ECHELON CORP
Form 10-Q
August 07, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2017
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 001-37755
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 No.
2901 Patrick Henry Drive Santa Clara, CA	95054
Address of Principal Executive Offices	Zip Code

(408) 938-5200
Registrant's Telephone Number, Including Area Code

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report

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 o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x
Emerging growth company o	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:
Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.   Yes o   No o

APPLICABLE ONLY TO CORPORATE ISSUERS
As of July 31, 2017, 4,454,155 shares of the registrant’s common stock were outstanding.

Table of Contents

ECHELON CORPORATION
FORM 10 Q
FOR THE QUARTER ENDED JUNE 30, 2017
INDEX

FORWARD-LOOKING INFORMATION

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

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

Table of Contents

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

	June 30, 2017	December 31, 2016
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$7,727	$ 9,803
Restricted investments	1,250	1,250
Short-term investments	11,973	11,983
Accounts receivable, net	3,607	3,015
Inventories	2,636	2,570
Deferred cost of revenues	1,229	1,104
Other current assets	1,305	900
Total current assets	29,727	30,625
Property and equipment, net	360	445
Intangible assets, net	840	953
Other long term assets	863	885
Total assets	$31,790	$ 32,908
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$2,235	$ 1,697
Accrued liabilities	1,732	2,174
Deferred revenues	3,838	3,671
Total current liabilities	7,805	7,542
LONG-TERM LIABILITIES:		
Other long-term liabilities	703	688
Total long-term liabilities	703	688
STOCKHOLDERS' EQUITY:		
Common stock	48	48
Additional paid-in capital	358,967	358,123
Treasury stock	(28,130)	(28,130)
Accumulated other comprehensive loss	(2,108)	(2,437)
Accumulated deficit	(305,749)	(303,180)
Total Echelon Corporation stockholders' equity	23,028	24,424
Noncontrolling interest in subsidiary	254	254
Total stockholders' equity	23,282	24,678
Total liabilities and stockholders' equity	$31,790	$ 32,908

See accompanying notes to condensed consolidated financial statements.

3

Table of Contents

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenues [2]	$8,021	$8,061	$15,820	$16,708
Cost of revenues [1]	3,495	3,415	6,821	7,220
Gross profit	4,526	4,646	8,999	9,488
Operating expenses:				
Product development [1]	2,255	1,985	4,482	4,178
Sales and marketing [1]	1,463	1,679	2,925	2,981
General and administrative [1]	1,929	2,197	3,853	4,208
Total operating expenses	5,647	5,861	11,260	11,367
Loss from operations	(1,121)	(1,215)	(2,261)	(1,879)
Interest and other income (expense), net	(220)	503	(285)	298
Loss before provision for income taxes	(1,341)	(712)	(2,546)	(1,581)
Income tax expense (benefit)	29	51	23	57
Net loss	$(1,370)	$(763)	$(2,569)	$(1,638)
Basic and diluted net loss per share	$(0.31)	$(0.17)	$(0.58)	$(0.37)
Shares used in computing net loss per share:				
Basic	4,445	4,420	4,440	4,419
Diluted	4,445	4,420	4,440	4,419

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

(2) Includes related party amounts of $0 and $0 for the three months ended June 30, 2017 and 2016, respectively. Includes related party amounts of $0 and $1,312 for the six months ended June 30, 2017 and 2016, respectively. See Note 5 and Note 12 for additional information on related party transactions.

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net loss	$(1,370)	$(763)	$(2,569)	$(1,638)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustment	246	(523)	329	(339)
Unrealized holding gain (loss) on available-for-sale securities	1	1	—	13
Total other comprehensive income (loss)	247	(522)	329	(326)
Comprehensive loss	$(1,123)	$(1,285)	$(2,240)	$(1,964)

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	Six Months Ended June 30, 2017	2016
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net loss	$(2,569)	$(1,638)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	220	261
Provision for (recovery of) allowance for doubtful accounts	(7)	2
Increase in accrued investment income	(40)	(20)
Stock-based compensation	909	176
Adjustment to contingent consideration	—	(318)
Change in operating assets and liabilities:		
Accounts receivable	(668)	364
Inventories	(66)	79
Deferred cost of revenues	(111)	(230)
Other current assets	(398)	219
Accounts payable	544	(791)
Accrued liabilities	(111)	(1,022)
Deferred revenues	226	1,038
Deferred rent	(32)	99
Net cash used in operating activities	(2,103)	(1,781)
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchases of available for sale short term investments	(11,950)	(7,988)
Proceeds from maturities and sales of available for sale short term investments	12,000	13,000
Change in other long term assets	24	—
Purchase of property and equipment	(31)	(67)
Net cash provided by investing activities	43	4,945
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Repurchase of common stock from employees for payment of taxes on vesting of restricted stock units and upon exercise of stock options	(64)	(32)
Net cash used in financing activities	(64)	(32)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	48	(16)
NET CHANGE IN CASH AND CASH EQUIVALENTS	(2,076)	3,116
CASH AND CASH EQUIVALENTS:		
Beginning of period	9,803	7,691
End of period	$7,727	$10,807
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for income taxes	$68	$85

See accompanying notes to condensed consolidated financial statements.

Table of Contents

ECHELON CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

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

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for the fair presentation of the results of operations for the interim periods covered, and of the financial condition of the Company at the date of the interim balance sheet. The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements for the year ended December 31, 2016 included in its Annual Report on Form 10 K.

There have been no material changes to the Company’s significant accounting policies as compared to the significant accounting policies described in its Annual Report on Form 10 K for the fiscal year ended December 31, 2016.

Risks and Uncertainties

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

- The Company’s sales are currently concentrated, as approximately 29.1% of revenues for the six months ended June 30, 2017, were derived from one customer, Avnet Europe Comm VA ("Avnet"), the Company's primary distributor of its IIoT products in Europe and Japan. Customers in any of the Company’s target market sectors may experience unexpected reductions in demand for their products and consequently reduce their purchases from the Company, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. In addition, if any of these customers are unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to the Company.
- The Company utilizes third-party contract electronic manufacturers to manufacture, assemble, and test its products. If any of these third-parties were unable to obtain the necessary capital to operate their business, they may be unable to provide the Company with timely services or to make timely deliveries of products.
- From time to time, the Company has experienced shortages or interruptions in supply for certain products or components used in the manufacture of the Company’s products that have been or will be discontinued. In order to ensure an adequate supply of these items, the Company has occasionally purchased quantities of these items that are in excess of the Company’s then current estimate of short-term requirements. If the long-term requirements do not materialize as originally expected, or if the Company develops alternative solutions that no longer employ these items and the Company is not able to dispose of these excess products or components, the Company could be subject to increased levels of excess and obsolete inventories.
- In an effort to manage costs and inventory risks, the Company has decreased the inventory levels of certain products. If there is an unexpected increase in demand for these items, the Company might not be able to supply its customers with products in a timely manner.

Table of Contents

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

(i) New Accounting Standards Recently Adopted

In July 2015, the FASB issued an update to ASC 330, Inventory: Simplifying the Measurement of Inventory. Under this update, subsequent measurement of inventory is based on the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated cost of completion and disposal. This update does not apply to inventory that is measured using last-in, first-out or the retail inventory method. This update was adopted by the Company in the first quarter of fiscal year 2017. There was no impact on the Company's financial statements as a result of the adoption.

(ii) New Accounting Standards Not Yet Effective

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which superseded existing revenue recognition guidance under current U.S. GAAP. The standard is a comprehensive revenue recognition model that requires a company to recognize revenue to depict the transfer of goods or services to a customer at an amount that reflects the consideration it expects to receive in exchange for those goods or services. In doing so, among other things, companies will generally need to use more judgment and make more estimates than under the current guidance. Recently, the FASB has issued guidance clarifying certain topics such as (i) gross versus net revenue reporting, (ii) identifying performance obligations and licensing, (iii) accounting for shipping and handling fees and costs, and (iv) accounting for consideration given by a vendor to a customer.

The standard permits two methods of adoption: (i) retrospectively to each prior reporting period presented (the full retrospective method), or (ii) retrospectively with the cumulative effect of initially applying the standard recognized at the date of initial application (the cumulative catch-up transition method). The Company currently anticipates adopting the standard using the full retrospective method to restate each prior reporting period presented.

The standard will be effective for Echelon in the fiscal year beginning January 1, 2018. The Company currently anticipates the standard will have a material impact on its financial statements and disclosures, and continues to make progress in assessing all potential impacts of the standard, including any impacts of recently issued amendments. The Company currently believes the most significant impact of adopting the new standard will relate to its accounting for sales made to distributors under agreements that contain a limited right to return unsold products and price adjustment provisions. Under the existing revenue guidance, the Company has historically concluded that the price to these distributors is not fixed or determinable at the time it delivers products to them. Accordingly, revenue from sales to these distributors has not historically been recognized until the distributor resells the product. By contrast, under the new standard, the Company expects to recognize revenue, including estimates for applicable variable consideration, predominately at the time of shipment to these distributors, thereby accelerating the timing of revenue for products sold through the distribution channel. During the year ended December 31, 2016, the Company recognized approximately $14.7 million of revenue sold through such distributors. As of December 31, 2016, the amount of revenue and cost of revenues sold through the distribution channel that were deferred was $2.6 million and $668,000, respectively.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which requires, among other things, the recognition of lease assets and lease liabilities on the balance sheet by lessees for certain leases classified as operating leases under previous GAAP. ASU 2016-02 is effective for annual and interim periods beginning after December 15, 2018. ASU 2016-02 mandates a modified retrospective transition method with early adoption permitted. The Company is currently evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures.

Table of Contents

Revenue Recognition

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

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

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

Deferred Revenue and Deferred Cost of Revenues

Deferred revenue consists of amounts billed or payments received in advance of revenue recognition. Deferred cost of revenues related to deferred product revenues includes direct product costs and applied overhead. Deferred cost of revenues 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 revenues are recognized.

Restricted Investments

As of June 30, 2017, restricted investments consist of balances maintained by the Company with an investment advisor in money market funds and permitted treasury bills. These balances represent collateral for a $1.0 million operating line of credit issued to the Company by its primary bank for credit card purchases. Because the Company’s agreement with the lender prevents the Company from withdrawing these funds, they are considered restricted.

Fair Value Measurements

The Company measures at fair value its cash equivalents and available-for-sale investments using a valuation hierarchy based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's own assumptions. These two types of inputs have created the following fair value hierarchy:

- Level 1 - Quoted prices for identical instruments in active markets;
- Level 2 - Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and
- Level 3 - Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires the Company to minimize the use of unobservable inputs and to use observable market data, if available, when estimating fair value. Other than cash and money market funds, the Company's only financial assets and liabilities required to be measured at fair value on a recurring basis at June 30, 2017, are its fixed income available-for-sale securities. See Note 2 of these Notes to condensed consolidated financial statements for a summary of the input levels used in determining the fair value of these assets and liabilities as of June 30, 2017.

Long-Lived Assets

We perform periodic reviews to determine whether facts and circumstances exist that would indicate that the carrying

Table of Contents

amounts of property, plant and equipment and long-lived intangible assets might not be fully recoverable. If facts and circumstances indicate that the carrying amount of these assets might not be fully recoverable, we compare projected undiscounted net cash flows associated with the related asset or group of assets over their estimated remaining useful lives against their respective carrying amounts. In the event that the projected undiscounted cash flows are not sufficient to recover the carrying value of the assets, the assets are written down to their estimated fair values based on the expected discounted future cash flows attributable to the assets. Evaluation of impairment of property, plant and equipment and long-lived intangible assets requires estimates in the forecast of future operating results that are used in the preparation of the expected future undiscounted cash flows. Actual future operating results and the remaining economic lives of our property, plant and equipment and long-lived intangible assets could differ from our estimates used in assessing the recoverability of these assets. These differences could result in impairment charges, which could have a material adverse impact on our results of operations.

Contingent Consideration

During the quarter ended March 31, 2016, the contingent consideration payable to Lumewave's shareholders, which the Company recognized upon its purchase of Lumewave in August 2014, decreased by approximately $318,000. This reduction was due to the Company's determination that it was no longer probable that the minimum targets specified in the purchase agreement would be met due to sales force transitions and scheduling delays for some of our larger lighting projects. Accordingly, the Company reduced the associated liability to $0 as of March 31, 2016. This resulted in a $318,000 adjustment, which was recorded as a reduction to general and administrative expenses in the Company's condensed consolidated statements of operations.

2. Financial Instruments:

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

Assets and Liabilities Measured at Fair Value on a Recurring Basis

On a recurring basis, the Company measures certain of its financial assets, namely its cash equivalents and available-for-sale investments, at fair value. The fair value of the Company’s financial assets measured at fair value on a recurring basis was determined using the following inputs at June 30, 2017 (in thousands):

	Fair Value Measurements at Reporting Date Using		
	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs

	Total	(Level 1)	(Level 2)	(Level 3)
Assets:				
Money market funds [1]	$4,570	$ 4,570	$ —	$ —
U.S. government securities[2]	13,223	—	13,223	—
Total	$17,793	$ 4,570	$ 13,223	$ —

The fair value of the Company’s financial assets measured at fair value on a recurring basis was determined using the following inputs at December 31, 2016 (in thousands):

Table of Contents

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money market funds [1]	$4,513	$ 4,513	$ —	$ —
U.S. government securities[2]	13,233	—	13,233	—
Total	$17,746	$ 4,513	$ 13,233	$ —

[1] Included in cash and cash equivalents in the Company's condensed consolidated balance sheets

[2] Represents the portfolio of available for sale securities that is included in restricted investments and short-term investments in the Company's condensed consolidated balance sheets

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

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

As of June 30, 2017, the Company's available-for-sale securities had contractual maturities of six months and an average remaining term to maturity of three months. As of June 30, 2017, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses of the Company's short-term investments by major security type were as follows (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. government securities	$ 11,970	$ 11,968	$ —	$ 2

The amortized cost basis, aggregate fair value and gross unrealized holding gains and losses for the Company's available-for-sale short-term investments, by major security type, were as follows as of December 31, 2016 (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. government securities	$ 11,984	$ 11,983	$ —	$ 1

Market values were determined for each individual security in the investment portfolio. The Company reviews its investments on a regular basis to evaluate whether or not any have experienced an other-than-temporary decline in fair value.

3. Earnings Per Share:

The computation of diluted net loss per share does not include stock options, performance shares, and contingently issuable shares of 923,306 and 355,338 for the three and six months ended June 30, 2017 and 2016, respectively, because the effect of their inclusion would be anti-dilutive based on their respective exercise prices.

4. Stockholders’ Equity and Employee Stock Option Plans:

On April 17, 2017, the Company's Board of Directors approved an amendment to the Tax Benefit Preservation Plan (the "Tax Plan"), dated as of April 22, 2016, by and between the Company and Computershare Inc., as rights agent (the “Rights Agent”), to extend the Final Expiration Date (as such term is defined in the Tax Plan) to April 25, 2019.

Table of Contents

Stock-based Compensation Expense

The following table summarizes stock-based compensation expense for the three and six months ended June 30, 2017 and 2016 and its allocation within the condensed consolidated statements of operations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Cost of revenues	$45	$(28)	$74	$(17)
Product development	119	41	243	40
Sales and marketing	27	43	129	(78)
General and administrative	251	121	463	231
Total	$442	$177	$909	$176

The negative expense amounts reflected in the table above are primarily due to the reversal of previously recognized expense resulting from the forfeiture of equity awards for certain employees whose employment terminated during the respective periods.

Stock Award Activity

There were no options exercised during the three and six months ended June 30, 2017 and 2016.

The total fair value of RSUs vested and released during the three and six months ended June 30, 2017 was $147,000 and $196,000, respectively. The total fair value of RSUs vested and released during the three and six months ended June 30, 2016 was approximately $92,000 and $96,000, respectively. The fair value is calculated by multiplying the fair market value of the Company’s common stock on the vesting date by the number of shares of common stock issued upon vesting.

5. Significant Customers:

The Company markets its products and services throughout the world to original equipment manufacturers (OEMs) and systems integrators in the building, industrial, transportation, utility/home, and other automation markets. During the three and six months ended June 30, 2017 and 2016, the Company had two customers that accounted for a significant portion of its revenues: Avnet Europe Comm VA (“Avnet”), the Company’s primary distributors of its IIoT products in Europe and Japan, and Enel Distribuzione Spa ("Enel"), an Italian utility company. For the three and six months ended June 30, 2017 and 2016, the percentage of the Company’s revenues attributable to sales made to these customers was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Avnet	28.6%	29.9%	29.1%	28.3%
Enel	— %	— %	— %	7.9 %
Total	28.6%	29.9%	29.1%	36.2%

6. Commitments and Contingencies:

Legal Actions

From time to time, in the ordinary course of business, the Company may be subject to certain legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, or other matters. In accordance with generally accepted accounting principles, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While the Company believes it has adequately provided for such contingencies as of June 30, 2017, 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.

Table of Contents

Line of Credit
As of June 30, 2017, the Company maintained an operating credit line of $1.0 million with its primary bank for company credit card purchases. This line of credit is secured by a collateral of the first priority on $1.3 million of the Company's investments (presented as restricted investments in the condensed consolidated balance sheets). The restricted investments are classified as current assets due to the contractual duration of the underlying credit agreement.

7. Accumulated Other Comprehensive Income (Loss), Net of Tax (Amounts in thousands):

	Foreign currency translation adjustment	Unrealized gain (loss) on available-for-sale securities	Accumulated Other Comprehensive Income (Loss)
Beginning balance at December 31, 2016	$ (2,435)	$ (2)	$ (2,437)
Change during January - June 2017	329	—	329
Balance at June 30, 2017	$ (2,106)	$ (2)	$ (2,108)

None of the above amounts have been reclassified in the condensed consolidated statement of operations.

8. Inventories:

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

	June 30, 2017	December 31, 2016
Purchased materials	$ 103	$ 148
Finished goods	2,533	2,422
	$ 2,636	$ 2,570

9. Accrued Liabilities:

Accrued liabilities consist of the following (in thousands):

	June 30, 2017	December 31, 2016
Accrued payroll and related costs	$ 953	$ 1,299
Warranty reserve	138	118
Restructuring charges	185	273
Other accrued liabilities	456	484
	$ 1,732	$ 2,174

10. Segment Disclosure:

ASC Topic 280, Segment Reporting, establishes standards for reporting information about operating segments, products and services, geographic areas of operations and major customers. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company's chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer and his direct reports (CODM). The Company operates in one principal industry segment - the IIoT segment, which is its reportable segment.

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 and other assets include property and equipment, acquired intangible assets, and

Table of Contents

deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of June 30, 2017 and December 31, 2016, long-lived assets of approximately $2.0 million and $2.2 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the condensed consolidated financial statements.

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, value-added resellers, and local distributors, primarily in EMEA and APJ. Revenues are attributed to geographic areas based on the country where the products are shipped to or the services are delivered. Summary revenue information by geography for the three and six months ended June 30, 2017 and 2016 is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Americas	$3,295	$3,154	$6,465	$5,709
EMEA	2,774	3,189	5,649	7,861
APJ	1,952	1,718	3,706	3,138
Total	$8,021	$8,061	$15,820	$16,708

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

11. Income Taxes:

The provision for income taxes for the three months ended June 30, 2017 and 2016 was $29,000 and $51,000, respectively. The provision for income taxes for the six months ended June 30, 2017 and 2016 were $23,000 and $57,000, respectively. The difference between the statutory rate and the Company’s effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits.

As of June 30, 2017 and December 31, 2016, the Company had gross unrecognized tax benefits of approximately $9.3 million and $9.2 million, respectively, of which $357,000 and $364,000, respectively, if recognized, would impact the effective tax rate on income from continuing operations. The Company’s policy is to recognize interest and/or penalties related to unrecognized tax benefits in income tax expense. As of June 30, 2017 and December 31, 2016, the Company had accrued $52,000 and $62,000, respectively, for interest and penalties. The $10,000 reduction in interest and penalties on gross unrecognized tax benefits during the six months ended June 30, 2017 was primarily attributable to the expiration of the statute of limitations in certain foreign jurisdictions.

12. Related Parties:

In June 2000, the Company entered into a stock purchase agreement with Enel pursuant to which Enel purchased 300,000 newly issued shares of its common stock for $130.7 million. The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To the Company’s knowledge, Enel has disposed of none of its 300,000 shares. Under the terms of the stock purchase agreement, Enel has the right to nominate one member of the Company’s board of directors. While a representative of Enel served on the board until March 14, 2012, no Enel representative is presently on the board.

In October 2006, the Company entered into a new development and supply agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from the Company. The development and supply agreement expired in March 2016.

For the three and six months ended June 30, 2017, the Company recognized no revenue from products sold to Enel and its designated manufacturers. For the three and six months ended June 30, 2016, the Company recognized revenue from products sold to Enel and its designated manufacturers of approximately $0 and $1.3 million, respectively.

As of June 30, 2017 and December 31, 2016, none of the Company’s total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

Table of Contents

13. Joint Venture:
On March 23, 2012, the Company entered into an agreement with Holley Metering Limited (“Holley Metering”), a designer and manufacturer of energy meters in China, to create a joint venture, Zhejiang Echelon-Holley Technology Co., Ltd. (“Echelon-Holley”). The joint venture's intended focus was on the development and sales of smart energy products for China and rest-of-world markets. The Company has a 51.0% ownership interest in the joint venture and exercises controlling influence. Therefore, Echelon-Holley’s accounts are included in the Company’s condensed consolidated financial statements as of June 30, 2017 and 2016, and for the six months then ended. Holley Metering’s interests in Echelon-Holley’s net assets are reported in the non-controlling interest in subsidiary on the condensed consolidated balance sheet as of June 30, 2017. Net loss attributable to the non-controlling interest in Echelon-Holley was $0 and $0 during the three and six months ended June 30, 2017 and 2016, respectively.
As of June 30, 2017, Echelon and Holley Metering had contributed in cash a total of approximately $4.0 million in Share Capital, as defined in the joint venture agreement, to Echelon-Holley in proportion to their respective ownership interests.
In connection with the decision to sell the Grid business announced in the third quarter of 2014, the Company undertook a process to sell the remaining net assets of the joint venture and recorded the net assets and liabilities of the joint venture at the lower of their carrying amount or fair value less cost to sell, and classified them as held for sale on the accompanying balance sheet at December 31, 2014. The major classes of assets and liabilities that were classified as held for sale were inventory, deferred revenues and the related deferred costs of sales, and accrued liabilities.
During the quarter ended September 30, 2015, the Company concluded that it would no longer pursue a sale, but would instead work with Holley Metering to shut the joint venture down. The remaining net assets of the joint venture were immaterial as of September 30, 2015. As of June 30, 2017, the Company is continuing to work with Holley Metering to complete the shut-down.
14. Restructuring:

During the fourth quarter of 2016, the Company undertook restructuring actions affecting approximately 7 employees to be terminated between October 2016 and September 2017, as part of an overall plan to reshape the Company for the future. In connection with this restructuring, the Company recorded restructuring charges of approximately $286,000 related to termination benefits for these personnel during the year ended December 31, 2016.
The following table sets forth a summary of restructuring activities related to the Company's 2016 restructuring program (in thousands):

	December 31, 2016	Costs Incurred	Cash Payments	June 30, 2017
Accrued termination benefits	$ 273	$ —	$ (88)	$ 185

15

Table of Contents

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

The following discussion should be read in conjunction with the condensed consolidated financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business. These statements may be identified by the use of words such as “we believe,” “expect,” “anticipate,” “intend,” “plan,” “goal,” “contin “may,” "target"," and similar expressions. Forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. In particular, these statements include statements such as: our plan to focus our product development spend in our foundational technology to broaden the applicability of our control networking platform into new markets; our predictions about the smart energy market, increased pricing pressures and worldwide macro-economic conditions; our projections of IIoT revenues; our expectations on shipments to Enel and revenues from Enel; our expectation that we will achieve a return on our investment of resources into our products; estimates of our future gross margins and factors affecting our gross margins; statements regarding reinvesting a portion of our earnings from foreign operations; plans to use our cash reserves to strategically acquire other companies, products, or technologies; our projections of our combined cash, cash equivalent and short term investment balance; the sufficiency of our cash reserves to meet cash requirements; our expectations that our IIoT revenues will not fluctuate significantly from foreign currency sales; estimates of our interest income and expense; our belief that we have adequately provided for legal contingencies; and our belief that we have made adequate provisions for tax exposure and legal matters. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the “Factors That May Affect Future Results of Operations” section. Therefore, our actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to review or update publicly any forward-looking statements for any reason, except as required by law.

EXECUTIVE OVERVIEW

Echelon Corporation was incorporated in California in February 1988 and reincorporated in Delaware in January 1989. We went public on the NASDAQ market under the symbol "ELON" in July 1998. We are based in Santa Clara, California, and maintain offices in several foreign countries throughout Europe and Asia. Our products enable "things" in commercial and industrial applications — such as air conditioners, lighting, manufacturing equipment, electricity meters, light switches, thermostats, and valves — to be made “smart” and inter-connected, part of an emerging market known as the Industrial Internet of Things ("IIoT").

Our widely deployed, open standard, multi-vendor energy control networking platform powers applications for smart cities, smart buildings, and smart campuses that help customers save on their energy usage; prevent failure or reduce failure duration; reduce carbon footprint; improve safety, comfort, and convenience; and more. Our solutions, which feature a programmable, distributed intelligence architecture that is designed for both high reliability and fast action, are implemented over the powerline or through wireless communication systems for flexibility in installation and operation.

We offer two product lines, the first of which is comprised of chips, modules, gateways, and design and management software that enables Original Equipment Manufacturers ("OEMs") to quickly design and bring to market interoperable smart systems for their commercial and industrial customers. These products are generally marketed under the LONWORKS and IzoT brand names. We refer to revenues from these products as "embedded systems" revenues.

Our second product line is a range of control networking solutions designed specifically for the lighting market within the IIoT. As this market continues its transition to solid state lighting, or LEDs, we have focused our initial offerings on outdoor lighting control solutions, as we believe that the incremental energy savings, maintenance benefits, and safety improvements resulting from the implementation of controls offers a compelling return on investment. In addition, due to the abundance of lighting fixtures in most locations, the lighting control system can host a variety of "smart" applications that can further improve safety and comfort on roadways, in parking lots and garages, on campuses, in tunnels, and more. Our lighting control solutions consist of wired and wireless control nodes placed at the lighting fixtures of a wide variety of manufacturers, “smart” gateways for interconnecting the control nodes, and a software-based Central Management System, or CMS, which is used for startup, commissioning, management, and monitoring of the lighting network. These solutions are sold to end users typically through manufacturers' representatives, energy services companies, and distributors, and are generally marketed under the LumInsight and Lumewave by Echelon brand names. We refer to revenues from these products as "outdoor lighting" revenues.

Table of Contents

The following tables provide an overview of key financial metrics for the three and six months ended June 30, 2017 and 2016 that our management team focuses on in evaluating our financial condition and operating performance (in thousands, except percentages).

	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	$ Change	% Change
Revenues	$8,021	$ 8,061	$(40)	(0.5)%
Gross margin	56.4 %	57.6 %	---	(1.2) ppt
Operating expenses	$5,647	$ 5,861	$(214)	(3.7)%
Net loss	$(1,370)	$ (763)	$(607)	79.6 %

	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016	$ Change	% Change
Revenues	$15,820	$ 16,708	$(888)	(5.3)%
Gross margin	56.9 %	56.8 %	---	0.1 ppt
Operating expenses	$11,260	$ 11,367	$(107)	(0.9)%
Net loss	$(2,569)	$ (1,638)	$(931)	56.8 %

	Balance as of June 30, 2017	Balance as of December 31, 2016	$ Change	% Change
Cash, cash equivalents, and short-term investments *	$20,950	$ 23,036	$(2,086)	(9.1)%

* As of June 30, 2017 and December 31, 2016, includes $1.3 million of restricted investments presented separately on condensed consolidated balance sheet

- Revenues: Our revenues decreased by 0.5% during the second quarter of 2017 as compared to the same period in 2016, and decreased by 5.3% during the six months ended June 30, 2017 as compared to the same period in 2016. The decrease in revenues between the two six-month periods was mainly due to a decrease in sales of components sold to Enel. For further analysis please see the topic Revenues in the Results of Operations discussion later in this section.
- Gross margin: Our gross margins decrease