Change	2007 over 2006 % Change	2006 over 2005 % Change
Total revenues	$ 137,577	$ 57,276	$ 74,428	$ 80,301	($17,152)	140.2%	(23.0%)

The $80.3 million increase in total revenues in 2007 as compared to 2006 was primarily attributable to a $69.8 million increase in NES revenues, a $7.1 million increase in Enel Project revenues, and a $3.5 million increase in LonWorks Infrastructure revenues. The $17.2 million decrease in

total revenues in 2006 as compared to 2005 was primarily the result of an expected $19.8 million reduction in Enel Project revenues partially offset by a $2.8 million increase in LonWorks Infrastructure revenues.

NES revenues

	Year Ended December 31,			2007 over 2006	2006 over 2005	2007 over 2006	2006 over 2005
(Dollars in thousands)	**2007**	**2006**	**2005**	**$ Change**	**$ Change**	**% Change**	**% Change**
NES Revenues	$ 70,558	$ 791	$ 883	$ 69,767	($92)	8,820.1%	(10.4%)

During 2007, NES revenues were generated primarily from large scale deployments of our NES system products, whereas in 2006, NES revenues were generated primarily from the completion of system trials and, to a lesser extent, from limited shipments of NES products. During 2005, NES revenues were primarily generated from the completion of system trials.

Table of Contents

2007 NES revenues of $70.6 million included $14.4 million of shipments of hardware products that were accepted by our customers and, in some cases paid for, in 2006. However, we could not record this revenue in 2006 since we had not yet met all of the required criteria for revenue recognition.

We expect that, during 2008, shipments of our NES products will continue to increase over 2007 levels. Our ability to recognize revenue on these shipments depends on several factors, including, but not limited to, delivery to the customer of all of the software called for in any given agreement, the impact any modifications to existing shipment schedules included in the contracts that have been awarded to us thus far has on delivery dates, and certain contractual provisions, such as customer acceptance. In addition, the complex revenue recognition rules relating to products such as our NES system will likely require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period. (See Note 1 of the Notes to Consolidated Financial Statements for a more detailed explanation of our revenue recognition methodology used to report sales of our NES system.) In some instances, the reasons for these deferrals may not be fully under our control, which could result in the actual timing of revenue being significantly different than we currently anticipate.

We also expect that some foreign utilities will require us to price our NES system in the respective utility s local currency, which will expose us to foreign currency risk. During 2007, the portion of our NES revenue transactions conducted in currencies other than the U.S. dollar, principally the European Euro and the Australian dollar, was about $3.9 million, or 5.6%. NES revenue transactions conducted in foreign currencies during 2006 and 2005 were immaterial. In most cases, in the event of a significant contract award, we intend to hedge this foreign currency risk so long as we can secure forward currency contracts that are reasonably priced and that are consistent with the scheduled deliveries for that project. In addition, we will face foreign currency exposures from the time we submit our foreign currency denominated bid until the award of a contract by the utility (the bid to award term). This bid to award term can often exceed several months. If a utility awards us a contract that gives the utility the right to exercise options for additional supply in the future, we would also be exposed to foreign currency risk until such time as these options, if any, were exercised. We may decide that it is too expensive to hedge the foreign currency risks during the bid to award term or for any unexercised options. Any resulting adverse foreign currency fluctuations could significantly harm our revenues, results of operations, and financial condition.

LonWorks Infrastructure revenues

	Year Ended December 31,			2007 over 2006	2006 over 2005	2007 over 2006	2006 over 2005
(Dollars in thousands)	**2007**	**2006**	**2005**	**$ Change**	**$ Change**	**% Change**	**% Change**
LonWorks Infrastructure Revenues	$ 52,840	$ 49,382	$ 46,612	$ 3,458	$ 2,770	7.0%	5.9%

Our LonWorks Infrastructure 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. The $3.5 million increase in LonWorks Infrastructure revenues in 2007 as compared to 2006 was primarily attributable to the one-time effect of revisions we made in 2006 to our revenue recognition methodology for sales made to our distributor partners. During the first quarter of 2006, we modified our revenue recognition method for sales made to our European distributor, EBV (see EBV revenue discussion below). Under the revised method, revenue on sales made to EBV is deferred until EBV sells the products through to its end use customers. During the second quarter of 2006, we completed a similar revision to our revenue recognition methodology for sales made to our Asian distributor partners. This revision was necessary as, during the quarter, we modified our agreements with our Asian distributor partners. These contractual modifications, which allow the distributors to return certain of their excess inventory, were made to address changing business conditions in our Asian markets and to expand our customer base there. The revenue recognition methodology revisions for EBV and our Asian distributors resulted in one-time reductions in revenue of approximately $2.9 million and $1.0 million during the first and second quarters of 2006, respectively.

Excluding the impact of these revenue recognition revisions, LonWorks Infrastructure revenues decreased by approximately $442,000, or 0.9%, during 2007 as compared to 2006. We believe this decrease was due in part to a general slowdown in economic activity in some of the markets we serve, particularly in North America.

The $2.8 million increase in LonWorks Infrastructure revenues for the year ended December 31, 2006 as compared to the same period in 2005 was evident in all of the geographic markets that we serve, particularly in EMEA and the Americas, and to a lesser extent, in Asia. As discussed above, during 2006 we revised our revenue recognition methodology for sales made to our distributor partners in Europe and Asia, which had the one-time effect of reducing our 2006 LWI revenue by approximately $3.9 million. Excluding the impact of these revenue recognition revisions, LonWorks Infrastructure revenues for 2006 would have increased by approximately $6.7 million, or 14.3%, compared to 2005. Partially offsetting this increase was the unfavorable impact of exchange rates on sales made in foreign currencies, which resulted in a $145,000 decrease between the two years. We believe the overall $2.8 million increase is due, at least in part, to our customer s utilization of our products in new applications, such as energy management and street lighting controls.

As long as current worldwide economic conditions do not deteriorate, we currently believe our LonWorks Infrastructure revenues will grow modestly in 2008 as compared to 2007. However, within any given region, revenue growth may fluctuate up or down. In addition, the expected improvement in 2008 LonWorks Infrastructure 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 our LonWorks Infrastructure products and services. In general, if the dollar were to strengthen against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would decrease. Conversely, if the dollar were to weaken against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would increase. 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 LonWorks Infrastructure revenues conducted in currencies other than the United States dollar, principally the Japanese Yen, was about 6.8% in 2007, 6.3% in 2006, and 4.6% in 2005. We do not currently expect that, during 2008, the amount of our LonWorks Infrastructure 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

	Year Ended December 31,			2007 over 2006	2006 over 2005	2007 over 2006	2006 over 2005
(Dollars in thousands)	**2007**	**2006**	**2005**	**$ Change**	**$ Change**	**% Change**	**% Change**
Enel Project Revenues	$ 14,180	$ 7,103	$ 26,933	$ 7,077	($19,830)	99.6%	(73.6%)

In October 2006, we entered into two new agreements with Enel, a development and supply agreement and a software enhancement agreement. Under the development and supply agreement, Enel is purchasing additional metering kit and data concentrator products from us. Under the software enhancement agreement, we are providing software enhancements to Enel for use in its Contatore Elettronico system. There were no revenues from either of these new agreements during 2006. The $14.2 million of Enel project revenue recognized during 2007 related primarily to shipments under the new development and supply agreement, and to a lesser extent, from revenues attributable to the software enhancement agreement. Both the development and supply agreement and the software enhancement agreement expire on December 31, 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

The $19.8 million decrease in Enel Project revenues in 2006 as compared to 2005 was primarily attributable to the expected 2005 completion of our sales of components and products for the deployment phase of Enel s Contatore Elettronico project. Early in 2006, Enel asked us to provide them with spare parts for use in their system in Italy. We agreed to this request, and the $7.1 million of Enel project revenue represents our shipments against this request.

We sell our products to Enel and its designated manufacturers in United States dollars. Therefore, the associated revenues are not subject to foreign currency risks.

We currently expect that 2008 Enel Project revenues will decrease from the $14.2 million reported in 2007, due primarily to a reduction in the number metering kits we expect to ship to Enel and its designated meter manufacturers during 2008.

EBV revenues

	Year Ended December 31,			2007 over 2006	2006 over 2005	2007 over 2006	2006 over 2005
(Dollars in thousands)	**2007**	**2006**	**2005**	**$ Change**	**$ Change**	**% Change**	**% Change**
EBV Revenues	$ 17,564	$ 15,511	$ 15,610	$ 2,053	($99)	13.2%	(0.6%)

Sales to EBV, our largest distributor and the sole independent distributor of our LonWorks Infrastructure products in Europe, accounted for 12.8% of our total revenues in 2007, 27.1% in 2006, and 21.0% in 2005. The primary factor contributing to the $2.1 million increase in EBV revenues during 2007 as compared to 2006 was the fact that, during the first quarter of 2006, we revised our revenue recognition methodology for sales made to EBV. Under the revised methodology, revenues, as well as cost of goods sold, are deferred on items shipped to EBV that remain in EBV s inventories at quarter-end. Revenue is then recognized on these products, along with the corresponding gross margin, when EBV sells them to its customers in future periods. This revision resulted in a one-time revenue decrease of approximately $2.9 million for the quarter ended March 31, 2006. The revision did not have an impact on cash flows from operations or require any changes to historical financial

statements.

Excluding the impact of the accounting method revision, EBV s shipments to its customers decreased by approximately $847,000 during 2007 as compared to 2006. We believe this decrease is the result of the Restriction of Hazardous Substances, or RoHS, regulations, which became effective in the European Union July 1, 2006. Under these new rules, manufacturers such as Echelon were required to eliminate certain hazardous substances (e.g., lead, cadmium, mercury, etc.) from the products they sell into

the region. We believe that many of EBV s customers increased their purchases of our non-RoHS compliant products during the first half of 2006, prior to effective date of the new regulations. This resulted in a high level of EBV revenue during the first half of 2006.

The primary factor contributing to the $99,000 decrease in EBV revenues between 2006 and 2005 was again the $2.9 million reduction in revenues attributable to the revenue recognition methodology revision we made during the first quarter of 2006. Excluding the impact of this revision, 2006 EBV revenues would have increased by approximately $2.8 million as compared to 2005. We believe this increase was the result of increased purchasing of non-RoHS compliant products during the first half of 2006 as discussed above, as well as EBV s customers utilizing our products in new applications, such as energy management and street lighting controls.

We currently sell our products to EBV in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency exchange rate risks. However, EBV has the right, on notice to our company, to require that we sell our products to them in Euros.

Our contract with EBV, which has been in effect since 1997 and to date has been renewed annually thereafter, expires in December 2008. If our agreement with EBV is not renewed, or is renewed on terms that are less favorable to us, our revenues could decrease and our results of operations could be harmed.

Product revenues

	Year Ended December 31,			2007 over	2006 over	2007 over	2006 over
				2006	2005	2006	2005
(Dollars in thousands)	**2007**	**2006**	**2005**	**$ Change**	**$ Change**	**% Change**	**% Change**
Product Revenues	$ 135,405	$ 56,515	$ 73,563	$ 78,890	($17,048)	139.6%	(23.2%)

The $78.9 million increase in product revenues between 2007 and 2006 was primarily attributable to a $69.2 million increase in NES product revenues, a $6.3 million increase in Enel Project product revenues, and a $3.4 million increase in LonWorks Infrastructure product revenues. The $17.0 million decrease in product revenues between 2006 and 2005 was attributable to the $19.8 million decrease in Enel program revenues partially offset by a $2.8 million increase in LonWorks Infrastructure product revenues.

Service revenues

	Year Ended December 31,			2007 over	2006 over	2007 over	2006 over
				2006	2005	2006	2005
(Dollars in thousands)	**2007**	**2006**	**2005**	**Change**	**$ Change**	**% Change**	**% Change**
Service Revenues	$ 2,172	$ 761	$ 865	$ 1,411	($104)	185.4%	(12.0%)

The $1.4 million increase in service revenues during 2007 as compared to 2006 was primarily due to approximately $732,000 of custom software development revenues generated from the Enel Project, and, to a lesser extent, an increase in NES support revenues of approximately $623,000.

Gross Profit and Gross Margin (As Restated)

	Year Ended December 31,			2007 over	2006 over	2007 over	2006 over
	2007	2006	2005	2006	2005	2006	2005
(Dollars in thousands)	**(As Restated) [(1)]**	**(As Restated) [(1)]**	**(As Restated) [(1)]**	**$ Change[(1)]**	**$ Change[(1)]**	**% Change[(1)]**	**% Change[(1)]**
Gross Profit	$ 50,182	$ 33,360	$ 41,419	$ 16,822	($8,059)	50.4%	(19.5%)
Gross Margin	36.5%	58.2%	55.6%			(21.7)%	2.6%

(1) See Note 2 of Notes to Consolidated Financial Statements for an explanation of the restatements.

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.

The 21.7 percentage point decrease in gross margin during 2007 as compared to 2006 was due primarily to the mix of revenues reported. During 2007, the proportion of our revenues attributable to sales of our NES system products increased significantly as compared to 2006. In general, gross margins generated from sales of our NES system products are much lower than those generated from both sales of our LonWorks Infrastructure products and services as well as sales made under the Enel Project. As a result, when NES revenues are higher as a percentage of overall revenues, as they were during 2007, overall gross margins will be lower. Conversely, when NES revenues comprise a lower percentage of overall revenues, as they were during 2006, overall gross margins will be higher.

Table of Contents

Partially offsetting the decrease in gross margins during 2007 as compared to 2006 was the impact of higher revenues. As discussed above, a portion of our cost of goods sold relates to indirect costs. Some of these costs do not increase or decrease in conjunction with revenue levels, but rather remain relatively constant from quarter to quarter. As a result, when overall revenues increase, as they did during 2007 as compared to 2006, gross margins are favorably impacted.

The 2.6 percentage point increase in gross margin during 2006 as compared to 2005 was due primarily to the mix of products sold and favorable manufacturing and overhead absorption variances experienced during the year. Partially offsetting these favorable factors were the impact of lower overall revenues on gross margins and SFAS 123R equity compensation charges. Stock-based compensation expense recorded under SFAS 123R during 2006 increased our total cost of revenues by approximately $452,000 (as restated), which reduced our gross margin for 2006 by 0.8 of a percentage point.

We expect that, during 2008, gross margins will increase modestly from 2007 levels due primarily to an expected increase in overall revenues and, to a lesser extent, improved gross margins we expect to generate from increased sales of the more recent, cost reduced versions of our NES products. Our 2008 gross margins may also be impacted as we transition the manufacture of our products at WKK Technology to alternative CEMs in Asia. This effort will require us to purchase inventory from WKK that WKK procured in anticipation of our production requirements, and resell that inventory to the new CEMs as they require it. This process will likely result in historically high inventory levels during 2008, and could also increase our exposure to excess and obsolete inventories.

Operating Expenses (As Restated)

Product development (As Restated)

	Year Ended December 31,			2007 over	2006 over	2007 over	2006 over
	2007	2006	2005	2006	2005	2006	2005
(Dollars in thousands)	(As Restated) (1)	(As Restated) (1)	(As Restated) (1)	$ Change(1)	$ Change(1)	% Change(1)	% Change(1)
Product Development	$ 32,644	$ 28,221	$ 24,853	$ 4,423	$ 3,368	15.7%	13.6%

(1) See Note 2 of Notes to Consolidated Financial Statements for an explanation of the restatement.

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

The $4.4 million increase in product development expenses during 2007 as compared to 2006 was primarily due to a $3.1 million (as restated) increase in compensation and other employee related expenses attributable to an increase in our product development personnel headcount and increased stock-based compensation expenses. To a lesser extent, increases in fees paid to third party service providers, equipment and supply expenses, and facility costs also contributed to the year-over-year increase.

The $3.4 million increase in product development expenses during 2006 as compared to 2005 was primarily due to an increase in compensation expenses for our product development personnel, which was comprised of an approximately $1.9 million (as restated) increase in stock-based compensation expenses resulting from our 2006 adoption of SFAS 123R, and to a lesser extent, increases in our product development personnel headcount. In addition, increases in fees paid to third party consultants, as well as expenses associated with materials and other supplies consumed in the product development process, also contributed to the year-over-year increase.

We expect that, during 2008, product development expenses will increase from 2007 levels. This increase will primarily be the result of increased development efforts related to our NES system products.

Table of Contents

Sales and marketing (As Restated)

(Dollars in thousands)	Year Ended December 31, 2007 (As Restated) (1)	2006 (As Restated) (1)	2005 (As Restated) (1)	2007 over 2006 $ Change(1)	2006 over 2005 $ Change(1)	2007 over 2006 % Change(1)	2006 over 2005 % Change(1)
Sales and Marketing	$ 21,181	$ 20,408	$ 20,994	$ 773	($586)	3.8%	(2.8%)

(1) See Note 2 of Notes to Consolidated Financial Statements for an explanation of the restatement.
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.

Of the $773,000 increase in sales and marketing expenses in 2007 as compared to 2006, approximately $460,000 was attributable to the unfavorable impact of foreign currency exchange rate fluctuations between the United States dollar and the local currency in several of the foreign countries in which we operate. Excluding the impact of these exchange rate fluctuations, sales and marketing expenses increased by approximately $313,000 (as restated), or 1.5%, between the two years.

Sales and marketing expenses decreased $586,000 during 2006 as compared to 2005, due primarily to reductions in travel and entertainment costs, recruiting and other employee related administrative expenses, and advertising and product promotion charges. Partially offsetting these decreases were an increase of $1.2 million (as restated) in equity compensation charges resulting from our 2006 adoption of SFAS 123R, and the unfavorable impact of foreign currency exchange rate fluctuations, which increased overall sales and marketing expenses by approximately $11,000 in 2006 as compared to 2005.

We expect that, during 2008, our sales and marketing expenses will increase over 2007 levels due in part to increased commissions paid to our sales personnel. In addition, if the United States dollar were to weaken against the foreign currencies where we operate, our sales and marketing expenses could increase further. Conversely, if the dollar were to strengthen against these currencies, it would have a favorable impact on our sales and marketing expenses.

General and administrative (As Restated)

(Dollars in thousands)	Year Ended December 31, 2007 (As Restated) (1)	2006 (As Restated) (1)	2005 (As Restated) (1)	2007 over 2006 $ Change(1)	2006 over 2005 $ Change(1)	2007 over 2006 % Change(1)	2006 over 2005 % Change(1)
General and Administrative	$ 16,083	$ 13,949	$ 19,401	$ 2,134	($ 5,452)	15.3%	(28.1%)

(1) See Note 2 of Notes to Consolidated Financial Statements for an explanation of the restatement.
General and administrative expenses consist primarily of payroll and related expenses for executive, accounting, and administrative personnel, professional fees for legal and accounting services rendered to our company, facility costs, insurance, and other general corporate expenses.

Of the $2.1 million increase in general and administrative expenses during 2007 as compared to 2006, approximately $842,000 (as restated) related to an increase in stock-based compensation expenses. The remaining $1.3 million increase between the two periods was primarily attributable to increases in other compensation related expenses for our executive, accounting, and administrative personnel, and to a lesser extent, increases in cash compensation paid to our Board of Directors, fees paid to our independent accountants, and costs associated with other third party service providers.

General and administrative expenses decreased approximately $5.5 million in 2006 as compared to 2005, due primarily to the 2005 costs associated with the Enel arbitration; including the arbitration award itself of $5.1 million, as well as associated legal fees and other arbitration related costs. Partially offsetting this decrease was a $1.1 million (as restated) increase in stock-based compensation expenses resulting from our 2006 adoption of SFAS 123R.

We believe that, during 2008, general and administrative costs will increase modestly above 2007 levels.

Table of Contents

Interest and Other Income, Net

	Year Ended December 31,			2007 over 2006	2006 over 2005	2007 over 2006	2006 over 2005
(Dollars in thousands)	2007	2006	2005	$ Change	$ Change	% Change	% Change
Interest and Other Income, Net	$ 5,717	$ 5,817	$ 5,225	($100)	$ 592	(1.7%)	11.3%

Interest and other income, 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.

During 2007, interest and other income, net decreased by approximately $100,000 as compared to 2006. This decrease was primarily due to a $331,000 decrease in interest income, partially offset by a $214,000 reduction in foreign exchange translation and transaction losses. The reduction in interest income is primarily the result of a reduction in our average invested cash balance between the periods, which was primarily attributable to our operating losses. To a lesser extent, recent reductions in the weighted average yield our investment portfolio earns also contributed to the year-over-year decline in interest income.

The $592,000 increase in interest and other income, net in 2006 as compared to 2005 was also attributable to fluctuations in interest income and foreign exchange losses. During 2006, interest income increased by approximately $1.6 million over 2005 levels. This increase was primarily attributable to an overall improvement in the average yield on our investment portfolio. Yields increased steadily during 2006 as a result of the Federal Reserve s interest rate increases, which began in June 2004. As short-term investments we purchased in 2004 and 2005 came to maturity, the proceeds were re-invested in instruments with higher effective yields, thus increasing interest income. Partially offsetting the beneficial impact of higher average yields is the fact that our average invested cash balance decreased during 2006 as a result of our operating losses and repurchases of our common stock.

Partially offsetting the $1.6 million increase in interest income during 2006 was a $984,000 increase in foreign exchange losses on our short-term intercompany balances. In accordance with SFAS No. 52, *Foreign Currency Translation*, we account for foreign currency translation gains and losses associated with our short-term intercompany balances by reflecting these amounts as either other income or loss in our consolidated statements of operations. During periods when the U.S. dollar strengthens in value against these foreign currencies, the associated translation gains favorably impact other income. Conversely, when the U.S. dollar weakens, as it did during 2006, the resulting translation losses negatively impact other income.

We expect that, during 2008, interest and other income, net will decrease from the $5.7 million reported for 2007. This expected decrease is primarily attributable to our current belief that the average yield on our investment portfolio will trend downwards as short-term interest rates fall. In addition, future fluctuations in the exchange rates between the United States dollar and the currencies in which we maintain our short-term intercompany balances (principally the European Euro and the British Pound Sterling) will also affect our interest and other income, net.

Interest Expense on Lease Financing Obligations (As Restated)

	Year Ended December 31,			2007 over 2006	2006 over 2005	2007 over 2006	2006 over 2005
(Dollars in thousands)	2007 (As Restated) [1]	2006 (As Restated) [1]	2005 (As Restated) [1]	$ Change	$ Change	% Change	% Change
Interest Expense on Lease Financing Obligations	$ 1,211	$ 1,379	$ 1,530	($168)	($151)	(12.2%)	(9.9%)

In December 1999 and October 2000, we entered into two separate lease agreements with a local real estate developer for the two buildings we currently occupy at our San Jose headquarters site. As discussed in Notes 2 and 3 of Notes to Consolidated Financial Statements in Item 8 of this Report, we have accounted for these leases in accordance with EITF 97-10 and SFAS 98. The application of this accounting literature causes Echelon to be considered the deemed owner of the two buildings for accounting purposes only.

Accordingly, we have recorded as an asset on our balance sheet the costs paid by our lessor to construct our headquarters facility, along with a corresponding financing liability for an amount equal to these lessor paid construction costs. The monthly rent payments we make to our lessor under our lease agreements are recorded in our financial statements partially as land lease expense and partially as 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.

We expect that, during 2008, interest expense on lease financing obligations will decrease from the $1.2 million reported for 2007. 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. Therefore, a higher percentage of the payments we make in 2008 will be allocated to principal repayment and less will be allocated to interest expense.

Table of Contents

Provision for Income Taxes

(Dollars in thousands)	Year Ended December 31, 2007	2006	2005	2007 over 2006 $ Change	2006 over 2005 $ Change	2007 over 2006 % Change	2006 over 2005 % Change
Provision for Income Taxes	$ 452	$ 350	$ 154	$ 102	$ 196	29.1%	127.3%

The provision for income taxes for 2007, 2006, and 2005 includes a provision for state and foreign taxes based on our annual estimated effective tax rate for the year. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes and our valuation allowance on our deferred tax assets. Income taxes of $452,000 in 2007 and $350,000 in 2006 consist primarily of taxes related to profitable foreign subsidiaries and various state minimum taxes. Income taxes of $154,000 in 2005 primarily consist of taxes related to profitable foreign subsidiaries and various state minimum taxes, partially offset by a reduction in our income tax exposure reserve associated with the resolution of an outstanding tax matter.

We currently expect that our 2008 provision for income taxes will increase over the $452,000 recorded in 2007, primarily due to our belief that we will be subject to federal alternative minimum taxes in 2008 resulting from differences in the tax treatment of certain expense items.

Off-Balance-Sheet Arrangements and Other Contractual Obligations

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

Lease Commitments. We lease our present corporate headquarters facility in San Jose, California, under two non-cancelable leases. The first lease agreement expires in 2011 and the second lease agreement expires in 2013. Upon expiration, both lease agreements provide for extensions of up to ten years. As part of these lease transactions, we provided the lessor security deposits in the form of two standby letters of credit totaling $6.2 million. The leases of our corporate headquarters facilities are accounted for under EITF 97-10 and SFAS 98 (see Notes 2, 3 and 8 of Notes to Consolidated Financial Statements in Item 8 of this Report).

In addition, we lease facilities under operating leases for our sales, marketing, and product development personnel located elsewhere within the United States and in nine foreign countries throughout Europe and Asia, including a land lease for accounting purposes associated with our corporate headquarters facilities (see Notes as referenced above). These operating leases expire on various dates through 2018, 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 that range from one to six months, and in some cases, up to one year. We also obtain individual components for our products from a wide variety of individual suppliers. We generally acquire these components through the issuance of purchase orders, and in some cases through demand forecasts, both of which cover periods ranging from one to nine months.

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

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

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer s or director s lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that 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 consolidated statements of income, was approximately $573,000 during 2007, $493,000 during 2006, and $496,000 during 2005.

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 December 31, 2007, we have adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

Legal Actions. On May 3, 2004, we announced that Enel filed a request for arbitration to resolve a dispute regarding our marketing and supply obligations under the Research and Development and Technological Cooperation Agreement dated June 28, 2000. The arbitration took place in London in early March 2005 under the rules of arbitration of the International Court of Arbitration of the International Chamber of Commerce. We received the arbitration panel s decision on September 29, 2005. The arbitration tribunal awarded Enel 4,019,750 in damages plus interest from December 15, 2004 and the sums of $52,000 and 150,000 in arbitration and legal related costs, respectively. These amounts, which total approximately $5.2 million, were included in our results of operations for the year ended December 31, 2005. The arbitration tribunal refused Enel s request to extend the supply or marketing obligations of Echelon.

In addition to the matter described above, from time to time, in the ordinary course of business, we are also subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, 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 December 31, 2007, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

As of December 31, 2007, our contractual obligations were as follows (in thousands):

	Payments due by period				
	Total	Less than 1 year	2-3 years	4-5 years	More than 5 years
Lease financing obligations (As Restated) [1]	$ 19,111	$ 3,894	$ 8,191	$ 6,238	$ 788
Operating leases (As Restated) [1]	$ 5,677	$ 1,560	$ 2,611	$ 1,177	$ 329
Purchase commitments	37,779	37,702	77		
Total	$ 62,567	$ 43,156	$ 10,879	$ 7,415	$ 1,117

(1) See Note 2 of Notes to Consolidated Financial Statements for an explanation of the restatement.

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 December 31, 2007, we raised $289.3 million from the sale of preferred stock and common stock, including the exercise

of stock options and warrants from our employees and directors.

In March and August 2004, our Board of Directors approved a stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. There were no repurchases during the year ended December 31, 2007. Since inception, we have repurchased a total of 2,204,184 shares

38

Table of Contents

under the program at a cost of $16.1 million. As of December 31, 2007, 795,816 shares are available for repurchase. The stock repurchase program will expire in March 2008.

The following table presents selected financial information for each of the last three fiscal years (dollars in thousands):

	As of December 31,		
	2007	2006	2005
Cash, cash equivalents, and short-term investments	$ 107,190	$ 124,157	$ 154,480
Trade accounts receivable, net	33,469	13,918	11,006
Working capital (As restated) [1]	126,711	129,521	154,869
Stockholder s equity (As restated[1])	153,211	153,663	178,551

(1) See Note 2 of Notes to Consolidated Financial Statements for an explanation of the restatement.

As of December 31, 2007, we had $107.2 million in cash, cash equivalents, and short-term investments, a decrease of $17.0 million as compared to December 31, 2006. Historically, our primary source of cash, other than stock sales and exercises of stock options and warrants as discussed above, has been receipts from revenue. Our primary uses of cash have been cost of revenues, compensation related payments and other operating expenses, acquisitions, capital expenditures, and purchases under our stock repurchase program.

Cash flows from operating activities. Cash flows from operating activities has historically been driven by net income levels, adjustments for non-cash charges such as depreciation, amortization, in-process research and development charges, and stock-based compensation expenses; and fluctuations in operating asset and liability balances. Net cash used in operating activities was $13.1 million (as restated) in 2007, a $5.3 million decrease (as restated) from 2006. During 2007, net cash used in operating activities was primarily the result of our net loss of $15.7 million (as restated) and changes in our operating assets and liabilities of $13.2 million (as restated); partially offset by stock-based compensation charges of $7.8 million (as restated), depreciation and amortization of $7.4 million (as restated), and a decrease in accrued investment income of $436,000. Cash used in operating activities in 2006 of $18.4 million (as restated) was primarily the result of our net loss of $25.1 million (as restated); changes in our operating assets and liabilities of $5.3 million (as restated); and an increase in accrued investment income of $446,000; partially offset by stock-based compensation charges of $5.5 million (as restated) and depreciation and amortization of $7.1 million (as restated). Cash used in operating activities in 2005 of $3.5 million (as restated) was primarily the result of our net loss of $20.3 million (as restated) and an increase in accrued investment income of $959,000; partially offset by changes in our operating assets and liabilities of $9.9 million (as restated); depreciation and amortization of $6.9 million (as restated); and stock-based compensation charges of $850,000 (as restated).

Cash flows from investing activities. Cash flows from investing activities has historically been driven by transactions involving our short-term investment portfolio, capital expenditures, changes in our long-term assets, and acquisitions. Net cash provided by investing activities was $47.2 million for 2007, a $42.4 million increase over 2006. Net cash provided by investing activities in 2007 was primarily the result of proceeds from maturities and sales of our available-for-sale short-term investments; partially offset by capital expenditures of $8.1 million. During 2006, net cash provided by investing activities of $4.8 million was primarily the result of proceeds from maturities and sales of our available-for-sale short-term investments; partially offset by capital expenditures of $4.7 million. During 2005, net cash provided by investing activities of $39.8 million was primarily the result of proceeds from maturities and sales of our available-for-sale short-term investments and the $11.1 million release of our restricted investments; partially offset by capital expenditures of $2.1 million.

Cash flows from financing activities. Cash flows from financing activities has historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase program. Net cash provided by financing activities was $4.1 million (as restated) for 2007, a $12.7 million (as restated) increase over 2006. Net cash provided by financing activities in 2007 was primarily attributable to proceeds of $11.2 million from issuance of common stock upon exercise of options by our employees, partially offset by $4.5 million of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of options, and $2.6 million (as restated) of principal payments on our lease financing obligations. During 2006, net cash used in financing activities of $8.6 million (as restated) was primarily attributable to $6.3 million of open-market repurchases of our common stock under our stock repurchase program, and repurchases of $239,000 of our common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of stock options, and $2.3 million (as restated) of principal payments on our lease financing obligations; partially offset by proceeds of $265,000 from issuance of common stock as a result of options exercised by our employees. During 2005, net cash used in financing activities of $11.6 million (as restated) was due to $9.6 million of stock repurchases under our stock repurchase program and $2.0 million (as restated) of principal payments on our lease financing obligations.

Table of Contents

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

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

Our existing cash, cash equivalents, and investment balances will likely decline during the first half of 2008 as a result of our anticipated operating losses. However, we currently expect that these balances will increase during the second half of 2008 as we expect to return to profitability on a quarterly basis. In addition, any weakening of current economic conditions, or changes in our planned cash outlay, could also negatively affect our existing cash, cash equivalents, and investment balances. However, based on our current business plan and revenue prospects, we believe that our existing cash and short-term investment balances will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. Cash from operations could be affected by various risks and uncertainties, including, but not limited to, the risks detailed in Part I, Item 1A Risk Factors. In the unlikely event that we would require additional financing within this period, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

Related Party Transactions

During the years ended December 31, 2007, 2006, and 2005, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for $130.7 million (see Note 11 to our accompanying consolidated financial statements for additional information on our transactions with Enel). The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our knowledge, Enel has not disposed of any of its 3.0 million shares.

Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. As of February 29, 2008, a representative of Enel has not been appointed to our board.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, we cooperated with Enel to integrate 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. Both the new development and supply agreement and the software enhancement agreement expire in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

During 2007, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $14.2 million, $3.0 million of which was included in accounts receivable at December 31, 2007. During 2006, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $7.1 million, none of which was included in accounts receivable at December 31, 2006. During 2005, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $26.9 million.

Table of Contents

Recently Issued Accounting Standards

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007) (SFAS 141R), *Business Combinations*, and Statement of Financial Accounting Standards No. 160 (SFAS 160), *Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin No. 51*. SFAS 141R will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. SFAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. SFAS 141R and SFAS 160 are effective in 2009. We are currently evaluating the impact that SFAS 141R and SFAS 160 will have on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (SFAS 159), *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for our financial statements issued in 2008. We believe that the adoption of SFAS 157 will not have a material impact on our consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*, which defines fair value, establishes guidelines for measuring fair value, and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. However, in February 2008, the FASB issued FASB Staff Position FAS 157-2 (FSP FAS 157-2), which delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. As of January 1, 2008, we will adopt SFAS 157 except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in FSP FAS 157-2. The partial adoption of SFAS 157 is not expected to have a material impact on our consolidated financial position, results of operations, or cash flows. We are currently evaluating the impact of adopting SFAS 157 for nonfinancial assets and liabilities.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk Disclosures. The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments to hedge these exposures.

Interest Rate Sensitivity. We maintain a short-term investment portfolio consisting mainly of fixed income securities with a weighted average maturity of less than one year. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately and uniformly by 100 basis points from levels at December 31, 2007, the fair market value of the portfolio would decline by an immaterial amount, due primarily to the fact that current interest rates remain at historically low levels. We currently intend to hold our fixed income investments until maturity or for a period of time as needed to recover any decline in value due to interest rate fluctuation, and therefore we would not expect our operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates. However, in the unlikely event it was necessary, we could decide to sell some or all of our short-term investments prior to maturity to meet the liquidity needs of the company.

Foreign Currency Exchange Risk. We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant. Due to our modest exposure to foreign currency fluctuations, if foreign exchange rates were to fluctuate by 10% from rates at December 31, 2007, our financial position and results of operations would not be materially affected. However, it is possible that there could be a material impact in the future.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Financial Statements and Supplementary Data required by this item are set forth in Item 6 and at the pages indicated in Item 15(a).

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Table of Contents

ITEM 9A. CONTROLS AND PROCEDURES (As Restated)

(a) Evaluation of Effectiveness of Disclosure Controls and Procedures

We have designed our disclosure controls and procedures to ensure that information we are required to disclose in reports that we file or submit under the Securities and Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. As of the end of the period covered by this Annual Report on Form 10-K/A, under the supervision of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such terms are defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities and Exchange Act of 1934. Based on this evaluation and considering the material weaknesses in internal control over financial reporting described below, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were not effective as of December 31, 2007.

(b) Management s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934). Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2007. This evaluation was based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

In the Company s previously filed Annual Report on Form 10-K for the year ended December 31, 2007, we concluded that the Company s internal control over financial reporting as of December 31, 2007 was effective. However, in April 2008, the Company determined that a restatement of its previously issued financial statements was necessary. As a result of such financial statement restatement, we reassessed our internal control over financial reporting and identified material weaknesses as of December 31, 2007, as follows:

- We lacked policies and procedures for the timely review of the amortization settings within our third-party equity compensation software application; these settings ensure that the automated calculation of stock-based compensation expense uses our selected method of amortization under SFAS 123R; and,

- We lacked effectively designed policies and procedures for the accounting and disclosure of our San Jose, California facilities leases.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our company s annual or interim financial statements will not be prevented or detected on a timely basis.

These material weaknesses resulted in the restatement of our previously issued consolidated financial statements as of December 31, 2007 and 2006, and for each of the years in the three-year period ended December 31, 2007, and each of the quarterly periods in 2007 and 2006, to correct reported stock-based compensation expense and other expenses, assets and liabilities associated with accounting for our San Jose, California headquarters facilities leases in such consolidated financial statements.

As a result of the aforementioned material weaknesses as of December 31, 2007, we have revised our previously reported assessment of the effectiveness of internal control over financial reporting and have concluded that, as of December 31, 2007, the Company s internal control over financial reporting was not effective.

The Company s independent registered public accounting firm, KPMG LLP, has issued an attestation report on the Company s internal control over financial reporting. This report appears on page 47 of this Form 10-K/A.

(c) Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended December 31, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Subsequent to March 31, 2008, we have or are planning to take the following actions to address the material weaknesses in our internal control over financial reporting noted above:

- develop reports to show critical inputs within our third-party equity compensation software application;
- implement controls to ensure an appropriate and timely review of all critical input settings within our equity compensation software application;
- provide additional training for all employees who are users of the equity compensation software application or the information reported by the application; and,
- design and implement controls to properly account and provide required disclosures for our San Jose, California headquarters facilities leases.

For the quarter ended March 31, 2008, we reviewed all amortization settings and corrected the settings within our third-party equity compensation software application to ensure proper amortization of stock-based compensation expense. We have also corrected the accounting for our San Jose, California headquarters facilities leases.

We believe as a result of the actions we have taken to date, the information contained in this Form 10-K/A fairly presents, in all material respects, our financial condition and results of operations for the periods contained therein.

ITEM 9B. OTHER INFORMATION

Echelon is scheduled to hold its 2007 annual meeting of stockholders on May 27, 2008. The meeting will commence at 10:00 a.m., PST, and will be held at our corporate headquarters located at 570 Meridian Avenue, San Jose, California 95126. The date of record for the annual meeting is March 31, 2008.

Table of Contents

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE MATTERS

The information regarding our executive officers required by this Item is incorporated herein by reference from the section titled Executive Officers of Registrant in Part I of this annual report on Form 10-K/A. The remaining information required by this Item is incorporated herein by reference from our Proxy Statement for the 2008 Annual Meeting of Stockholders (the 2008 Proxy Statement), which was filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year ended December 31, 2007.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference from our 2008 Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item is incorporated herein by reference from our 2008 Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference from our 2008 Proxy Statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated herein by reference from our 2008 Proxy Statement.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) The following documents are filed as part of this Form:

1. Financial Statements (As Restated)

	Page
Reports of Independent Registered Public Accounting Firm	46
Consolidated Balance Sheets	48
Consolidated Statements of Operations	49
Consolidated Statements of Stockholders Equity	50
Consolidated Statements of Cash Flows	51
Consolidated Statements of Comprehensive Income (Loss)	52
Notes to Consolidated Financial Statements	53

2. Financial Statement Schedule

Schedule II Valuation and Qualifying Accounts 82

All other schedules have been omitted because they are not applicable or the required information is included in the Consolidated Financial Statements or the Notes thereto.

44

Table of Contents

3. Exhibits

Item 601 of Regulation S-K requires the following exhibits listed below. Each management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K/A has been identified.

ExhibitNo.	Description of Document
3.2*	Amended and Restated Certificate of Incorporation of Registrant.
3.3*	Amended and Restated Bylaws of Registrant.
4.1*	Form of Registrant s Common Stock Certificate.
4.2*	Second Amended and Restated Modification Agreement dated May 15, 1997.
10.1*	Form of Indemnification Agreement entered into by Registrant with each of its directors and executive officers.
10.2*+	1997 Stock Plan and forms of related agreements.
10.2(a)*+	Form of 1997 Stock Plan Stock Option Agreement with early exercise feature
10.2(b)*+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement with early exercise feature
10.2(c)*+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement
10.2(d)*+	Form of 1997 Stock Plan Performance Share Agreement
10.2(e)*+	Form of 1997 Stock Plan Performance Share Agreement for non-US employees
10.2(f)*+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria for non-US employees
10.2(g)*+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for non-US employees
10.2(h)*+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria
10.2(i)*+	Form of 1997 Stock Plan Performance Share Agreement
10.2(j)*+	Form of 1997 Stock Plan Stock Appreciation Right Agreement
10.3*+	1988 Stock Option Plan and forms of related agreements.
10.4*	Second Amended and Restated Modification Agreement dated May 15, 1997 (included in Exhibit 4.2).
10.5*	Form of International Distributor Agreement.
10.6*	Form of OEM License Agreement.
10.7*	Form of Software License Agreement.
10.8*	International Distributor Agreement between the Company and EBV Elektronik GmbH as of December 1, 1997.
10.9*+	1998 Director Option Plan.
21.1*	Subsidiaries of the Registrant.
23.1	Consent of KPMG LLP, Independent Registered Public Accounting Firm.
24.1*	Power of Attorney (see signature page).
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Previously filed.

\+ Indicates management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 14(c) of Form 10-K.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Echelon Corporation:

We have audited the accompanying consolidated balance sheets of Echelon Corporation and subsidiaries (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of operations, stockholders equity, comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2007. In connection with our audits of the consolidated financial statements, we have also audited the financial statement schedule as listed in item 15(a). These consolidated financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Echelon Corporation and subsidiaries as of December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 2 to the consolidated financial statements, the consolidated financial statements as of December 31, 2007 and 2006, and for each of the years in the three-year period ended December 31, 2007, have been restated.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Echelon Corporation and subsidiaries internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 17, 2008, except as to the third through sixth paragraphs of Management s Annual Report on Internal Control over Financial Reporting (as restated), which are as of May 16, 2008, expressed an adverse opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP

Mountain View, California

March 17, 2008, except as to Note 2, which is as of May 16, 2008

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Echelon Corporation:

We have audited Echelon Corporation s (the Company) internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Annual Report on Internal Control over Financial Reporting (as restated) appearing under Item 9A(b) of the 2007 Annual Report on Form 10-K/A. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company s annual or interim financial statements will not be prevented or detected on a timely basis. Material weaknesses related to the accounting for stock-based compensation and leases have been identified and included in management s restated assessment of the effectiveness of internal control over financial reporting.

As stated in the third through sixth paragraphs of Management s Annual Report on Internal Control over Financial Reporting (as restated), management s assessment of the effectiveness of the Company s internal control over financial reporting has been restated to reflect the impact of the aforementioned material weaknesses in internal control over financial reporting.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Echelon Corporation and subsidiaries as of December 31, 2007, and the related consolidated statements of operations, stockholders equity, comprehensive income (loss), and cash flows for the year then ended. These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2007 consolidated financial statements, and this report does not affect our report dated March 17, 2008, except as to Note 2, which is as of May 16, 2008, which expressed an unqualified opinion on those consolidated financial statements.

In our opinion, because of the effect of the aforementioned material weaknesses on the achievement of the objectives of the control criteria, Echelon Corporation has not maintained effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the COSO.

/s/ KPMG LLP

Mountain View, California

March 17, 2008, except as to the third through sixth paragraphs of Management s Annual Report on Internal Control over Financial Reporting (as restated), which are as of May 16, 2008

Table of Contents

ECHELON CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

	December 31,	
	2007 (As Restated) [1]	2006 (As Restated) [1]
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 76,062	$ 37,412
Short-term investments	31,128	86,745
Accounts receivable, net of allowances of $1,428 in 2007 and $1,041 in 2006 [2]	33,469	13,918
Inventories	14,012	11,359
Deferred cost of goods sold	6,656	19,060
Other current assets	2,092	2,138
Total current assets	163,419	170,632
Property and equipment, net	30,776	30,405
Goodwill	8,548	8,278
Other long-term assets	1,964	1,957
TOTAL ASSETS	$ 204,707	$ 211,272
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 12,945	$ 6,893
Accrued liabilities	4,551	4,796
Current portion lease financing obligations	2,900	2,579
Deferred revenues	16,312	26,843
Total current liabilities	36,708	41,111
Long-Term Liabilities:		
Lease financing obligations, excluding current portion	13,151	16,052
Other long-term liabilities	1,637	446
Total long-term liabilities	14,788	16,498
Commitments and Contingencies (Note 8)		
Stockholders Equity:		
Preferred stock, $0.01 par value:		
Authorized 5,000,000 shares; none outstanding		
Common stock, $0.01 par value:		
Authorized 100,000,000 shares		
Issued 43,205,524 shares in 2007 and 41,576,721 shares in 2006		
Outstanding 40,736,340 shares in 2007 and 39,107,537 shares in 2006	432	416
Additional paid-in capital	298,556	283,728
Treasury stock, at cost (2,469,184 shares in 2007 and 2006)	(19,259)	(19,259)
Accumulated other comprehensive income	1,718	997
Accumulated deficit	(128,236)	(112,219)

Total stockholders equity	153,211	153,663
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 204,707	$ 211,272

[1] See Note 2 for explanation of the restatement of the Consolidated Financial Statements.

[2] Includes related party amounts of $3,000 in 2007 and $0 in 2006. See Note 11 for additional information on related party transactions.

See accompanying notes to the consolidated financial statements.

48

Table of Contents

ECHELON CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Year Ended December 31,		
	2007 (As Restated) [1]	2006 (As Restated) [1]	2005 (As Restated) [1]
REVENUES:			
Product	$ 135,405	$ 56,515	$ 73,563
Service	2,172	761	865
Total revenues [2]	137,577	57,276	74,428
COST OF REVENUES:			
Cost of product	85,035	22,039	30,928
Cost of service	2,360	1,877	2,081
Total cost of revenues	87,395	23,916	33,009
Gross profit	50,182	33,360	41,419
OPERATING EXPENSES:			
Product development	32,644	28,221	24,853
Sales and marketing	21,181	20,408	20,994
General and administrative	16,083	13,949	19,401
Total operating expenses	69,908	62,578	65,248
Loss from operations	(19,726)	(29,218)	(23,829)
Interest and other income, net	5,717	5,817	5,225
Interest expense on lease financing obligations	(1,211)	(1,379)	(1,530)
Loss before provision for income taxes	(15,220)	(24,780)	(20,134)
Provision for income taxes	452	350	154
NET LOSS	$ (15,672)	$ (25,130)	$ (20,288)
Loss per share:			
Basic	$ (0.39)	$ (0.64)	$ (0.50)
Diluted	$ (0.39)	$ (0.64)	$ (0.50)
Shares used in per share calculation:			
Basic	39,891	39,487	40,377
Diluted	39,891	39,487	40,377

[1] See Note 2 for explanation of the restatement of the Consolidated Financial Statements.

[2] Includes related party amounts of $14,180 in 2007, $7,103 in 2006, and $26,933 in 2005. See Note 11 for additional information on related party transactions

See accompanying notes to the consolidated financial statements.

Table of Contents

ECHELON CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands)

	Common Stock		Treasury Stock			Accumulated Other Comprehensive		
	Shares	Amount	Shares	Amount	Additional Paid-In Capital	Income (Loss)	Accumulated Deficit	Total
BALANCE AT DECEMBER 31, 2004 (As Previously Reported)	41,477	$ 415	(290)	$ (3,367)	$ 277,442	$ 922	$ (64,350)	$ 211,062
Cumulative effect of restatements on prior periods [1]							(2,451)	(2,451)
BALANCE AT DECEMBER 31, 2004 (As Restated) [1]	41,477	$ 415	(290)	$ (3,367)	$ 277,442	$ 922	$ (66,801)	$ 208,611
Repurchase of stock			(1,383)	(9,558)				(9,558)
Repurchase of employee shares	(4)				(24)			(24)
Stock-based compensation (As Restated)[1]					850			850
Foreign currency translation adjustment						(1,077)		(1,077)
Unrealized holding gain on available-for-sale securities						37		37
Net loss (As Restated) [1]							(20,288)	(20,288)
BALANCE AT DECEMBER 31, 2005 (As Restated) [1]	41,473	$ 415	(1,673)	$ (12,925)	$ 278,268	$ (118)	$ (87,089)	$ 178,551
Exercise of stock options	125	1			763			764
Release of performance shares	72	1			(1)			
Stock received for payment of option exercise price	(61)	(1)			(498)			(499)
Stock received for payment of employee taxes on vesting of performance shares and upon exercise of stock options	(29)				(239)			(239)
Repurchase of stock			(796)	(6,334)				(6,334)
Repurchase of employee shares	(3)				(25)			(25)
Stock-based compensation (As Restated)[1]					5,460			5,460
Foreign currency translation adjustment						751		751
Unrealized holding gain on available-for-sale securities						364		364
Net loss (As Restated) [1]							(25,130)	(25,130)
BALANCE AT DECEMBER 31, 2006 (As Restated) [1]	41,577	$ 416	(2,469)	$ (19,259)	$ 283,728	$ 997	$ (112,219)	$ 153,663
Exercise of stock options	1,949	19			18,378			18,397
Release of performance shares	228	2			(2)			
Stock received for payment of option exercise price	(332)	(3)			(7,166)			(7,169)
Stock received for payment of employee taxes on vesting of performance shares and upon exercise of stock options	(213)	(2)			(4,127)		(345)	(4,474)
Repurchase of employee shares	(3)				(54)			(54)
Stock-based compensation (As Restated)[1]					7,799			7,799
Foreign currency translation adjustment						651		651

Unrealized holding gain on available-for-sale securities						70		70
Net loss (As Restated) [1]							(15,672)	(15,672)
BALANCE AT DECEMBER 31, 2007 (As Restated) [1]	43,206	$ 432	(2,469)	$ (19,259)	$ 298,556	$ 1,718	$ (128,236)	$ 153,211

[1] See Note 2 for explanation of the restatement of the Consolidated Financial Statements.

See accompanying notes to the consolidated financial statements.

50

Table of Contents

ECHELON CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended December 31,		
	2007 (As Restated) [1]	**2006 (As Restated) [1]**	**2005 (As Restated) [1]**
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	$ (15,672)	$ (25,130)	$ (20,288)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	7,441	7,120	6,885
Increase in (reduction of) allowance for doubtful accounts	88	(23)	15
Loss (gain) on disposal of fixed assets	10	(2)	67
Reduction of (increase in) accrued investment income	436	(446)	(959)
Stock-based compensation	7,799	5,460	850
Change in operating assets and liabilities:			
Accounts receivable	(19,621)	(2,889)	6,240
Inventories	(2,631)	(8,119)	2,344
Other current assets	93	(380)	259
Accounts payable	6,262	2,921	(1,185)
Deferred cost of goods sold	12,404	(18,738)	38
Accrued liabilities	925	(2,776)	2,021
Deferred revenues	(10,518)	24,747	314
Deferred rent	(75)	(105)	(100)
Net cash used in operating activities	(13,059)	(18,360)	(3,499)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of available-for-sale short-term investments	(65,545)	(85,971)	(94,144)
Proceeds from sales and maturities of available-for-sale short-term investments	120,796	95,436	124,594
Release of restricted investments			11,106
Changes in other long-term assets	31	37	335
Capital expenditures	(8,053)	(4,696)	(2,099)
Net cash provided by investing activities	47,229	4,806	39,792
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from exercise of stock options	11,216	265	
Principal payments of lease financing obligations	(2,580)	(2,297)	(2,064)
Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options	(4,520)	(239)	
Repurchase of common stock under stock repurchase program		(6,334)	(9,582)
Net cash provided by (used in) financing activities	4,116	(8,605)	(11,646)
EFFECT OF EXCHANGE RATES ON CASH	364	491	(1,077)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	38,650	(21,668)	23,570
CASH AND CASH EQUIVALENTS:			
Beginning of year	37,412	59,080	35,510

End of year	$ 76,062	$ 37,412	$ 59,080
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid for interest on lease financing obligations	$ 1,196	$ 1,366	$ 1,518
Cash paid for income taxes	$ 431	$ 199	$ 449

[1] See Note 2 for explanation of the restatement of the Consolidated Financial Statements.

See accompanying notes to the consolidated financial statements.

Table of Contents

ECHELON CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

	Year Ended December 31,		
	2007 (As Restated) [1]	2006 (As Restated) [1]	2005 (As Restated) [1]
Net loss	$ (15,672)	$ (25,130)	$ (20,288)
Other comprehensive income (loss), net of tax:			
Foreign currency translation adjustment	651	751	(1,077)
Unrealized holding gain on available-for-sale securities	70	364	37
Comprehensive loss	$ (14,951)	$ (24,015)	$ (21,328)

[1] See Note 2 for explanation of the restatement of the Consolidated Financial Statements.

See accompanying notes to the consolidated financial statements.

52

Table of Contents

ECHELON CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING POLICIES:

(a) Operations

Echelon Corporation (the Company) was incorporated in California in February 1988 and was reincorporated in Delaware in January 1989. The Company develops, markets, and supports a wide range of hardware and software products and services that enable OEMs and systems integrators to design and implement open, interoperable, distributed control networks. The Company s products are based on its LonWorks networking technology, an open standard for interoperable networked control. In a LonWorks control network, intelligent control devices, called nodes, communicate using the Company s LonWorks protocol. For the electric utility industry, the Company has developed an advanced metering infrastructure system called the Networked Energy Services (NES) system. The NES system provides a two-way information and control path between the utility and its customer, which enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. The Company sells its products and services around the world to the building, industrial, transportation, utility/home and other automation markets.

(b) Basis of Presentation

The Company s consolidated financial statements reflect operations of the Company and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated.

(c) Use of Estimates

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

(d) Reclassifications

Certain reclassifications have been made to the prior year amounts to conform with the fiscal year 2007 presentation. Specifically, $239,000 has been reclassified within financing cash flows in the Company s 2006 Consolidated Statements of Cash Flows to separately report components of stock repurchase activity. See Note 2 regarding the restatement of these consolidated financial statements.

(e) Revenue Recognition

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

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

period.

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

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.

53

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 the warranties on its NES Hardware products, based on stated renewal rates. These revenues are recognized ratably over the associated service period, which generally commences upon the latter of the delivery of all software, or the customer s acceptance of any given Hardware shipment.

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

The Company accounts for the rights of return, price protection, rebates, and other sales incentives offered to its distributors in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, *Revenue Recognition When Right of Return Exists,* and EITF 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products).* During the first and second quarters of 2006, the Company modified its revenue recognition method for sales made to its distributor partners. Under the revised method, revenue on sales made to distributors is deferred until the distributor sells the products through to its end-use customers. The impacts of this revenue recognition methodology revision were one-time reductions in revenues of approximately $2.9 million and $1.0 million during the first and second quarters of 2006, respectively.

(f) 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.

(g) Stock-Based Compensation (As Restated)

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

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

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

Prior to January 1, 2006, the Company accounted for equity compensation according to the provisions of APB 25, and applied the disclosure provisions of SFAS 123 as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, as if the fair-value-based method had been applied in measuring compensation expense. Under APB 25, no compensation

Table of Contents

expense was recorded in the Company s statement of operations for stock options where the exercise price was equal to or greater than the fair market value of the underlying stock on the date of grant. However, during 2005, the Company did record compensation expense for share awards issued during 2005. The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation for the year ended December 31, 2005 (in thousands, except per share amounts).

Net loss as reported (As Restated)	$ (20,288)
Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects (As Restated)	850
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects (As Restated)	(13,265)
Pro forma net loss (As Restated)	$ (32,703)
Basic net income (loss) per share:	
As reported (as restated)	$ (0.50)
Pro forma (as restated)	$ (0.81)
Diluted net loss per share:	
As reported (as restated)	$ (0.50)
Pro forma (as restated)	$ (0.81)

Further information regarding stock-based compensation can be found in Note 5 of these Notes to Consolidated Financial Statements. See also Note 2 of these Notes to Consolidated Financial Statements for explanation of the restatement of these financial statements.

(h) Cash and Cash Equivalents

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

(i) Short-Term Investments

The Company classifies its investments in marketable debt securities as available-for-sale in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Securities classified as available-for-sale are reported at fair value with the related unrealized holding gains and losses, net of tax, being included in accumulated other comprehensive income (loss). 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 (in thousands):

	December 31,					
	2007			2006		
	Amortized Cost	**Aggregate Fair Value**	**Net Unrealized Holding Gains**	**Amortized Cost**	**Aggregate Fair Value**	**Net Unrealized Holding Gains/ (Losses)**
U.S. corporate securities:						
Commercial paper	$	$	$	$ 46,492	$ 46,497	$ 5

Corporate notes and bonds	22,442	22,462	20	20,712	20,684	(28)
	22,442	22,462	20	67,204	67,181	(23)
Foreign corporate notes and bonds	515	517	2	1,508	1,504	(4)
U.S. government agency securities	8,141	8,149	8	18,064	18,060	(4)
Total investments in debt securities	$ 31,098	$ 31,128	$ 30	$ 86,776	$ 86,745	$ (31)

As of December 31, 2007 and 2006, the Company s available-for-sale securities had original contractual maturities of between ten to twenty-four months, and from four to twenty-four months, respectively. As of December 31, 2007 and 2006, the average remaining term to maturity for the Company s available-for-sale securities was six and eight months, respectively. The fair value of available-for-sale securities was determined based on quoted market prices or other readily available market information at the reporting date for those instruments.

55

Table of Contents

The following tables show gross unrealized losses and fair value for those investments that were in an unrealized loss position as of December 31, 2007 and 2006, aggregated by investment category and the length of time that individual securities have been in a continuous loss position (in thousands):

	December 31, 2007					
	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Corporate notes and bonds	5,946	(14)	769	(1)	6,715	(15)
Total	$ 5,946	$ (14)	$ 769	$ (1)	$ 6,715	$ (15)

	December 31, 2006					
	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Corporate notes and bonds	$ 13,394	$ (28)	$ 2,095	$ (3)	$ 15,489	$ (31)
Foreign corporate notes and bonds			1,504	(4)	1,504	(4)
U.S. government agency securities	3,281	(6)	3,627	(11)	6,908	(17)
Total	$ 16,675	$ (34)	$ 7,226	$ (18)	$ 23,901	$ (52)

Market values were determined for each individual security in the investment portfolio. The decline in value of these investments is primarily related to changes in interest rates and is considered to be temporary in nature. Investments are reviewed periodically to identify possible impairment. When evaluating the investments, the Company reviews factors such as length of time and extent to which fair value has been below cost basis, the financial condition of the issuer, and the Company s ability and intent to hold the investment for a period of time which may be sufficient for anticipated recovery in market value. For each of the three years ended December 31, 2007, gross realized gains and losses on the Company s investment portfolio were not material.

(j) Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and are primarily comprised of direct material costs, including manufacturing 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):

	December 31,	
	2007	2006
Purchased materials	$ 4,379	$ 3,378
Work-in-process	360	107
Finished goods	9,273	7,874
	$ 14,012	$ 11,359

(k) Impairment of Long-Lived Assets Including Goodwill

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability is measured by comparing the asset s carrying value to the future undiscounted cash flows the asset is

expected to generate. If long-lived assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair value. For the three years ended December 31, 2007, the Company recognized no material impairments.

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

(l) Software Development Costs

For software to be sold, leased, or otherwise marketed, the Company capitalizes eligible computer software development costs upon the establishment of technological feasibility, which the Company has defined as completion of a working model. For the three years ended December 31, 2007, costs that were eligible for capitalization were insignificant and, thus, the Company has charged all software development costs to product development expense in the accompanying consolidated statements of operations.

(m) Accrued Liabilities (As Restated)

Accrued liabilities consisted of the following (in thousands):

	December 31,	
	2007 (As Restated) [1]	**2006 (As Restated) [1]**
Accrued payroll and related costs	$ 3,006	$ 2,776
Accrued taxes	37	1,307
Customer deposits	932	5
Other accrued liabilities	576	708
	$ 4,551	$ 4,796

(1) See Note 2 of these Notes to Consolidated Financial Statements.

(n) Foreign Currency Translation

The functional currency of the Company s subsidiaries is the local currency. Accordingly, all assets and liabilities are translated into U.S. dollars at the current exchange rate as of the applicable balance sheet date. Revenues and expenses are translated at the average exchange rate prevailing during the period. Gains and losses resulting from the translation of the financial statements are included in accumulated other comprehensive income (loss).

Remeasurement adjustments for non-functional currency monetary assets and liabilities, including short-term intercompany balances, are included in other income (expense) in the accompanying consolidated statements of operations. Currently, the Company does not employ a foreign currency hedge program utilizing foreign currency exchange contracts as the foreign currency transactions and risks to date have not been significant.

(o) Concentrations of Credit Risk and Suppliers

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.

Table of Contents

With the exception of amounts owed the Company on sales made to certain significant customers, concentrations of credit risk with respect to trade receivables are generally limited due to the Company s large number of customers and their dispersion across many different industries and geographies. For the years ended December 31, 2007 and 2006, the percentage of the Company s total accounts receivable balance that were due from the following significant customers is as follows:

	December 31,	
	2007	2006
Telvent Energia Y Medio Ambeinte	35.7%	51.8%
Limited Liability Company Engineering Center ENERGOAUDITCONTROL	27.7%	0.0%
ES Elektrosandberg AB	12.0%	2.5%
Enel (and its contract manufacturers)	9.0%	0.0%
EBV	1.7%	15.3%
Total	86.1%	69.6%

For most of the Company s products requiring assembly, it relies on a limited number of contract electronic manufacturers, principally WKK Technology, TYCO, Jabil, and Flextronics. The Company also maintains manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products, including those used in the Company s NES system. The Neuron Chip, which is an important component that the Company and its customers use in control network devices, is currently manufactured and distributed by two providers, Toshiba and Cypress Semiconductor. Another semiconductor supplier, STMicroelectronics, manufactures the Company s power line smart transceiver products, for which the Company has no alternative source. In addition, the Company currently purchases several key products and components from sole or limited source suppliers with which it does not maintain signed agreements that would obligate them to supply to the Company on negotiated terms.

If any of the Company s key suppliers were to stop manufacturing the Company s products or cease supplying the Company with its key components, it could be expensive and time consuming to find a replacement. Also, as the Company s NES business grows, it will be required to expand its business with its key suppliers or find additional sources of supply, as it has recently done with Flextronics and Jabil. There is no guarantee that the Company would be able to find acceptable alternative or additional sources.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with the Company s product, assembly and test specifications could adversely affect the Company s revenues and gross profit, and could result in claims against the Company by its customers, which could harm the Company s results of operations and financial position.

(p) Computation of Basic and Diluted Net Loss Per Share and Pro Forma Basic Net Loss Per Share (As Restated)

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average shares of common stock outstanding during the period. Diluted net income per share is calculated by adjusting the weighted average number of outstanding shares assuming conversion of all potentially dilutive stock options and warrants under the treasury stock method.

The following is a reconciliation of the numerators and denominators of the basic and diluted net income (loss) per share computations for the years ended December 31, 2007, 2006, and 2005 (in thousands, except per share amounts):

	Year Ended December 31,		
	2007 (As Restated) [1]	2006 (As Restated) [1]	2005 (As Restated) [1]
Net loss (Numerator):			
Net loss, basic and diluted	$ (15,672)	$ (25,130)	$ (20,288)
Shares (Denominator):			
Weighted average shares used in basic computation	39,891	39,487	40,377

Common shares issuable upon exercise of stock options (treasury stock method)			
Weighted average shares used in diluted computation	39,891	39,487	40,377
Net loss per share:			
Basic	$ (0.39)	$ (0.64)	$ (0.50)
Diluted	$ (0.39)	$ (0.64)	$ (0.50)

(1) See Note 2 of these Notes to Consolidated Financial Statements.

Table of Contents

For the years ended December 31, 2007, 2006, and 2005, the diluted net loss per share calculation is equivalent to the basic net loss per share calculation as there are no potentially dilutive stock options due to the Company s net loss position. The number of stock options and performance shares excluded from these calculations in 2007, 2006, and 2005 were 7,907,702, 8,985,716, and 8,502,441, respectively.

(q) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109*. FIN 48 requires the Company to take a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon effective settlement. The Company re-evaluates its income tax positions on a quarterly basis to consider factors such as changes in facts or circumstances, changes in or interpretations of tax law, effectively settled issues under audit, and new audit activity. Such a change in recognition or measurement would result in recognition of a tax benefit or an additional charge to the tax provision. Upon adoption of FIN 48, the Company adopted an accounting policy to classify interest and penalties on unrecognized tax benefits as income tax expense. For years prior to the adoption of FIN 48, the Company also reported interest and penalties on unrecognized tax benefits as income tax expense.

(r) Comprehensive Income (Loss)

Comprehensive income (loss) for the Company consists of net income (loss) plus the effect of unrealized holding gains or losses on investments classified as available-for-sale and foreign currency translation adjustments.

(s) Recent Accounting Pronouncements

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007) (SFAS 141R), *Business Combinations*, and Statement of Financial Accounting Standards No. 160 (SFAS 160), *Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin No. 51*. SFAS 141R will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. SFAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. SFAS 141R and SFAS 160 are effective in 2009. The Company is currently evaluating the impact that SFAS 141R and SFAS 160 will have on its consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (SFAS 159), *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for financial statements issued in 2008. The Company does not believe the adoption of SFAS 157 will have a material impact on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*, which defines fair value, establishes guidelines for measuring fair value, and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. However, in February 2008, the FASB issued FASB Staff Position FAS 157-2 (FSP FAS 157-2), which delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. As of January 1, 2008, the Company will adopt SFAS 157 except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in FSP FAS 157-2. The partial adoption of SFAS 157 is not expected to have a material impact on the Company s consolidated financial position, results of operations, or cash flows. The

Company is currently evaluating the impact of adopting SFAS 157 for nonfinancial assets and liabilities.

Table of Contents

2. RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS

During the preparation of its financial results for the quarter ended March 31, 2008, the Company identified an error in its previously reported equity compensation expense and determined it had inappropriately accounted for the 1999 and 2001 leases of its San Jose, California corporate headquarters facilities.

Restatement of stock-based compensation expense: The Company identified an error in its previously reported stock-based compensation expense for the years ended December 31, 2007, 2006 and 2005. 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 SFAS 123R, 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 the Company uses to manage and account for its 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 the Company had elected to use for all of its 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.

Restatement related to the leases of our San Jose, California headquarters facilities: The Company inappropriately accounted for the leases of its 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 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11* (SFAS 98), the Company should have reflected an asset on its balance sheet for the costs paid by the lessor to construct its headquarters facilities, as well as a corresponding liability, because the Company was the deemed owner of the headquarters facilities for accounting purposes during the construction periods. Upon completion of construction, the Company 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. The Company has 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 was 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 the Company has made or is 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, the Company should have recognized land lease expense, depreciation expense on the assets it is deemed to own and interest expense on the associated lease financing obligations.

Therefore the Company has restated its consolidated balance sheets as of December 31, 2007 and 2006, and its consolidated statements of operations, stockholders equity, cash flows and comprehensive income (loss) for each of the years in the three-year period ended December 31, 2007 and each of the quarters in 2007 and 2006, to reflect the restatement adjustments applicable to those periods.

The tables on the following pages present the effects of all restatement adjustments on the consolidated financial statements reconciling the previously reported data to the as restated data for the Consolidated Balance Sheets as of December 31, 2007 and 2006, and the Consolidated Statements of Operations and Cash Flows for each of the years in the three-year period ended December 31, 2007. Other than the cumulative effect of restatement adjustments to the accumulated deficit as of January 1, 2005, the effects of the restatement adjustments on the Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss) for each of the years in the three-year period ended December 31, 2007, relate solely to the change in the Company s net loss resulting from the restatements and therefore have not been specifically reconciled below.

Table of Contents

The following table presents the effects of the adjustments made to the Company s previously reported consolidated balance sheets as of December 31, 2007 and 2006 (in thousands):

	December 31,					
	2007			2006		
	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated
ASSETS						
Current Assets:						
Cash and cash equivalents	$ 76,062	$	$ 76,062	$ 37,412	$	$ 37,412
Short-term investments	31,128		31,128	86,745		86,745
Accounts receivable, net	33,469		33,469	13,918		13,918
Inventories	14,012		14,012	11,359		11,359
Deferred cost of goods sold	6,656		6,656	19,060		19,060
Other current assets	2,328	(236)	2,092	2,359	(221)	2,138
Total current assets	163,655	(236)	163,419	170,853	(221)	170,632
Property and Equipment, net	18,283	12,493	30,776	15,188	15,217	30,405
Goodwill	8,548		8,548	8,278		8,278
Other long-term assets	1,964		1,964	1,957		1,957
TOTAL ASSETS	$ 192,450	$ 12,257	$ 204,707	$ 196,276	$ 14,996	$ 211,272
LIABILITIES AND STOCKHOLDERS EQUITY						
Current Liabilities:						
Accounts payable	$ 12,945	$	$ 12,945	$ 6,893	$	$ 6,893
Accrued liabilities	4,516	35	4,551	4,697	99	4,796
Current portion lease financing obligations		2,900	2,900		2,579	2,579
Deferred revenues	16,312		16,312	26,843		26,843
Total current liabilities	33,773	2,935	36,708	38,433	2,678	41,111
Long-Term Liabilities:						
Lease Financing Obligations, net of current portion		13,151	13,151		16,052	16,052
Deferred rent, net of current portion	1,298	(930)	368	1,268	(822)	446
Other long-term liabilities	1,269		1,269			
Total long-term liabilities	2,567	12,221	14,788	1,268	15,230	16,498
Commitments and Contingencies						
Stockholders Equity:						
Preferred stock						
Common stock	432		432	416		416
Additional paid-in capital	296,585	1,971	298,556	282,930	798	283,728
Treasury stock	(19,259)		(19,259)	(19,259)		(19,259)
Accumulated other comprehensive income	1,718		1,718	997		997
Accumulated deficit	(123,366)	(4,870)	(128,236)	(108,509)	(3,710)	(112,219)
Total stockholders equity	156,110	(2,899)	153,211	156,575	(2,912)	153,663
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 192,450	$ 12,257	$ 204,707	$ 196,276	$ 14,996	$ 211,272

Table of Contents

The following table presents the effects of the adjustments made to the Company s previously reported consolidated statements of operations for each of the years ended December 31, 2007, 2006 and 2005 (in thousands, except per share data):

	Year Ended December 31,								
	2007			2006			2005		
	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated
REVENUES:									
Product	$ 135,405	$	$ 135,405	$ 56,515	$	$ 56,515	$ 73,563	$	$ 73,563
Service	2,172		2,172	761		761	865		865
	137,577		137,577	57,276		57,276	74,428		74,428
COST OF REVENUES:									
Cost of product	84,934	101	85,035	22,032	7	22,039	30,955	(27)	30,928
Cost of service	2,389	(29)	2,360	1,917	(40)	1,877	2,124	(43)	2,081
	87,323	72	87,395	23,949	(33)	23,916	33,079	(70)	33,009
Gross profit	50,254	(72)	50,182	33,327	33	33,360	41,349	70	41,419
OPERATING EXPENSES:									
Product development	32,511	133	32,644	28,357	(136)	28,221	25,098	(245)	24,853
Sales and marketing	21,030	151	21,181	20,372	36	20,408	21,023	(29)	20,994
General and admin	16,490	(407)	16,083	14,505	(556)	13,949	20,018	(617)	19,401
	70,031	(123)	69,908	63,234	(656)	62,578	66,139	(891)	65,248
Loss from operations	(19,777)	51	(19,726)	(29,907)	689	(29,218)	(24,790)	961	(23,829)
Interest and other income, net	5,717		5,717	5,817		5,817	5,225		5,225
Interest expense on lease financing obligations		(1,211)	(1,211)		(1,379)	(1,379)		(1,530)	(1,530)
Loss before provision for income taxes	(14,060)	(1,160)	(15,220)	(24,090)	(690)	(24,780)	(19,565)	(569)	(20,134)
Provision for income taxes	452		452	350		350	154		154
NET LOSS	$ (14,512)	$ (1,160)	$ (15,672)	$ (24,440)	$ (690)	$ (25,130)	$ (19,719)	$ (569)	$ (20,288)
Loss per share:									
Basic	$ (0.36)	$ (0.03)	$ (0.39)	$ (0.62)	$ (0.02)	$ (0.64)	$ (0.49)	$ (0.01)	$ (0.50)
Diluted	$ (0.36)	$ (0.03)	$ (0.39)	$ (0.62)	$ (0.02)	$ (0.64)	$ (0.49)	$ (0.01)	$ (0.50)
Shares used in per share calculation:									
Basic	39,891		39,891	39,487		39,487	40,377		40,377
Diluted	39,891		39,891	39,487		39,487	40,377		40,377

Table of Contents

The following table presents the effects of the adjustments made to the Company s previously reported consolidated statements of cash flows for each of the years ended December 31, 2007, 2006 and 2005 (in thousands):

	Year Ended December 31,								
	2007			2006			2005		
	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated
CASH FLOWS FROM OPERATING ACTIVITIES:									
Net loss	$ (14,512)	$ (1,160)	$ (15,672)	$ (24,440)	$ (690)	$ (25,130)	$ (19,719)	$ (569)	$ (20,288)
Adjustments:									
Depreciation/ amortization	4,717	2,724	7,441	4,396	2,724	7,120	4,162	2,723	6,885
Allowance for doubtful accounts	88		88	(23)		(23)	15		15
Disposal of fixed assets	10		10	(2)		(2)	67		67
Accrued investment income	436		436	(446)		(446)	(959)		(959)
Stock-based compensation	6,626	1,173	7,799	4,925	535	5,460	587	263	850
Change in operating assets and liabilities:									
Accounts receivable	(19,621)		(19,621)	(2,889)		(2,889)	6,240		6,240
Inventories	(2,631)		(2,631)	(8,119)		(8,119)	2,344		2,344
Other current assets	77	16	93	(392)	12	(380)	246	13	259
Accounts payable	6,262		6,262	2,921		2,921	(1,185)		(1,185)
Deferred cost of goods sold	12,404		12,404	(18,738)		(18,738)	38		38
Accrued liabilities	925		925	(2,776)		(2,776)	2,021		2,021
Deferred revenues	(10,518)		(10,518)	24,747		24,747	314		314
Deferred rent	98	(173)	(75)	179	(284)	(105)	266	(366)	(100)
Net cash used in operating activities	(15,639)	2,580	(13,059)	(20,657)	2,297	(18,360)	(5,563)	2,064	(3,499)
CASH FLOWS FROM INVESTING ACTIVITIES:									
Purchase of investments	(65,545)		(65,545)	(85,971)		(85,971)	(94,144)		(94,144)
Proceeds from investments	120,796		120,796	95,436		95,436	124,594		124,594
Release of restricted investments							11,106		11,106
Other long-term assets	31		31	37		37	335		335
Capital expenditures	(8,053)		(8,053)	(4,696)		(4,696)	(2,099)		(2,099)
Net cash provided by investing activities	47,229		47,229	4,806		4,806	39,792		39,792
CASH FLOWS FROM FINANCING ACTIVITIES:									
Proceeds from stock options	11,216		11,216	265		265			
Principal payments of lease financing obligations		(2,580)	(2,580)		(2,297)	(2,297)		(2,064)	(2,064)
Repurchases of common stock	(4,520)		(4,520)	(6,573)		(6,573)	(9,582)		(9,582)
Net cash provided by (used in) financing activities	6,696	(2,580)	4,116	(6,308)	(2,297)	(8,605)	(9,582)	(2,064)	(11,646)
EFFECT OF EXCHANGE RATES ON CASH	364		364	491		491	(1,077)		(1,077)
NET CHANGE IN CASH AND CASH EQUIVALENTS	38,650		38,650	(21,668)		(21,668)	23,570		23,570
CASH AND CASH EQUIVALENTS:									
Beginning of year	37,412		37,412	59,080		59,080	35,510		35,510

End of year	$	76,062	$		$	76,062	$	37,412	$		$	37,412	$	59,080	$		$	59,080

Table of Contents

The correction of the Company s accounting for its San Jose, California headquarters facilities leases required the Company to calculate the adjustments by year beginning with the year ended December 31, 2000. The cumulative effect of the restatement adjustments related to the lease accounting errors for the years 2000 through 2004 is reported as a $2.5 million increase to the 2005 beginning accumulated deficit balance in the accompanying Consolidated Statement of Stockholders Equity. The financial statement effects of all restatement adjustments by year are summarized in the following table (in thousands):

		Adjustments related to error in lease accounting			
Fiscal Year	Increase in stock-based compensation expense	Net increase (decrease) in rent expense	Increase in depreciation expense	Increase in interest expense	Net increase in expense
2000	$	$ 281	$	$	$ 281
2001		31	301	199	531
2002		(1,606)	1,204	945	543
2003		(3,173)	2,344	1,483	654
2004		(3,948)	2,724	1,666	442
Cumulative effect of restatement on prior periods		(8,415)	6,573	4,293	$ 2,451
2005	263	(3,947)	2,723	1,530	569
2006	535	(3,948)	2,724	1,379	690
2007	1,173	(3,948)	2,724	1,211	1,160
	$ 1,971	$ (20,258)	$ 14,744	$ 8,413	$ 4,870

Notes affected by the restatements are Notes 1(g), *Stock-based Compensation (As Restated),* 1(m), *Accrued Liabilities (As Restated),* and 1(p) *Computation of Basic and Diluted Net Loss Per Share and Pro Forma Basic Net Loss Per Share (As Restated)*; Note 3, *Property and Equipment (As Restated),* Note 5, *Stock-based Compensation (As Restated)*; Note 8, *Commitments and Contingencies (As Restated)*; Note 9, *Income Taxes (As Restated);* and Note 13, *Selected Quarterly Financial Data (Unaudited) (As Restated).*

3. PROPERTY AND EQUIPMENT (As Restated)

Property and equipment are stated at cost. The cost of buildings and improvements for our leased San Jose, California headquarters facilities, for which we are the deemed owner for accounting purposes only, includes both costs paid for directly by the Company and the costs paid for by the builder (lessor).

Depreciation is provided using the straight-line method as follows:

Buildings and leasehold improvements are depreciated over the shorter of the remaining lease term or estimated useful life (see further information in Notes 2 and 8);

Computer equipment and related software, other equipment, and furniture and fixtures are depreciated over estimated useful lives of two to five years; and

Certain telecommunications equipment is depreciated over its estimated useful life of 10 years.

A summary of property and equipment, net (as restated) as of December 31, 2007 and 2006 is as follows (in thousands):

	December 31,	
	2007 (As Restated)[1]	**2006 (As Restated)[1]**
Buildings and improvements	$ 40,850	$ 40,850
Computer and other equipment	19,403	13,465
Software	4,511	4,097
Furniture and fixtures	2,666	2,545
Leasehold improvements	3,809	3,352
	71,239	64,309
Less: Accumulated depreciation and amortization	(40,463)	(33,904)
Property and equipment, net	$ 30,776	$ 30,405

(1) See Note 2 of these Notes to Consolidated Financial Statements.

Accounting for buildings and improvements

In December 1999, the Company entered into a lease agreement with a real estate developer for its existing corporate headquarters in San Jose, California. This agreement requires minimum rental payments for ten years totaling approximately $20.6 million and also required that the Company provide a $3.0 million security deposit, which requirement has since been reduced to $1.2 million. The Company satisfied the security deposit requirement by causing to have issued a standby letter of credit (LOC) in July 2000. The LOC is subject to annual renewals and is currently secured by a $15.0 million line of credit at the bank that issued the LOC. The line of credit is maintained primarily for the purpose of providing standby letters of credit as required under the Company s lease agreements, as well as for providing standby letters of credit that arise from time to time in the general course of business. As of December 31, 2007 and 2006, no amounts had been drawn against the line of credit or the letters of credit.

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

Both the December 1999 and October 2000 leases permit the Company to exercise an option to extend the respective lease for two sequential five-year terms.

As discussed in Note 2, the Company has accounted for the two buildings at its San Jose, California headquarters site under EITF 97-10 and SFAS 98. EITF 97-10 applies to entities involved with the construction of an asset that will be leased when the construction project is completed. During construction, the Company paid for certain tenant improvements, including structural elements of the buildings and, in accordance with EITF 97-10, is therefore the deemed owner for accounting purposes of the two buildings at its San Jose, California headquarters site. Accordingly, the Company recorded assets for the total costs of the buildings and improvements, including the costs paid by the lessor (the legal owner of the buildings that the Company leases), with corresponding liabilities for the costs paid by the lessor. Upon completion of construction of each building, the Company did not meet the sale-leaseback criteria in SFAS 98 for derecognition of the building assets and liabilities. Therefore the leases are accounted for as financing obligations.

For the December 1999 and October 2000 lease agreements, the Company initially recorded assets and corresponding lease financing obligations for the building and improvement costs paid by the lessor in the amount of $12.0 million and $15.2 million, respectively. The Company has recorded depreciation expense associated with the building and improvement costs paid by the lessor of $2.7 million in each of the years ended December 31, 2007, 2006 and 2005. As of December 31, 2007 and 2006, the net book value of the buildings and improvements paid for by the lessor was $12.5 million and $15.2 million, respectively.

Under the lease agreements, a portion of each lease payment is accounted for as an operating lease of land and recorded as expense on a straight-line basis over the terms of the respective leases, which includes the construction period. The remaining lease payments are considered to be payments of principal and interest on the lease financing obligations. For the years ended December 31, 2007, 2006 and 2005, land lease expense was $452,000 for each year, principal reductions on the lease financing obligations were $2.6 million, $2.3 million and $2.1 million, respectively, and interest expense was $1.2 million, $1.4 million and $1.5 million, respectively. See Note 8 for further information on commitments for future minimum lease payments associated with the lease financing obligations.

Table of Contents

4. STOCKHOLDERS EQUITY AND EMPLOYEE STOCK OPTION PLANS

(a) Preferred Stock

With the closing of the Company s initial public offering (IPO) in July 1998, all of the then outstanding preferred stock automatically converted into 7,887,381 shares of common stock. Upon conversion of the outstanding preferred stock to common stock, such preferred stock was retired. As of December 31, 2007, the Company was authorized to issue 5,000,000 shares of new $0.01 par value preferred stock, of which none was outstanding as of December 31, 2007.

(b) Common Stock

As of December 31, 2007, the Company was authorized to issue 100,000,000 shares of $0.01 par value common stock, of which 40,736,340 were outstanding.

In March and August 2004 and March 2006, the Company s board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company s common stock. During 2007, the Company did not repurchase any shares under the program. Since the repurchase program s inception, the Company has repurchased 2,204,184 shares at a cost of $16.1 million. As of December 31, 2007, 795,816 shares were available for repurchase. The stock repurchase program will expire in March 2008.

(c) Stock Option Programs

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

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

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

1997 Stock Plan

During 1997, the Company adopted the 1997 Stock Plan (the 1997 Plan) for employees, officers and directors, which was amended and restated in May 2004. As of December 31, 2007, a total of 14,531,383 shares of Common Stock were reserved for issuance under the 1997 Plan. This plan includes annual increases on the first day of the Company s fiscal year (beginning in 2000) not to exceed the lesser of (i) 5,000,000 shares or (ii) 4% of the outstanding shares on such date. Incentive stock options to purchase shares of common stock may be granted at not less than 100% of the fair market value. Options granted prior to June 15, 2000 and after May 5, 2003, generally have a term of five years from the date of grant. Options granted June 15, 2000 through May 5, 2003, generally have a term of ten years. The exercise price of stock options granted under the 1997 Plan is determined by the Board of Directors (or a Committee of the Board of Directors), but will be at least equal to 100% of the fair market value per share of common stock on the date of grant (or at least 110% of such fair market value for an incentive stock option granted to a stockholder with greater than 10% voting power of all our stock), except that up to 10% of the aggregate number of shares reserved for issuance under the 1997 Plan (including shares that have been issued or are issuable in connection with options exercised or granted under the 1997 Plan) may have exercise prices that are from 0% to 100% of the fair market value of the common stock on the date of grant. Options generally vest ratably over four years.

The 1997 Plan also allows for the issuance of stock purchase rights and options that are immediately exercisable through execution of a restricted stock purchase agreement. Shares purchased pursuant to a stock purchase agreement generally vest ratably over four years. In the event of termination of employment, the Company, at its discretion, may repurchase unvested shares at a price equal to the original issuance price. In addition, the 1997 Plan allows for the issuance of stock appreciation rights, performance shares and performance units. Stock appreciation rights are rights to receive, in cash or shares of our common stock, as designated on the grant date, the appreciation in fair market

value of common stock between the exercise date and the date of grant. Stock appreciation rights may be granted alone or in tandem with options. The exercise price of stock appreciation right will be at least equal to 100% of the fair market value per share of common stock on the date of grant. Stock appreciation rights issued by the Company generally vest in equal, annual installments over four years, and expire on the fifth anniversary of the grant date. Performance units and performance

shares are awards that result in a payment to a participant, generally in the form of an issuance of shares of the Company s common stock, at such time as specified performance goals or other vesting criteria are achieved or the awards otherwise vest. Performance shares issued by the Company generally vest in equal, annual installments over four years, although certain of these performance shares vest 100% after two years while others have additional financial-based performance requirements that must be met before vesting can occur. Performance shares with performance-based vesting conditions expire no later than the fourth anniversary of the grant date if the performance criteria have not been met.

1998 Directors Option Plan

Non-employee directors are entitled to participate in the 1998 Director Option Plan (the Director Plan). The Director Plan was adopted by the Board of Directors in May 1998 and became effective upon the closing of the initial public offering of the Company s stock in July 1998. The Director Plan will terminate in July 2008 unless terminated sooner by the Board. As of December 31, 2007, a total of 1,030,000 shares of Common Stock are reserved for issuance under the Director Plan. The plan provides for an increase each year equal to 100,000 shares or such lesser amount as the Board may determine. The plan also provides for the automatic grant of 25,000 shares of common stock (the First Option) to each non-employee director on the date he or she first becomes a director. Each non-employee director is also automatically granted an option to purchase 10,000 shares (a Subsequent Option) on the date of the Company s Annual Stockholder Meeting provided that he or she is re-elected to the Board or otherwise remains on the Board, and provided that on such date, he or she shall have served on the Board for at least the preceding six months. Each First Option and each Subsequent Option shall have a term of five years and the shares subject to the option shall vest as to 25% of the shares subject to option on each anniversary of the date of grant for options granted before May 11, 1999 and 100% on the date of grant for options granted on or after May 11, 1999. The exercise price of each First Option and Subsequent Option shall be 100% of the fair market value per share of the common stock on the date of grant. During 2007 and 2006, options to purchase an aggregate of 60,000 and 50,000 shares, respectively, were granted under the Director Plan. The weighted average exercise prices for the option grants in 2007, 2006, and 2005, were $13.74, $7.99, and $7.18, respectively.

In the event of a merger of the Company with or into another corporation or the sale of substantially all of the assets of the Company, each option granted under the Director Plan shall be assumed or an equivalent option may be substituted by the successor corporation. Following such assumption or substitution, if the optionee s status as a director of the successor corporation terminates other than upon a voluntary resignation by the optionee, the option shall become fully exercisable, including as to shares as to which it would not otherwise be exercisable. If the outstanding options are not assumed or substituted, the options shall become fully vested and exercisable. Options granted must be exercised within three months of the end of the optionee s tenure as a director of the Company, or within twelve months after such director s termination by death or disability, but in no event later than the expiration of the option s five year term; provided, however, that shares subject to an option granted to a director who has served as a director with the Company for at least five years shall become fully vested and exercisable for the remainder of the option s five year term upon such director s termination. No option granted under the Director Plan is transferable by the optionee other than by will or the laws of descent and distribution, and each option is exercisable, during the lifetime of the optionee, only by such optionee.

(d) Option Vesting Acceleration

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

Table of Contents

(e) Stock Award Activity

The following table summarizes stock award activity under all plans for the years ended December 31, 2007, 2006, and 2005:

		Options Outstanding	
	Shares Available for Grant	Number Outstanding	Weighted-Average Exercise Price Per Share
BALANCE AT DECEMBER 31, 2004	8,109,556	5,594,842	$ 14.91
Options granted	(3,575,814)	3,575,814	6.99
Performance shares granted	(417,949)		
Options cancelled	1,081,183	(1,081,183)	16.22
Performance shares cancelled	4,981		
Additional shares reserved	1,747,463		
BALANCE AT DECEMBER 31, 2005	6,949,420	8,089,473	$ 11.24
Options and stock appreciation rights granted	(852,734)	852,734	8.40
Performance shares granted	(387,909)		
Options and stock appreciation rights cancelled	534,902	(534,902)	12.94
Performance shares cancelled	25,896		
Options exercised		(124,625)	6.13
Additional shares reserved	1,692,020		
BALANCE AT DECEMBER 31, 2006	7,961,595	8,282,680	$ 10.91
Options and stock appreciation rights granted	(1,022,219)	1,022,219	24.72
Performance shares granted	(441,871)		
Options and stock appreciation rights cancelled	323,070	(323,070)	12.35
Performance shares cancelled	42,183		
Options exercised		(1,949,006)	9.44
Additional shares reserved	1,664,301		
BALANCE AT DECEMBER 31, 2007	8,527,059	7,032,823	$ 13.26

The total intrinsic value of options exercised during the years ended December 31, 2007 and 2006 was approximately $24.8 million and $261,000, respectively. There were no options exercised in 2005. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the shares.

Table of Contents

The following table provides additional information regarding performance share activity for the years ended December 31, 2007, 2006, and 2005:

	Number Nonvested and Outstanding	Weighted-Average Grant Date Fair-Value
BALANCE AT DECEMBER 31, 2004		$
Performance shares granted	417,949	7.82
Performance shares forfeited	(4,981)	7.85
BALANCE AT DECEMBER 31, 2005	412,968	$ 7.82
Performance shares granted	387,909	8.59
Performance shares vested and released	(71,945)	8.19
Performance shares forfeited	(25,896)	8.05
BALANCE AT DECEMBER 31, 2006	703,036	$ 8.20
Performance shares granted	441,871	21.61
Performance shares vested and released	(227,845)	7.60
Performance shares forfeited	(42,183)	9.84
BALANCE AT DECEMBER 31, 2007	874,879	$ 15.05

No performance shares were awarded prior to the year ended December 31, 2005. Performance shares awarded in 2005 did not begin to vest until 2006. The fair value of each performance share grant was estimated on the date of grant by multiplying the number of shares granted times the fair market value of the Company s stock on the grant date. The total intrinsic value of performance shares vested and released during the years ended December 31, 2007 and 2006 was approximately $3.5 million and $582,000, respectively. The intrinsic value is calculated by multiplying the fair market value of the Company s stock on the vesting date by the number of shares vested.

The following table provides additional information for significant ranges of outstanding and exercisable stock options and stock appreciation rights as of December 31, 2007:

Exercise Price Range	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price per Share	Aggregate Intrinsic Value
$6.11	803,609	2.41	$ 6.11	$ 11,676,439
6.30-8.12	228,555	2.60	7.18	3,075,809
8.19	815,488	2.62	8.19	10,152,826
8.24-8.52	809,753	3.46	8.44	9,878,971
8.58-10.89	963,578	2.24	10.56	9,711,074
11.14-12.91	758,762	2.23	12.17	6,424,821
13.00-16.06	346,350	3.32	14.03	2,291,247
16.35	768,712	4.14	16.35	3,297,774
16.38-23.44	732,572	3.39	19.02	1,824,862
$24.82-$30.76	805,444	4.68	27.83	
Outstanding	7,032,823	3.11	$ 13.26	$ 58,333,824
Vested and expected to vest	6,868,902	3.11	$ 13.14	$ 57,363,238

Exercisable	5,026,267	2.81	$ 12.01	$ 44,066,170

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company s closing stock price of $20.64 as of December 31, 2007, the last market trading day of 2007, which would have been received by the option holders had all option holders exercised their options as of that date.

Table of Contents

5. STOCK-BASED COMPENSATION (As Restated):

(a) Valuation of Options Granted

The Company has elected to use the BSM option-pricing model to estimate the fair value of stock-based awards, which incorporates various assumptions including volatility, expected term of the option from the date of grant to the time of exercise, risk-free interest rates, and dividend yields. The weighted average fair value of options granted during the years ended December 31, 2007, 2006, and 2005, was $10.86, $3.49, and $3.60, respectively, and was determined using the following weighted average assumptions:

	Year Ended December 31,		
	2007	2006	2005
Expected dividend yield	0.0%	0.0%	0.0%
Risk-free interest rate	4.1%	4.6%	4.0%
Expected volatility	54.6%	50.5%	57.5%
Expected term (in years)	3.6	3.6	3.6

The expected dividend yield reflects the fact that the Company has not paid any dividends in the past and does not currently intend to pay dividends in the foreseeable future. The risk-free interest rate assumption is based on U.S. Treasury yields in effect at the time of grant for the expected term of the option. The expected volatility is primarily based on the historical volatility of the Company s common stock over the most recent period commensurate with the expected life of the option, and to a lesser extent is based on implied volatility calculated from the market traded options on the Company s stock. The expected life of the option has been calculated using the simplified method as permitted under SAB 107. Under the simplified method, the expected term is calculated by taking the average of the vesting term and the contractual term of the option. The simplified method was chosen due to the fact that there has been only limited exercise activity for options granted over the last several years, and thus, management has concluded that such exercise data does not provide a reasonable basis upon which to estimate expected term.

(b) Expense Allocation (As Restated)

Compensation expense for all share-based payment awards, including those granted prior to January 1, 2006, has been recognized in accordance with SFAS 123R using the accelerated multiple-option approach. As stock-based compensation expense recognized in the Consolidated Statement of Operations for the years ended December 31, 2007 and 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures have been estimated based on historical experience. In the Company s pro forma information required under SFAS 123 for periods prior to January 1, 2006, the Company accounted for forfeitures as they occurred.

Of the 874,879 performance shares nonvested as of December 31, 2007, 144,274 (with a grant date fair value of $1.3 million) were subject to certain financial based performance requirements that must be achieved before vesting can occur. Cumulative compensation expense of $436,000 (as restated) through December 31, 2007 associated with these performance shares has been calculated assuming that those financial performance requirements will be achieved. If such requirements are not met, no compensation cost is recognized and any recognized compensation cost will be reversed.

As of December 31, 2007, total compensation cost related to non-vested stock options and other equity based awards not yet recognized was $18.1 million (as restated), which is expected to be recognized over the next 21 months on a weighted-average basis, and of which $822,000 (as restated) relates to awards subject to certain financial based performance requirements.

Table of Contents

The following table summarizes the stock-based compensation expense related to employee stock options and share awards under SFAS 123R for the years ended December 31, 2007 and 2006, and under SFAS 123 for the year ended December 31, 2005, which was allocated as follows (in thousands):

	Year Ended December 31,		
	2007 (As Restated [1])	2006 (As Restated [1])	2005 (As Restated [1])
Cost of sales product	$ 901	$ 487	$ 84
Cost of sales service	87	55	6
Stock-based compensation expense included in cost of sales	988	542	90
Product development	2,849	2,147	246
Sales and marketing	1,683	1,334	175
General and administrative	2,279	1,437	339
Stock-based compensation expense included in operating expenses	6,811	4,918	760
Total stock-based compensation expense related to stock options and share awards	7,799	5,460	850
Tax benefit			
Stock-based compensation expense related to stock options and share awards, net of tax	$ 7,799	$ 5,460	$ 850

(1) See Note 2 of these Notes to Consolidated Financial Statements.

Of the $7.8 million (as restated) of compensation expense recorded for the year ended December 31, 2007, approximately $3.3 million (as restated) related to equity compensation awards granted during 2007, while the remaining $4.5 million (as restated) related to equity compensation awards granted on or before December 31, 2006. Of the $5.5 million (as restated) of compensation expense recorded for the year ended December 31, 2006, approximately $941,000 (as restated) related to equity compensation awards granted during 2006, while the remaining $4.5 million (as restated) related to equity compensation awards granted on or before December 31, 2005. Compensation expense of $850,000 (as restated) for the year ended December 31, 2005, related solely to share awards, and did not reflect any compensation expense for stock options as the Company accounted for those equity compensation awards in accordance with APB 25. Under APB 25, no compensation expense was recorded in the Company s statement of operations for stock options where the exercise price was equal to or greater than the fair market value of the underlying stock on the date of grant.

As of December 31, 2007, approximately $74,000 and $37,000 of stock-based compensation expense was capitalized as part of the cost of inventory and deferred cost of goods sold, respectively. As of December 31, 2006 and 2005, no stock-based compensation expense was capitalized as part of the cost of an asset.

6. 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 years ended December 31, 2007, the Company had five 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), and 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 years ended December 31, 2007, 2006, and 2005, the percentages of the Company s revenues attributable to sales made to these customers were as follows:

Table of Contents

	Year Ended December 31,		
	2007	2006	2005
Telvent	28.2%	%	%
EBV	12.8%	27.1%	21.0%
ES	11.4%	0.1%	%
Enel	10.3%	12.4%	36.2%
EAC	7.2%	%	%
Total	69.9%	39.6%	57.2%

The Company s contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2008. Please refer to Note 11, Related Parties, for additional information regarding the Company s agreement with Enel.

7. GOODWILL:

The carrying amount of goodwill as of December 31, 2007, 2006, and 2005 relates to three acquisitions, including ARIGO Software GmbH (ARIGO) in 2001, BeAtHome in 2002, and MTC in 2003. The goodwill acquired as part of the ARIGO transaction is valued in Euros, and is therefore subject to foreign currency translation gains and losses. The changes in the carrying amount of goodwill, net for the years ended December 31, 2006 and 2007 are as follows (in thousands):

	Amount
Balance as of December 31, 2005	$ 8,018
Unrealized foreign currency translation gain	260
Balance as of December 31, 2006	8,278
Unrealized foreign currency translation gain	270
Balance as of December 31, 2007	$ 8,548

8. COMMITMENTS AND CONTINGENCIES (As Restated):

(a) Lease Commitments (As Restated)

As discussed in Note 3, the December 1999 and October 2000 leases of our corporate headquarters facilities are accounted for under EITF 97-10 and SFAS 98. As of December 31, 2007, future minimum lease payments for these lease financing obligations were as follows (in thousands):

2008	$ 3,894
2009	4,027
2010	4,164
2011	3,881
2012	2,357
2013 and thereafter	788
Total payments	$ 19,111
Amount representing interest	(3,060)
Present value of future minimum lease payments	$ 16,051
Lease financing obligations classified as current	$ 2,900

Lease financing obligations classified as long-term	$ 13,151

The Company also leases facilities under operating leases for its sales, marketing, and product development personnel located elsewhere within the United States and in nine foreign countries throughout Europe and Asia including a land lease for accounting purposes associated with the Company s corporate headquarters facilities. These operating leases expire on various dates through 2018, and in some instances are cancelable with advance notice. Lastly, the Company also leases certain equipment and, for some of its sales personnel, automobiles. These operating leases are generally less than five years in duration.

Table of Contents

As of December 31, 2007, future minimum lease payments under all operating leases, including the land lease associated with the Company s corporate headquarters facilities (see Note 3), were as follows (in thousands) (as restated):

2008	$ 1,560
2009	1,376
2010	1,235
2011	695
2012	482
2013 and thereafter	329
Total	$ 5,677

Rent expense for all operating leases was approximately $1.7 million (as restated) for 2007, $1.6 million (as restated) for 2006, and $1.7 million (as restated) for 2005. Although certain of the operating lease agreements provide for escalating rent payments over the term of the lease, rent expense under these agreements is recognized on a straight-line basis. As of December 31, 2007, the Company has accrued approximately $467,000 (as restated) of deferred rent related to these agreements, of which approximately $99,000 (as restated) is reflected in current liabilities while the remainder is reflected in other long-term liabilities in the accompanying consolidated balance sheet. As of December 31, 2006, the Company had accrued approximately $549,000 (as restated) of deferred rent related to these agreements, of which approximately $107,000 (as restated) is reflected in current liabilities while the remainder is reflected in other long-term liabilities. See Note 3 for explanation of land lease expense on the Company s corporate headquarters facilities.

(b) Royalties

The Company has certain royalty commitments associated with the shipment and licensing of certain of its products. Royalty expense is generally based on a dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which is recorded as a component of cost of product revenues in the Company s consolidated statements of income, was approximately $573,000, $493,000, and $496,000 for the years ended December 31, 2007, 2006, and 2005, respectively.

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

(c) Guarantees

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

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

(d) Taxes

The Company conducts operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on the Company s operations in that particular location. While the

Company strives to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with generally accepted accounting principles, the Company makes a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and the Company believes that, as of December 31, 2007, it has adequately provided for such contingencies. However, it is possible that the Company s results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where the Company conducts its operations.

(e) Legal Actions

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

In addition to the matter described above, from time to time, in the ordinary course of business, the Company is also subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While the Company believes it has adequately provided for such contingencies as of December 31, 2007, the amounts of which were immaterial, it is possible that the Company s results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

9. INCOME TAXES (As Restated):

The provision for income taxes attributable to continuing operations is based upon income (loss) before income taxes from continuing operations as follows (in thousands):

	Year Ended December 31,		
	2007 (As Restated)[1]	2006 (As Restated)[1]	2005 (As Restated)[1]
Domestic	$ (15,802)	$ (24,612)	$ (19,502)
Foreign	582	(168)	(632)
	$ (15,220)	$ (24,780)	$ (20,134)

(1) See Note 2 of these Notes to Consolidated Financial Statements.

The Company accounts for income taxes in accordance with SFAS No. 109 (SFAS 109), *Accounting for Income Tax*es. SFAS 109 provides for an asset and liability approach under which deferred income taxes are based upon enacted tax laws and rates applicable to the periods in which the taxes become payable.

Table of Contents

The provision for income taxes consists of the following (in thousands):

	Year Ended December 31,		
	2007	2006	2005
Federal:			
Current	$	$	$
Deferred			
Total federal provision			
State:			
Current	10	10	20
Deferred			
Total state provision	10	10	20
Foreign:			
Current	442	340	134
Deferred			
Total foreign provision	442	340	134
Total provision for income taxes	$ 452	$ 350	$ 154

The provision for income taxes differs from the amount estimated by applying the statutory Federal income tax rate to income before taxes as follows (in thousands):

	Year Ended December 31,		
	2007 (As Restated)[1]	2006 (As Restated)[1]	2005 (As Restated)[1]
Federal tax at statutory rate of 35%	$ (5,327)	$ (8,673)	$ (7,047)
State taxes, net of federal benefit	10	10	20
U.S.-Foreign rate differential	239	399	355
Change in Valuation Allowance	5,346	8,134	6,362
Others	184	480	464
Total provision for income taxes	$ 452	$ 350	$ 154

(1) See Note 2 of these Notes to Consolidated Financial Statements.

As of December 31, 2007 and 2006, a valuation allowance has been recorded for the entire gross deferred tax asset as a result of uncertainties regarding the realization of the asset balance. As of December 31, 2007 and 2006, the Company had no significant deferred tax liabilities. The components of the net deferred income tax asset are as follows (in thousands):

	December 31,	
	2007 (As Restated)[1]	2006 (As Restated)[1]
Net operating loss carry forwards	$ 34,898	$ 36,949
Tax credit carry forwards	13,250	11,635

Fixed and intangible assets	7,191	7,195
Capitalized research and development costs	56	
Reserves and other cumulative temporary differences	10,546	6,711
Gross deferred income tax assets	65,941	62,490
Valuation allowance	(65,941)	(62,490)
Net deferred income tax assets	$	$

(1) See Note 2 of these Notes to Consolidated Financial Statements.

As of December 31, 2007, part of our valuation allowance on deferred tax assets pertains to certain tax credits and net operating loss carry forwards. In the future, we will reduce the valuation allowance associated with these credits and losses upon the earlier of

Table of Contents

the period in which we utilize them to reduce the amount of income tax we would otherwise be required to pay on our income tax returns, or when it becomes more likely than not that the deferred tax assets are realizable. If the valuation allowance associated with these credits and losses is realized, the tax benefit of certain of these credits and losses will be accounted for as a credit to stockholders equity rather than as a reduction of income tax expense. In addition, the Internal Revenue Code of 1986, as amended, contains provisions that limit the net operating loss and credit carryforwards available for use in any given period upon the occurrence of certain events, including a significant change in ownership interests. The Company has performed an analysis of the ownership changes and has reported the net operating loss and credit carryforwards considering such limitations.

As of December 31, 2007, the Company had net operating loss carryforwards of $124.5 million for federal income tax reporting purposes and $43.1 million for state income tax reporting purposes, which expire at various dates through 2027. In addition, as of December 31, 2007, the Company had approximately $7.5 million and $8.3 million of tax credit carry forwards for increased research expenditures for federal and California purposes, respectively. The federal research tax credits will expire at various dates if not utilized by 2027 and the state tax credit can be carried over indefinitely. In accordance with current Internal Revenue Code rules, federal net operating loss carryforwards must be utilized in full before federal research and development tax credits can be used to offset current tax liabilities. As a result, depending on the Company s future taxable income in any given year, some or all of the federal increased research tax credits, as well as portions of the Company s federal and state net operating loss carryforwards, may expire before being utilized. In accordance with the provisions of SFAS 123R, footnote 82, the Company s net operating losses exclude tax deductions for stock-based compensation expense. Such benefits will not be realized and credited to stockholders equity until the deductions reduce taxes payable.

Amounts held by foreign subsidiaries are generally subject to United States income taxation on repatriation to the United States. The Company currently intends to permanently reinvest its undistributed earnings from its foreign subsidiaries outside the United States and United States income taxes have not been provided on a cumulative total earnings of $5.6 million. It is not practicable to determine the income tax liability that might be incurred if these earnings were to be distributed.

The Company adopted FIN 48 on January 1, 2007. This interpretation prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken on a tax return. FIN 48 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, and disclosure and transition.

The following is a rollforward of the Company s uncertain tax benefits (in thousands):

Balance as of January 1, 2007	$ 4,697
Tax positions related to current year:	
Additions	1,136
Reductions	
Tax positions related to prior years:	
Additions	229
Reductions	(187)
Settlements	
Lapses in statute of limitations	(67)
Balance as of December 31, 2007	$ 5,808

Included in the balance of total unrecognized tax benefits at December 31, 2007 are potential benefits of $921,000, which if recognized, would affect the effective rate on income from continuing operations.

Upon adoption, the Company had accrued interest and penalties related to the uncertain tax benefits of approximately $327,000. In 2007, the Company decreased the prior year balance by $13,000 and accrued $47,000 of additional penalties and interest.

The Company is subject to taxation in the United States and various state and foreign jurisdictions. In the United States, the tax years from 1992 remain open to examination by federal and most state tax authorities due to certain net operating loss and credit carryforward positions. In the foreign jurisdictions, the number of tax years open to examination by local tax authorities ranges from three to six years.

10. WARRANTY RESERVES:

When evaluating the reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical return rates, and historical costs of repair. In addition, certain other applicable factors, such as technical complexity, may also be taken into consideration when historical information is not yet available for recently introduced products. Estimated reserves for warranty costs are generally provided for when the associated revenue is recognized. In addition, additional warranty reserves may be established when the Company becomes aware of a specific warranty related problem, such as a product recall. Such additional warranty reserves are based on the Company s current estimate of the total out-of-pocket costs expected to be incurred to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. The reserve for warranty costs was $301,000 as of December 31, 2007 and $224,000 as of December 31, 2006.

11. RELATED PARTIES:

During the years ended December 31, 2007, 2006, and 2005, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

In June 2000, the Company entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock. Under the terms of the stock purchase agreement, Enel has the right to nominate a member of the Company s board of directors. A representative of Enel has not been appointed to the Company s board.

At the same time as the Company entered into the stock purchase agreement with Enel, it also entered into a Research and Development and Technological Cooperation Agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, the Company cooperated with Enel to integrate LonWorks technology into Enel s remote metering management project in Italy, the Contatore Elettronico. The Company completed the sale of its components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, the Company supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, the Company entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from Echelon. Under the software enhancement agreement, the Company provides software enhancements to Enel for use in its Contatore Elettronico system. Both the new development and supply agreement and the software enhancement agreement expire in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

For the years ended December 31, 2007, 2006, and 2005, the Company recognized revenues of approximately $14.2 million, $7.1 million, and $26.9 million, respectively, related to products and services sold to Enel and its contract manufacturers. As of December 31, 2007, approximately $3.0 million of the 2007 revenues were included in accounts receivable. As of December 31, 2006, there were no outstanding amounts due from Enel or its contract manufacturers.

On May 3, 2004, the Company announced that Enel filed a request for arbitration to resolve a dispute regarding the Company s marketing and supply obligations under the R&D Agreement. The arbitration was resolved with the issuance of a decision on September 29, 2005, calling for the Company to pay Enel approximately $5.2 million in damages, interest, and legal and arbitration related costs. For additional information regarding the arbitration, please refer to the Legal Actions section of Note 8, *Commitments and Contingencies*.

12. SEGMENT:

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company s chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer, the Chief Operating Officer, and their direct reports. SFAS 131 also requires disclosures about products and services, geographic areas, and major customers.

The Company operates 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 building automation, industrial automation, transportation, and utility/home automation markets. The Company s products provide the infrastructure and support required to implement and deploy open, interoperable, control network solutions. For the electric utility industry, the Company has developed an advanced metering infrastructure system called the Networked Energy Services (NES) system. The NES system provides a two-way information and control path between the utility and its customer, which enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize

distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. All 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. In total, the Company offers a wide ranging set of products and services that together constitute the LonWorks system. Any given customer purchases a small subset of such 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, loans to certain key employees, purchased technology, and deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of December 31, 2007 and 2006, long-lived assets of about $37.7 million (as restated) and $37.4 million (as restated), respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements.

The Company has three primary product lines: NES, LonWorks Infrastructure, and products and services sold to Enel. Summary revenue information by product line for the years ended December 31, 2007, 2006, and 2005 is as follows (in thousands):

	Year Ended December 31,		
	2007	**2006**	**2005**
NES	$ 70,558	$ 791	$ 883
LonWorks Infrastructure	52,840	49,382	46,612
Enel	14,179	7,103	26,933
Total	$ 137,577	$ 57,276	$ 74,428

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 customer is domiciled. Summary revenue information by geography for the years ended December 31, 2007, 2006 and 2005 is as follows (in thousands):

	Year Ended December 31,		
	2007	**2006**	**2005**
Americas	$ 18,561	$ 19,748	$ 17,052
EMEA	99,164	29,991	46,600
APJ	19,852	7,537	10,776
Total	$ 137,577	$ 57,276	$ 74,428

For information regarding the Company s major customers, please refer to Note 6, Significant Customers.

13. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED) (As Restated):

As discussed in Note 2 to these Notes to Consolidated Financial Statements, the Company has adjusted the consolidated financial statements for the years ended December 31, 2007 and 2006 including the interim periods contained therein to correct stock-based compensation expense and accounting for its San Jose, California corporate headquarters facilities leases. The following tables set forth certain consolidated statement of operations data (as restated) for each of the quarters in 2007 and 2006. This information has been derived from our quarterly unaudited consolidated financial statements. The quarterly unaudited consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements included in this report and include all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of such information when read in conjunction with our annual audited consolidated financial statements (as restated) and notes appearing in this report. The operating results for any quarter do not necessarily indicate the results for any subsequent period or for the entire fiscal year.

The following three tables reconcile the selected quarterly financial data as previously reported to the restated data for each of the quarters in 2007 and 2006 as follows:

Table A:	Selected Quarterly Financial Data As Restated
Table B:	Selected Quarterly Financial Adjustments to Data As Previously Reported
Table C:	Selected Quarterly Financial Data As Previously Reported

Table of Contents

Table A AS RESTATED

Selected Quarterly Financial Data

	Three Months Ended							
	Dec. 2007	Sep. 2007	June 2007	March 2007	Dec. 2006	Sep. 2006	June 2006	March 2006
	(in thousands, except per share data)							
	(As Restated)[1]							
Consolidated Statement of Operations Data:								
Revenues:								
Product	$ 46,158	$ 23,733	$ 26,437	$ 39,077	$ 13,622	$ 13,110	$ 19,209	$ 10,574
Service	741	980	259	192	244	181	165	171
Total revenues	46,899	24,713	26,696	39,269	13,866	13,291	19,374	10,745
Cost of revenues:								
Cost of product	27,066	14,004	15,331	28,634	5,233	4,935	7,306	4,565
Cost of service	650	722	505	483	499	499	443	436
Total cost of revenues	27,716	14,726	15,836	29,117	5,732	5,434	7,749	5,001
Gross profit	19,183	9,987	10,860	10,152	8,134	7,857	11,625	5,744
Operating expenses:								
Product development	8,928	7,820	8,118	7,778	7,287	6,833	7,142	6,959
Sales and marketing	5,902	4,884	4,968	5,427	5,059	5,079	5,108	5,162
General and administrative	4,376	3,976	4,163	3,568	3,423	3,597	3,664	3,265
Total operating expenses	19,206	16,680	17,249	16,773	15,769	15,509	15,914	15,386
Income (loss) from operations	(23)	(6,693)	(6,389)	(6,621)	(7,635)	(7,652)	(4,289)	(9,642)
Interest and other income, net	1,351	1,381	1,488	1,497	1,433	1,586	1,404	1,394
Interest expense on lease financing obligations	(287)	(297)	(308)	(319)	(329)	(340)	(350)	(360)
Income (loss) before provision for income taxes	1,041	(5,609)	(5,209)	(5,443)	(6,531)	(6,406)	(3,235)	(8,608)
Income tax expense	129	108	107	108	110	80	80	80
Net income (loss)	$ 912	$ (5,717)	$ (5,316)	$ (5,551)	$ (6,641)	$ (6,486)	$ (3,315)	$ (8,688)
Income (loss) per share:								
Basic	$ 0.02	$ (0.14)	$ (0.13)	$ (0.14)	$ (0.17)	$ (0.16)	$ (0.08)	$ (0.22)
Diluted	$ 0.02	$ (0.14)	$ (0.13)	$ (0.14)	$ (0.17)	$ (0.16)	$ (0.08)	$ (0.22)
Shares used in net income (loss) per share calculation:								
Basic	40,690	40,121	39,508	39,227	39,220	39,354	39,615	39,767
Diluted	43,721	40,121	39,508	39,227	39,220	39,354	39,615	39,767

(1) See Note 2 of these Notes to Consolidated Financial Statements.

Table of Contents

Table B ADJUSTMENTS to

Previously Reported

Selected Quarterly Financial Data

	Three Months Ended							
	Dec. 2007	Sep. 2007	June 2007	March 2007	Dec. 2006	Sep. 2006	June 2006	March 2006
	(in thousands, except per share data)							
	(Adjustments to Previously Reported)							
Consolidated Statement of Operations Data:								
Revenues:								
Product	$	$	$	$	$	$	$	$
Service								
Total revenues								
Cost of revenues:								
Cost of product	54	24	16	7	3	(1)	3	2
Cost of service	(4)	(7)	(9)	(9)	(12)	(10)	(9)	(9)
Total cost of revenues	50	17	7	(2)	(9)	(11)	(6)	(7)
Gross profit	(50)	(17)	(7)	2	9	11	6	7
Operating expenses:								
Product development	137	31	(12)	(23)	(41)	(42)	(21)	(32)
Sales and marketing	90	34	15	12	(1)	3	19	15
General and administrative	(32)	(107)	(128)	(140)	(136)	(149)	(134)	(137)
Total operating expenses	195	(42)	(125)	(151)	(178)	(188)	(136)	(154)
Income (loss) from operations	(245)	25	118	153	187	199	142	161
Interest and other income, net								
Interest expense on lease financing obligations	(287)	(297)	(308)	(319)	(329)	(340)	(350)	(360)
Income (loss) before provision for income taxes	(532)	(272)	(190)	(166)	(142)	(141)	(208)	(199)
Income tax expense								
Net income (loss)	$ (532)	$ (272)	$ (190)	$ (166)	$ (142)	$ (141)	$ (208)	$ (199)
Income (loss) per share:								
Basic	$ (0.02)	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.01)
Diluted	$ (0.01)	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.01)

Table of Contents

Table C AS PREVIOUSLY REPORTED

Selected Quarterly Financial Data

	Three Months Ended							
	Dec. 2007	Sep. 2007	June 2007	March 2007	Dec. 2006	Sep. 2006	June 2006	March 2006
	(in thousands, except per share data)							
	(As Previously Reported)[1]							
Consolidated Statement of Operations Data:								
Revenues:								
Product	$ 46,158	$ 23,733	$ 26,437	$ 39,077	$ 13,622	$ 13,110	$ 19,209	$ 10,574
Service	741	980	259	192	244	181	165	171
Total revenues	46,899	24,713	26,696	39,269	13,866	13,291	19,374	10,745
Cost of revenues:								
Cost of product	27,012	13,980	15,315	28,627	5,230	4,936	7,303	4,563
Cost of service	654	729	514	492	511	509	452	445
Total cost of revenues	27,666	14,709	15,829	29,119	5,741	5,445	7,755	5,008
Gross profit	19,233	10,004	10,867	10,150	8,125	7,846	11,619	5,737
Operating expenses:								
Product development	8,791	7,789	8,130	7,801	7,328	6,875	7,163	6,991
Sales and marketing	5,812	4,850	4,953	5,415	5,060	5,076	5,089	5,147
General and administrative	4,408	4,083	4,291	3,708	3,559	3,746	3,798	3,402
Total operating expenses	19,011	16,722	17,374	16,924	15,947	15,697	16,050	15,540
Income (loss) from operations	222	(6,718)	(6,507)	(6,774)	(7,822)	(7,851)	(4,431)	(9,803)
Interest and other income, net	1,351	1,381	1,488	1,497	1,433	1,586	1,404	1,394
Interest expense on lease financing obligations								
Income (loss) before provision for income taxes	1,573	(5,337)	(5,019)	(5,277)	(6,389)	(6,265)	(3,027)	(8,409)
Income tax expense	129	108	107	108	110	80	80	80
Net income (loss)	$ 1,444	$ (5,445)	$ (5,126)	$ (5,385)	$ (6,499)	$ (6,345)	$ (3,107)	$ (8,489)
Income (loss) per share:								
Basic	$ 0.04	$ (0.14)	$ (0.13)	$ (0.14)	$ (0.17)	$ (0.16)	$ (0.08)	$ (0.21)
Diluted	$ 0.03	$ (0.14)	$ (0.13)	$ (0.14)	$ (0.17)	$ (0.16)	$ (0.08)	$ (0.21)
Shares used in net income (loss) per share calculation:								
Basic	40,690	40,121	39,508	39,227	39,220	39,354	39,615	39,767
Diluted	43,721	40,121	39,508	39,227	39,220	39,354	39,615	39,767

(1) See Note 2 of these Notes to Consolidated Financial Statements.

Table of Contents

SCHEDULE II

ECHELON CORPORATION

VALUATION AND QUALIFYING ACCOUNTS

(in thousands)

	Balance at Beginning of Period	Charged/ (Credited) to Revenues and Expenses	Write-Off of Previously Provided Accounts	Balance at End of Period
Year Ended December 31, 2005				
Allowance for Doubtful Accounts	$ 300	$ 15	$ 15	$ 300
Year Ended December 31, 2006				
Allowance for Doubtful Accounts	$ 300	$ (23)	$ 27	$ 250
Year Ended December 31, 2007				
Allowance for Doubtful Accounts	$ 250	$ 88	$ 8	$ 330

	Balance at Beginning of Period	Charged to Revenues and Expenses	Write-Off of Previously Provided Accounts	Balance at End of Period
Year Ended December 31, 2005				
Allowance for Customer Returns and Sales Credits	$ 1,314	$ 4,739	$ 4,842	$ 1,211
Year Ended December 31, 2006				
Allowance for Customer Returns and Sales Credits	$ 1,211	$ 5,673	$ 6,093	$ 791
Year Ended December 31, 2007				
Allowance for Customer Returns and Sales Credits	$ 791	$ 6,531	$ 6,224	$ 1,098

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

May 16, 2008

ECHELON CORPORATION

By: /s/ OLIVER R. STANFIELD
Oliver R. Stanfield
Executive Vice President and Chief Financial Officer

(Duly Authorized Officer and Principal Financial and Accounting Officer)

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES EXCHANGE ACT OF 1934, THIS REPORT HAS BEEN SIGNED BY THE FOLLOWING PERSONS ON BEHALF OF THE REGISTRANT AND IN THE CAPACITIES AND ON THE DATES INDICATED.

Signatures	Title	Date
/s/ M. KENNETH OSHMAN M. Kenneth Oshman	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	May 16, 2008
/s/ OLIVER R. STANFIELD Oliver R. Stanfield	Executive Vice President and Chief Financial Officer (Principal Financial and Principal Accounting Officer)	May 16, 2008
* Armas Clifford Markkula, Jr.	Vice Chairman	May 16, 2008
* Robyn M. Denholm	Director	May 16, 2008
* Robert J. Finocchio, Jr.	Director	May 16, 2008
* Robert R. Maxfield	Director	May 16, 2008
* Richard M. Moley	Director	May 16, 2008

*	Director	May 16, 2008
Betsy Rafael		
*	Director	May 16, 2008
Larry W. Sonsini		

* /s/ OLIVER R. STANFIELD

Oliver R. Stanfield

Attorney-In-Fact

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description of Document
3.2*	Amended and Restated Certificate of Incorporation of Registrant.
3.3*	Amended and Restated Bylaws of Registrant.
4.1*	Form of Registrant s Common Stock Certificate.
4.2*	Second Amended and Restated Modification Agreement dated May 15, 1997.
10.1*	Form of Indemnification Agreement entered into by Registrant with each of its directors and executive officers.
10.2*+	1997 Stock Plan and forms of related agreements.
10.2(a)*+	Form of 1997 Stock Plan Stock Option Agreement with early exercise feature
10.2(b)*+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement with early exercise feature
10.2(c)*+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement
10.2(d)*+	Form of 1997 Stock Plan Performance Share Agreement
10.2(e)*+	Form of 1997 Stock Plan Performance Share Agreement for non-US employees
10.2(f)*+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria for non-US employees
10.2(g)*+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for non-US employees
10.2(h)*+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria
10.2(i)*+	Form of 1997 Stock Plan Performance Share Agreement
10.2(j)*+	Form of 1997 Stock Plan Stock Appreciation Right Agreement
10.3*+	1988 Stock Option Plan and forms of related agreements.
10.4*	Second Amended and Restated Modification Agreement dated May 15, 1997 (included in Exhibit 4.2).
10.5*	Form of International Distributor Agreement.
10.6*	Form of OEM License Agreement.
10.7*	Form of Software License Agreement.
10.8*	International Distributor Agreement between the Company and EBV Elektronik GmbH as of December 1, 1997.
10.9*+	1998 Director Option Plan.
21.1*	Subsidiaries of the Registrant.
23.1	Consent of KPMG LLP, Independent Registered Public Accounting Firm.
24.1*	Power of Attorney (see signature page).
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Previously filed.

\+ Indicates management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 14(c) of Form 10-K.