

ECHELON CORP  
Form 10-Q  
August 09, 2006

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

000-29748

(Commission file number)

ECHELON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction  
of  
incorporation or  
organization)

77-0203595

(IRS Employer  
Identification  
Number)

550 Meridian Avenue  
San Jose, CA 95126

(Address of principal executive office and zip code)

(408) 938-5200

(Registrant's telephone number, including area code)

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

Yes x No o

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

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

As of July 31, 2006, 39,421,115 shares of the registrant's common stock were outstanding.

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**ECHELON CORPORATION**  
**FORM 10-Q**  
**FOR THE QUARTER ENDED JUNE 30, 2006**

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**FORWARD-LOOKING INFORMATION**

*This report contains forward-looking statements within the meaning of the U.S. federal securities laws that involve risks and uncertainties. Certain statements contained in this report are not purely historical including, without limitation, statements regarding our expectations, beliefs, intentions, anticipations, commitments or strategies regarding the future that are forward-looking. These statements include those discussed in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, including "Liquidity and Capital Resources," "Recently Issued Accounting Standards" and "Factors That May Affect Future Results of Operations," and elsewhere in this report. These statements include statements concerning projected revenues, international revenues, expenses, gross profit, income, product development and market acceptance of our products.*

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

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

## PART I. FINANCIAL INFORMATION

## ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**ECHELON CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands)

|   | <b>June 30,</b>   | <b>December 31,</b> |
|---|-------------------|---------------------|
|   | <b>2006</b>       | <b>2005</b>         |
| <b>ASSETS</b>                                     |                   |                     |
| <b>CURRENT ASSETS:</b>                            |                   |                     |
| Cash and cash equivalents                         | \$ 48,566         | \$ 59,080           |
| Short-term investments                            | 92,799            | 95,400              |
| Accounts receivable, net                          | 16,789            | 11,006              |
| Inventories                                       | 4,460             | 3,240               |
| Other current assets                              | 7,677             | 2,289               |
| Total current assets                              | 170,291           | 171,015             |
| Property and equipment, net                       | 15,631            | 14,886              |
| Goodwill  | 8,198             | 8,018               |
| Other long-term assets                            | 1,997             | 2,019               |
| <b>TOTAL ASSETS</b>                               | <b>\$ 196,117</b> | <b>\$ 195,938</b>   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>       |                   |                     |
| <b>CURRENT LIABILITIES:</b>                       |                   |                     |
| Accounts payable                                  | \$ 6,724          | \$ 3,972            |
| Accrued liabilities                               | 4,970             | 7,473               |
| Deferred revenues                                 | 12,577            | 2,096               |
| Total current liabilities                         | 24,271            | 13,541              |
| <b>LONG-TERM LIABILITIES:</b>                     |                   |                     |
| Deferred rent                                     | 1,195             | 1,089               |
| Total long-term liabilities                       | 1,195             | 1,089               |
| <b>STOCKHOLDERS' EQUITY:</b>                      |                   |                     |
| Common stock                                      | 415               | 415                 |
| Additional paid-in capital                        | 280,911           | 278,005             |
| Treasury stock                                    | (15,470)          | (12,925)            |
| Accumulated other comprehensive income (loss)     | 460               | (118)               |
| Accumulated deficit                               | (95,665)          | (84,069)            |
| Total stockholders' equity                        | 170,651           | 181,308             |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$ 196,117</b> | <b>\$ 195,938</b>   |

*See accompanying notes to condensed consolidated financial statements.*

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

|   | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|---|--------------------------------|-------------------|------------------------------|-------------------|
|   | 2006                           | 2005              | 2006                         | 2005              |
| <b>REVENUES:</b>  |                                |                   |                              |                   |
| Product   | \$ 19,209                      | \$ 17,268         | \$ 29,783                    | \$ 38,784         |
| Service   | 165                            | 212               | 336                          | 379               |
| Total revenues  | 19,374                         | 17,480            | 30,119                       | 39,163            |
| <b>COST OF REVENUES:</b>                                |                                |                   |                              |                   |
| Cost of product (1)                                     | 7,303                          | 7,315             | 11,866                       | 16,022            |
| Cost of service (1)                                     | 452                            | 598               | 897                          | 1,104             |
| Total cost of revenues                                  | 7,755                          | 7,913             | 12,763                       | 17,126            |
| <b>GROSS PROFIT</b>                                     | <b>11,619</b>                  | <b>9,567</b>      | <b>17,356</b>                | <b>22,037</b>     |
| <b>OPERATING EXPENSES:</b>                              |                                |                   |                              |                   |
| Product development (1)                                 | 7,163                          | 6,360             | 14,154                       | 12,577            |
| Sales and marketing (1)                                 | 5,089                          | 5,396             | 10,236                       | 10,421            |
| General and administrative (1)                          | 3,798                          | 3,596             | 7,200                        | 8,047             |
| Total operating expenses                                | 16,050                         | 15,352            | 31,590                       | 31,045            |
| <b>LOSS FROM OPERATIONS</b>                             | <b>(4,431)</b>                 | <b>(5,785)</b>    | <b>(14,234)</b>              | <b>(9,008)</b>    |
| <b>INTEREST AND OTHER<br/>INCOME, NET</b>               | <b>1,404</b>                   | <b>1,281</b>      | <b>2,798</b>                 | <b>2,342</b>      |
| <b>LOSS BEFORE PROVISION FOR<br/>INCOME TAXES</b>       | <b>(3,027)</b>                 | <b>(4,504)</b>    | <b>(11,436)</b>              | <b>(6,666)</b>    |
| <b>INCOME TAX EXPENSE</b>                               | <b>80</b>                      | <b>100</b>        | <b>160</b>                   | <b>200</b>        |
| <b>NET LOSS</b>   | <b>\$ (3,107)</b>              | <b>\$ (4,604)</b> | <b>\$ (11,596)</b>           | <b>\$ (6,866)</b> |
| <b>NET LOSS PER SHARE:</b>                              |                                |                   |                              |                   |
| Basic   | \$ (0.08)                      | \$ (0.11)         | \$ (0.29)                    | \$ (0.17)         |
| Diluted   | \$ (0.08)                      | \$ (0.11)         | \$ (0.29)                    | \$ (0.17)         |
| <b>SHARES USED IN COMPUTING<br/>NET LOSS PER SHARE:</b> |                                |                   |                              |                   |
| Basic   | 39,615                         | 40,528            | 39,691                       | 40,774            |
| Diluted   | 39,615                         | 40,528            | 39,691                       | 40,774            |

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

|                     |        |      |        |       |
|---------------------|--------|------|--------|-------|
| Cost of product     | \$ 103 | \$ 9 | \$ 215 | \$ 18 |
| Cost of service     | 12     | --   | 26     | --    |
| Product development | 484    | 12   | 1,098  | 24    |

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|                            |     |    |     |     |
|----------------------------|-----|----|-----|-----|
| Sales and marketing        | 302 | 12 | 662 | 24  |
| General and administrative | 408 | 60 | 714 | 120 |

*See accompanying notes to condensed consolidated financial statements.*

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

|   | Six Months Ended |            |
|---|------------------|------------|
|   | 2006             | 2005       |
| <b>CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:</b>                             |                  |            |
| Net loss  | \$ (11,596)      | \$ (6,866) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                  |            |
| Depreciation and amortization   | 2,167            | 2,111      |
| Loss on disposal of fixed assets  | --               | 38         |
| Recovery of doubtful accounts   | (35)             | (1)        |
| Stock-based compensation  | 2,715            | 186        |
| Change in operating assets and liabilities:   |                  |            |
| Accounts receivable   | (5,748)          | 6,491      |
| Inventories   | (1,220)          | 672        |
| Other current assets  | (5,388)          | (266)      |
| Accounts payable  | 2,752            | (150)      |
| Accrued liabilities   | (2,503)          | 565        |
| Deferred revenues   | 10,481           | 51         |
| Deferred rent   | 106              | 141        |
| Net cash provided by (used in) operating activities                                       | (8,269)          | 2,972      |
| <b>CASH FLOWS PROVIDED BY (USED FOR) INVESTING ACTIVITIES:</b>                            |                  |            |
| Purchase of available-for-sale short-term investments                                     | (34,470)         | (61,886)   |
| Proceeds from maturities and sales of available-for-sale short-term investments           | 37,121           | 54,193     |
| Purchase of restricted investments  | --               | 89         |
| Change in other long-term assets  | (158)            | 224        |
| Capital expenditures  | (2,912)          | (826)      |
| Net cash used for investing activities  | (419)            | (8,206)    |
| <b>CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:</b>                             |                  |            |
| Repurchase of common stock  | (2,545)          | (7,090)    |
| Proceeds from issuance of common stock  | 191              | --         |
| Net cash used in financing activities   | (2,354)          | (7,090)    |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH   | 528              | (778)      |
| NET DECREASE IN CASH AND CASH EQUIVALENTS   | (10,514)         | (13,102)   |
| <b>CASH AND CASH EQUIVALENTS:</b>   |                  |            |
| Beginning of period   | 59,080           | 35,510     |
| End of period   | \$ 48,566        | \$ 22,408  |



SUPPLEMENTAL DISCLOSURES OF CASH FLOW  
INFORMATION:

|                                |    |    |    |     |
|--------------------------------|----|----|----|-----|
| Net cash paid for income taxes | \$ | 44 | \$ | 187 |
|--------------------------------|----|----|----|-----|

*See accompanying notes to condensed consolidated financial statements.*

**ECHELON CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**1. Basis of Presentation**

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

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2005 included in its Annual Report on Form 10-K.

**2. Summary of Significant Accounting Policies**

*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated.

*Foreign Currency Translation*

For foreign subsidiaries using the local currency as their functional currency, assets and liabilities are translated at exchange rates in effect at the balance sheet date and income and expenses are translated at average exchange rates. The effects of these translation adjustments are reported as a separate component of stockholders' equity. Remeasurement adjustments for non-functional currency monetary assets and liabilities are included in other income (expense) in the accompanying condensed consolidated statements of operations.

*Use of Estimates in the Preparation of Financial Statements*

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.

*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. Revenues from software licensing arrangements accounted for approximately 8.0% of total revenues for the quarter ended June 30, 2006 and 7.1% for the same period in 2005; and 9.6% of total revenues for the six months ended June 30, 2006 and 6.4% for the same period in 2005. 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 and certain of the Company's distributors for which no rights of return exist, these criteria are generally met at the time of shipment. For sales made to the Company's distributor partners that do have rights to return certain excess inventory, these criteria are generally met at the time the distributor sells the products through to its end-use customer. For sales of shrink-wrapped software, these criteria are generally met upon shipment to the final end-user.

In accordance with Statement of Position 97-2, or SOP 97-2, *Software Revenue Recognition*, 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 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 these PCS packages. 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.

The Company accounts for 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*.

Service revenue is recognized as the training services are performed, or ratably over the term of the support period. In the case of custom software development services, revenue is recognized when the customer accepts the software.

#### *Stock-Based Compensation*

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 eliminates 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 has elected to adopt 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*.

As permitted under SFAS 123R, 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.



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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 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 performance 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 three and six months ended June 30, 2005 (in thousands, except per share amounts).

|   | <b>Three<br/>Months<br/>Ended<br/>June 30,<br/>2005</b> | <b>Six<br/>Months<br/>Ended<br/>June 30,<br/>2005</b> |
|---|---|---|
| Net loss as reported  | \$ (4,604)  | \$ (6,866)  |
| Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects                           | 93  | 186   |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (2,442)   | (4,943)   |
| Pro forma net loss  | \$ (6,953)  | \$ (11,623)   |
| Basic net income/(loss) per share:  |   |   |
| As reported   | \$ (0.11)   | \$ (0.17)   |
| Pro forma   | \$ (0.17)   | \$ (0.29)   |
| Diluted net income/(loss) per share:  |   |   |
| As reported   | \$ (0.11)   | \$ (0.17)   |
| Pro forma   | \$ (0.17)   | \$ (0.29)   |

The weighted-average grant date fair value of options granted during the three and six months ended June 30, 2005 was \$2.38 and \$2.76, respectively, and was determined using the following weighted average assumptions:

|                          | <b>Three<br/>Months<br/>Ended<br/>June 30,<br/>2005</b> | <b>Six<br/>Months<br/>Ended<br/>June 30,<br/>2005</b> |
|--------------------------|---|---|
| Expected dividend yield  | 0.0%  | 0.0%  |
| Risk-free interest rate  | 3.6%  | 3.5%  |
| Expected volatility      | 56.2%   | 59.1%   |
| Expected life (in years) | 2.5   | 2.8   |

Further information regarding stock-based compensation can be found in Note 4 of these Notes to Condensed Consolidated Financial Statements.

*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 as cash and cash equivalents.

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*Short-Term Investments*

The Company classifies its investments in marketable debt securities as available-for-sale in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. As of June 30, 2006, the Company's available-for-sale securities had contractual maturities from three to twenty-four months and an average remaining term to maturity of seven months. The fair value of available-for-sale securities was determined based on quoted market prices at the reporting date for those instruments. As of June 30, 2006, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses by major security type were as follows (in thousands):

|   | Amortized<br>Cost | Aggregate<br>Fair Value | Unrealized<br>Holding Gains/<br>(Losses) |
|---|-------------------|-------------------------|--|
| U.S. corporate securities:                      |                   |                         |  |
| Commercial paper                                | \$ 6,745          | \$ 6,746                | \$ 1                                     |
| Certificates of deposit                         | 1,509             | 1,509                   | --                                       |
| Corporate notes and bonds                       | 40,499            | 40,357                  | (142)                                    |
|   | 48,753            | 48,612                  | (141)                                    |
| Foreign corporate notes and bonds               | 1,497             | 1,482                   | (15)                                     |
| U.S. government securities                      | 42,897            | 42,705                  | (192)                                    |
| Total investments in debt and equity securities | \$ 93,147         | \$ 92,799               | \$ (348)                                 |

*Computation of Net Loss Per Share*

Net loss per share has been calculated under SFAS No. 128, or SFAS 128, *Earnings per Share*. SFAS 128 requires companies to compute earnings per share under two different methods, basic and diluted. Basic net income per share is calculated by dividing net income 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 loss per share computations for the three months and six months ended June 30, 2006 and June 30, 2005 (in thousands, except per share amounts):

|   | Three Months<br>Ended June 30, |           | Six Months Ended<br>June 30, |           |
|---|--------------------------------|-----------|------------------------------|-----------|
|   | 2006                           | 2005      | 2006                         | 2005      |
| Net loss (Numerator):   |                                |           |                              |           |
|   | \$)                            | \$)       | \$                           | \$)       |
| Net loss, basic & diluted   | (3,107                         | (4,604    | (11,596)                     | (6,866    |
| Shares (Denominator):   |                                |           |                              |           |
| Weighted average common shares outstanding                                    | 39,615                         | 40,528    | 39,691                       | 40,774    |
| Shares used in basic computation  | 39,615                         | 40,528    | 39,691                       | 40,774    |
| Common shares issuable upon exercise of stock options (treasury stock method) | --                             | --        | --                           | --        |
| Shares used in diluted computation  | 39,615                         | 40,528    | 39,691                       | 40,774    |
| Net loss per share:   |                                |           |                              |           |
| Basic   | \$ (0.08)                      | \$ (0.11) | \$ (0.29)                    | \$ (0.17) |
| Diluted   | \$ (0.08)                      | \$ (0.11) | \$ (0.29)                    | \$ (0.17) |

In accordance with SFAS 128, for the three and six months ended June 30, 2006 and 2005, the diluted net loss per share calculation is equivalent to the basic net loss per share calculation as there were no potentially dilutive stock options due to the Company's net loss position. The number of stock options excluded from this calculation for the three and six months ended June 30, 2006 was 7,608,798. The number of stock options excluded from this calculation for the three and six months ended June 30, 2005 was 7,346,802.

*Impairment of Long-Lived Assets Including Goodwill*

The Company reviews property, plant, and equipment and certain identifiable intangibles, excluding goodwill, 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 property, plant, and equipment and certain identifiable intangibles are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair market value. For the three and six month periods ended June 30, 2006 and 2005, the Company has made no material adjustments to its long-lived assets.

Costs in excess of the fair value of tangible and other intangible assets acquired and liabilities assumed in a purchase business combination are recorded as goodwill. 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. 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 as a result of its required tests.

SFAS 142 also requires that intangible assets with definite lives be amortized over their estimated useful lives and reviewed for impairment in accordance with SFAS No. 144, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. As of June 30, 2006, the Company's acquired intangible assets with a definite life, which consisted of purchased technology, have been fully amortized.



*Recently Issued Accounting Standards*

In July, 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that the Company recognize in its financial statements the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of our 2007 fiscal year, with the cumulative effect, if any, of the change in accounting principal recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its condensed consolidated financial statements.

In February 2006, the FASB issued SFAS No. 155 ("SFAS 155"), *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133 ("SFAS 133"), *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140 ("SFAS 140"), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. SFAS 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided the Company has not yet issued financial statements, including for interim periods, for that fiscal year. As the Company does not currently engage in hedging activities, it does not currently expect the adoption of SFAS 155 will have a material impact on its consolidated financial position, results of operations, or cash flows.

In June 2005, the FASB issued SFAS No. 154 ("SFAS 154"), *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for how an entity accounts for, and reports, a change in accounting principle. Previously, most voluntary changes in accounting principles were implemented by reflecting a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, SFAS 154 does not change the transition provisions of any existing accounting pronouncements.

### 3. Stockholders' Equity and Employee Stock Option Plans

#### *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 June 30, 2006, 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 June 30, 2006.

#### *Common Stock*

As of June 30, 2006, the Company was authorized to issue 100,000,000 shares of \$0.01 par value common stock, of which 39,531,336 were outstanding.

In March and August 2004, the Company's board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company's common stock. During the quarter ended June 30, 2006, the Company repurchased 197,743 shares under the program at a cost of approximately \$1.6 million. During the six months ended June 30, 2006, the Company repurchased 319,455 shares under the program at a cost of approximately \$2.5 million. As of June 30, 2006, 1,272,546 shares were available for repurchase. The stock repurchase program will expire in March 2007.

#### *Comprehensive Loss*

Comprehensive income for the Company consists of net income plus the effect of unrealized holding gains or losses on investments classified as available-for-sale and foreign currency translation adjustments. Comprehensive loss for the three and six months ended June 30, 2006 and 2005 is as follows (in thousands):

|  | <b>Three Months Ended June 30,</b> |             | <b>Six Months Ended June 30,</b> |             |
|--|------------------------------------|-------------|----------------------------------|-------------|
|  | <b>2006</b>                        | <b>2005</b> | <b>2006</b>                      | <b>2005</b> |
| Net loss   | \$ (3,107)                         | \$ (4,604)  | \$ (11,596)                      | \$ (6,866)  |
| Other comprehensive income/(loss), net of tax:           |                                    |             |                                  |             |
| Foreign currency translation adjustment                  | 388                                | (474)       | 528                              | (778)       |
| Unrealized holding gain on available-for-sale securities | 15                                 | 205         | 50                               | 92          |
| Comprehensive loss                                       | \$ (2,704)                         | \$ (4,873)  | \$ (11,018)                      | \$ (7,552)  |

#### *Employee Stock Option Exchange Program*

On September 21, 2004, the Company announced a voluntary employee stock option exchange program (the "Exchange Program") whereby eligible employees were given an opportunity to exchange some or all of their outstanding options for a predetermined number of new stock options. Under the Exchange Program, participating eligible employees would receive one new stock option for each exchanged option with an exercise price less than \$12.00 per share. For exchanged options with an exercise price equal to or greater than \$12.00 per share, participants would receive between 0.2 and 0.67 new options for each option exchanged, depending on the exercise price of the exchanged option. The Company's Chief Executive Officer, President and Chief Operating Officer, and Executive Vice President and Chief Financial Officer, along with members of the board of directors, were not eligible to participate in the Exchange Program.

On October 21, 2004, in accordance with the Exchange Program, the Company accepted and cancelled options to purchase 3,816,812 shares of its common stock. On April 22, 2005, which was the first business day that was six months and one day after cancellation of the exchanged options, the Company granted new stock options totaling 2,148,725 shares. With the exception of new options granted to participating executive officers, the new options were granted at an exercise price of \$6.11, the closing price of the Company's stock on April 22, 2005. In accordance with the terms of the Exchange Program, the exercise price for new options granted to participating executive officers was \$8.52, which was the greater of the fair market value of the Company's stock on the date of grant, or 115% of the closing price of the Company's stock on the date the exchanged options were cancelled. For certain foreign employees, local laws restricted the Company from issuing the new options on April 22, 2005. For those employees, 7,268 new options were issued on May 25, 2005 at an exercise price of \$6.35, the closing price of the Company's stock on that date.

New options granted under the Exchange Program have a term equal to the greater of the remaining term of the exchanged options or 2 years from the new option grant date. New options are subject to a one-year cliff-vesting schedule, at which time the new option will be vested to the same percentage as the exchanged option would have been on that date. After one year from the date of grant, the new options will continue to vest and become exercisable as to 1/48th of the shares subject to the new option on each monthly anniversary of the new option grant date. All vesting of the new options is subject to the participating employee's continued employment with the Company on each relevant vesting date.

The Exchange Program had no impact on the Company's financial position, results of operations, or cash flows during 2005 or 2004.

#### *Option Vesting Acceleration*

On September 17, 2004, the Company's board of directors approved the acceleration of vesting for 668,340 outstanding options previously issued to the Company's Chief Executive Officer, President and Chief Operating Officer, and Executive Vice President and Chief Financial Officer. The accelerated options had exercise prices ranging from \$10.89 to \$16.69. The fair market value of the Company's stock on September 17, 2004 was \$8.27. The acceleration of the vesting of these options did not result in a compensation 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 \$3.2 million, all of which was recognized in 2004. The Company's board of directors approved the vesting acceleration for the three executive officers, as they were not eligible to participate in the previously discussed Exchange Program, and because doing so reduced the future stock compensation expense required to be included in the Company's results from operations under SFAS 123R.

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 compensation expense required to be reflected in the Company's statement of operations under SFAS 123R.

#### *Stock Option Program Description*

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 and in the

Company's Annual Report on Form 10-K.

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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*

The 1997 Stock Plan (the "1997 Plan") is a stockholder approved plan that provides for broad-based grants to employees, including executive officers. Based on the terms of individual option grants, options granted under the 1997 Plan generally expire five years after the date of grant, although options granted from June 15, 2000 through May 5, 2003, generally have a term of ten years. Options granted under the 1997 Plan generally vest at a rate of 25% per year over four years. In addition to incentive and nonstatutory stock options, the 1997 Plan also permits the granting of stock purchase rights, stock appreciation rights, performance units, and performance shares. To date, other than stock options, the Company has only granted performance shares under the 1997 Plan. Certain of these performance shares vest 100% on the two-year anniversary of the grant date, while the remaining performance shares vest 25% per year over four years.

#### *1998 Directors Option Plan*

Non-employee directors are entitled to participate in the stockholder approved 1998 Director Option Plan (the "Director Plan"). The Director Plan 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 have a term of five years and vest immediately upon grant.

#### *Stock Award Activity*

The following table summarizes stock award activity, including stock options and performance shares, and related information for the three and six month periods ended June 30, 2006 and 2005:

|                              | Shares<br>Available<br>for Grant | Options Outstanding   |   |
|------------------------------|----------------------------------|-----------------------|---|
|                              |                                  | Number<br>Outstanding | Weighted-Average<br>Exercise Price Per<br>Share |
| BALANCE AT MARCH 31, 2005    | 9,854,071                        | 5,488,435             | \$ 14.82  |
| Options granted              | (2,443,084)                      | 2,443,084             | 6.14  |
| Performance shares granted   | ---                              | ---                   | ---   |
| Options exercised            | ---                              | ---                   | ---   |
| Options forfeited or expired | 584,717                          | (584,717)             | 19.66   |
| BALANCE AT JUNE 30, 2005     | 7,995,704                        | 7,346,802             | \$ 11.66  |

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|   | Shares<br>Available<br>for Grant | Number<br>Outstanding | Options Outstanding |   |
|---|----------------------------------|-----------------------|---------------------|---|
|   |                                  |                       |                     | Weighted-Average<br>Exercise Price Per<br>Share |
| BALANCE AT MARCH 31, 2006               | 8,624,519                        | 8,005,244             | \$                  | 11.28   |
| Options granted                         | (60,950)                         | 60,950                |                     | 8.16  |
| Performance shares granted              | (3,650)                          | ---                   |                     | ---   |
| Options exercised                       | ---                              | (104,250)             |                     | 8.25  |
| Options forfeited or expired            | 353,146                          | (353,146)             |                     | 13.30   |
| Performance shares forfeited or expired | 17,721                           | ---                   |                     | ---   |
| BALANCE AT JUNE 30, 2006                | 8,930,786                        | 7,608,798             | \$                  | 11.23   |

|                              | Shares<br>Available<br>for Grant | Number<br>Outstanding | Options Outstanding |   |
|------------------------------|----------------------------------|-----------------------|---------------------|---|
|                              |                                  |                       |                     | Weighted-Average<br>Exercise Price Per<br>Share |
| BALANCE AT DECEMBER 31, 2004 | 8,109,556                        | 5,594,842             | \$                  | 14.91   |
| Options granted              | (2,493,084)                      | 2,493,084             |                     | 6.16  |
| Performance shares granted   | (109,355)                        | ---                   |                     | ---   |
| Options exercised            | ---                              | ---                   |                     | ---   |
| Options forfeited or expired | 741,124                          | (741,124)             |                     | 18.80   |
| Additional shares reserved   | 1,747,463                        | ---                   |                     | ---   |
| BALANCE AT JUNE 30, 2005     | 7,995,704                        | 7,346,802             | \$                  | 11.66   |

|   |           |           |    |       |
|---|-----------|-----------|----|-------|
| BALANCE AT DECEMBER 31, 2005            | 6,949,420 | 8,089,473 | \$ | 11.24 |
| Options granted                         | (69,025)  | 69,025    |    | 8.16  |
| Performance shares granted              | (109,667) | ---       |    | ---   |
| Options exercised                       | ---       | (104,250) |    | 8.25  |
| Options forfeited or expired            | 445,450   | (445,450) |    | 12.10 |
| Performance shares forfeited or expired | 22,588    | ---       |    | ---   |
| Additional shares reserved              | 1,692,020 | ---       |    | ---   |
| BALANCE AT JUNE 30, 2006                | 8,930,786 | 7,608,798 | \$ | 11.23 |

The following table provides additional information for significant ranges of outstanding and exercisable stock options as of June 30, 2006:

| Exercise Price Range               | Number Outstanding | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price per Share | Aggregate Intrinsic Value |
|------------------------------------|--------------------|--|---|---------------------------|
| \$6.11                             | 1,545,385          | 3.52   | \$ 6.11                                   | \$ 2,132,631              |
| 6.26-8.17                          | 272,193            | 2.63   | 7.20                                      | 128,567                   |
| 8.19                               | 955,580            | 4.13   | 8.19                                      | --                        |
| 8.24-10.65                         | 628,940            | 3.89   | 9.23                                      | --                        |
| 10.89                              | 849,420            | 2.71   | 10.89                                     | --                        |
| 11.14-12.88                        | 586,132            | 4.95   | 11.67                                     | --                        |
| 12.91                              | 798,670            | 1.89   | 12.91                                     | --                        |
| 13.00-16.06                        | 305,200            | 4.47   | 14.12                                     | --                        |
| 16.35                              | 834,812            | 4.45   | 16.35                                     | --                        |
| \$16.36-\$38.81                    | 832,466            | 4.57   | 19.26                                     | --                        |
| <b>Outstanding</b>                 | <b>7,608,798</b>   | <b>3.70</b>  | <b>\$ 11.23</b>                           | <b>\$ 2,261,198</b>       |
| <b>Vested and expected to vest</b> | <b>7,527,309</b>   | <b>3.70</b>  | <b>\$ 11.26</b>                           | <b>\$ 2,242,208</b>       |
| <b>Exercisable</b>                 | <b>6,281,493</b>   | <b>3.67</b>  | <b>\$ 11.98</b>                           | <b>\$ 1,797,672</b>       |

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of \$7.49 as of June 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date.

The following table provides additional information regarding performance share activity for the three and six month periods ended March 31, 2006 and 2005:

|                              | Number Nonvested and Outstanding | Weighted-Average Grant Date Fair-Value |
|------------------------------|----------------------------------|--|
| BALANCE AT MARCH 31, 2005    | 109,355                          | \$ 6.77                                |
| Performance shares granted   | ---                              | ---                                    |
| BALANCE AT JUNE 30, 2005     | 109,355                          | \$ 6.77                                |
| BALANCE AT MARCH 31, 2006    | 514,118                          | \$ 8.06                                |
| Performance shares granted   | 3,650                            | 8.94                                   |
| Performance shares forfeited | (17,721)                         | 7.98                                   |
| BALANCE AT JUNE 30, 2006     | 500,047                          | \$ 8.07                                |

|                              | Number<br>Nonvested<br>and<br>Outstanding | Weighted-Average<br>Grant Date<br>Fair-Value |
|------------------------------|---|--|
| BALANCE AT DECEMBER 31, 2004 | ---                                       | \$ ---                                       |
| Performance shares granted   | 109,355                                   | 6.77   |
| BALANCE AT JUNE 30, 2005     | 109,355                                   | \$ 6.77                                      |
| BALANCE AT DECEMBER 31, 2005 | 412,968                                   | \$ 7.82                                      |
| Performance shares granted   | 109,667                                   | 9.00   |
| Performance shares forfeited | (22,588)                                  | 8.02   |
| BALANCE AT JUNE 30, 2006     | 500,047                                   | \$ 8.07                                      |

No performance shares vested during the three or six-month periods ended June 30, 2006 and 2005.

#### 4. Stock-Based Compensation:

##### *Impact of Adopting SFAS 123R*

The Company adopted SFAS 123R on January 1, 2006, using the modified prospective method. The impact of adopting SFAS 123R on the Company's loss from continuing operations, pre-tax loss, net loss, basic and diluted net loss per share, cash flows from operations, and cash flows from financing activities for the three and six months ended June 30, 2006 is summarized in the following tables (in thousands, except per share amounts):

|   | Intrinsic Value<br>Method (A) | Fair Value<br>Method<br>(B) | Impact of<br>Adoption<br>(A) - (B) |
|---|-------------------------------|-----------------------------|------------------------------------|
| <b>Three months ended June 30, 2006</b> |                               |                             |                                    |
| Loss from continuing operations         | \$ (3,459)                    | \$ (4,431)                  | \$ (972)                           |
| Loss before provision for income taxes  | \$ (2,055)                    | \$ (3,027)                  | \$ (972)                           |
| Net loss                                | \$ (2,135)                    | \$ (3,107)                  | \$ (972)                           |
| Net loss per share - basic              | \$ (0.05)                     | \$ (0.08)                   | \$ (0.03)                          |
| Net loss per share - diluted            | \$ (0.05)                     | \$ (0.08)                   | \$ (0.03)                          |
| Cash flows from operations              | \$ (7,183)                    | \$ (7,183)                  | \$ --                              |
| Cash flows from financing activities    | \$ (1,377)                    | \$ (1,377)                  | \$ --                              |

|  | Intrinsic Value<br>Method (A) | Fair Value<br>Method<br>(B) | Impact of<br>Adoption<br>(A) - (B) |
|--|-------------------------------|-----------------------------|------------------------------------|
| <b>Six months ended June 30, 2006</b>  |                               |                             |                                    |
| Loss from continuing operations        | \$ (12,113)                   | \$ (14,234)                 | \$ (2,121)                         |
| Loss before provision for income taxes | \$ (9,315)                    | \$ (11,436)                 | \$ (2,121)                         |
| Net loss                               | \$ (9,475)                    | \$ (11,596)                 | \$ (2,121)                         |
| Net loss per share - basic             | \$ (0.24)                     | \$ (0.29)                   | \$ (0.05)                          |
| Net loss per share - diluted           | \$ (0.24)                     | \$ (0.29)                   | \$ (0.05)                          |
| Cash flows from operations             | \$ (8,269)                    | \$ (8,269)                  | \$ --                              |
| Cash flows from financing activities   | \$ (2,354)                    | \$ (2,354)                  | \$ --                              |



*Valuation of Options Granted*

SFAS 123R requires the use of a valuation model to calculate the fair-value of stock-based awards. The Company has elected to use the BSM option-pricing model, 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 BSM option-pricing model was developed for use in estimating the fair-value of traded options having no vesting or hedging restrictions and that are fully transferable. As the Company's employee stock options have certain characteristics that differ significantly from traded options, and because changes in the subjective assumptions used in the BSM option-pricing model can materially affect the estimated fair-value, in management's opinion, the Company's estimate of fair-value for its options based on the BSM option-pricing model may not provide an accurate measure of the fair-value an independent third-party would assign in an arms-length transaction.

The weighted average calculated fair value of options granted during the three and six months ended June 30, 2006, was \$2.23 and \$2.39, respectively, and was determined using the following weighted average assumptions:

|                          | <b>Three<br/>Months<br/>Ended<br/>June 30,<br/>2006</b> | <b>Six<br/>Months<br/>Ended<br/>June 30,<br/>2006</b> |
|--------------------------|---|---|
| Expected dividend yield  | 0.0%  | 0.0%  |
| Risk-free interest rate  | 4.9%  | 4.8%  |
| Expected volatility      | 46.8%   | 47.6%   |
| Expected life (in years) | 1.8   | 2.0   |

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 life of the option. The expected volatility is 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 does not include any implied volatility as there currently are no market traded options on the Company's stock that meet the criteria required for reliance on implied volatility in accordance with SAB 107. 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.

*Expense Allocation*

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 three and six months ended June 30, 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. As of June 30, 2006, total compensation cost related to non-vested stock options and other equity based awards not yet recognized was \$6.2 million, which is expected to be recognized over the next 16 months on a weighted-average basis.

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The following table summarizes the stock-based compensation expense related to employee stock options and performance shares under SFAS 123R for the three and six months ended June 30, 2006 and 2005, which was allocated as follows (in thousands):

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|  | <b>Three Months Ended June<br/>30,</b> |             |
|--|--|-------------|
|  | <b>2006</b>                            | <b>2005</b> |
| Cost of sales - product  | \$ 103                                 | \$ 9        |
| Cost of sales - service  | 12                                     | --          |
| Stock-based compensation expense included in cost of sales                                   | 115                                    | 9           |
| Product development  | 484                                    | 12          |
| Sales and marketing  | 302                                    | 12          |
| General and administrative   | 408                                    | 60          |
| Stock-based compensation expense included in operating expenses                              | 1,194                                  | 84          |
| Total stock-based compensation expense related to stock options and performance shares       | 1,309                                  | 93          |
| Tax benefit  | --                                     | --          |
| Stock-based compensation expense related to stock options and performance shares, net of tax | \$ 1,309                               | \$ 93       |

|  | <b>Six Months Ended June 30,</b> |             |
|--|----------------------------------|-------------|
|  | <b>2006</b>                      | <b>2005</b> |
| Cost of sales - product  | \$ 215                           | \$ 18       |
| Cost of sales - service  | 26                               | --          |
| Stock-based compensation expense included in cost of sales                                   | 241                              | 18          |
| Product development  | 1,098                            | 24          |
| Sales and marketing  | 662                              | 24          |
| General and administrative   | 714                              | 120         |
| Stock-based compensation expense included in operating expenses                              | 2,474                            | 168         |
| Total stock-based compensation expense related to stock options and performance shares       | 2,715                            | 186         |
| Tax benefit  | --                               | --          |
| Stock-based compensation expense related to stock options and performance shares, net of tax | \$ 2,715                         | \$ 186      |

Of the \$1.3 million of compensation expense recorded for the quarter ended June 30, 2006, approximately \$211,000 related to equity compensation awards granted during 2006, while the remaining \$1.1 million related to equity compensation awards granted on or before December 31, 2005. Of the \$2.7 million of compensation expense recorded for the six month period ended June 30, 2006, approximately \$284,000 related to equity compensation awards granted during 2006, while the remaining \$2.4 million related to equity compensation awards granted on or before December 31, 2005. Compensation expense of \$93,000 and \$186,000 for the three and six months ended June 30, 2005, respectively, related solely to performance 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.

During the three and six month periods ended June 30, 2006 and 2005, no stock-based compensation expense was capitalized as part of the cost of an asset.



*Comparative Results*

The following table reflects net loss and diluted net loss per share for the three and six months ended June 30, 2006 compared with the pro forma information for the three and six months ended June 30, 2005 (in thousands, except per share amounts):

|  | <b>Three Months Ended June 30,</b> |             |
|--|------------------------------------|-------------|
|  | <b>2006</b>                        | <b>2005</b> |
| Net loss - as reported for the prior period (1)  | N/A                                | \$ (4,604)  |
| Stock-based compensation expense related to employee stock options and performance share awards (2)    | \$ 1,309                           | \$ 2,349    |
| Tax benefit  | --                                 | --          |
| Stock-based compensation expense related to stock options and performance share awards, net of tax (3) | \$ 1,309                           | \$ 2,349    |
| Net loss, including the effect of stock-based compensation expense (4)                                 | \$ (3,107)                         | \$ (6,953)  |
| Diluted net loss per share - as reported for the prior period (1)                                      | N/A                                | \$ (0.11)   |
| Diluted net loss per share, including the effect of stock-based compensation expense (4)               | \$ (0.08)                          | \$ (0.17)   |

|  | <b>Six Months Ended June 30,</b> |             |
|--|----------------------------------|-------------|
|  | <b>2006</b>                      | <b>2005</b> |
| Net loss - as reported for the prior period (1)  | N/A                              | \$ (6,866)  |
| Stock-based compensation expense related to employee stock options and performance share awards (2)    | \$ 2,715                         | \$ 4,757    |
| Tax benefit  | --                               | --          |
| Stock-based compensation expense related to stock options and performance share awards, net of tax (3) | \$ 2,715                         | \$ 4,757    |
| Net loss, including the effect of stock-based compensation expense (4)                                 | \$ (11,596)                      | \$ (11,623) |
| Diluted net loss per share - as reported for the prior period (1)                                      | N/A                              | \$ (0.17)   |
| Diluted net loss per share, including the effect of stock-based compensation expense (3)               | \$ (0.29)                        | \$ (0.29)   |

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(1) Net loss and net loss per share prior to January 1, 2006 did not include stock-based compensation expense for employee stock options under SFAS 123 because the Company did not adopt the recognition provisions of SFAS 123. Net loss and net loss per share prior to January 1, 2006 did include stock-based compensation expense for performance share awards.

(2) Stock-based compensation expense related to employee stock options and performance share awards for the three and six months ended June 30, 2005 are net of amounts already reflected in the net loss for the respective periods.

(3) Stock-based compensation expense prior to January 1, 2006 is calculated based on the pro forma application of SFAS 123.

(4) Net loss and net loss per share prior to January 1, 2006 represents pro forma information based on SFAS 123.

## 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. For the last several years, the Company has had two customers that represent a majority of the Company's revenues: Enel S.p.A. ("Enel"), an Italian utility company (including Enel's third party meter manufacturers), and EBV Elektronik GmbH ("EBV"), the Company's primary distributor of its LonWorks® Infrastructure products in Europe. For the three and six months ended June 30, 2006 and 2005, the percentage of the Company's revenues attributable to sales made to these two customers were as follows:

|       | <b>Three Months Ended June 30,</b> |             | <b>Six Months Ended June 30,</b> |             |
|-------|------------------------------------|-------------|----------------------------------|-------------|
|       | <b>2006</b>                        | <b>2005</b> | <b>2006</b>                      | <b>2005</b> |
| Enel  | 35.4%                              | 33.0%       | 23.4%                            | 41.3%       |
| EBV   | 22.0%                              | 21.9%       | 22.3%                            | 19.6%       |
| Total | 57.4%                              | 54.9%       | 45.7%                            | 60.9%       |

The Company's contract with Enel expired in June 2005, and shipments under that contract were completed in 2005. The Company currently expects to supply Enel and its third party meter manufacturers with spare parts for Enel's Contatore Elettronico system during 2006. The Company's contract with EBV, which has been in effect since 1997 and to date has been renewed annually thereafter, expires in December 2006.

## 6. Commitments and Contingencies

### *Lease Commitments*

The Company leases its facilities under operating leases that expire on various dates through 2013. 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 \$1.5 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 line of credit at the bank that issued the LOC. At the end of the current ten-year lease term, the Company has the right, pursuant to the lease agreement, to extend the lease for two sequential five-year terms.

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. At the end of the current ten-year lease term, the Company has the right, pursuant to the lease agreement, to extend the lease for two sequential five-year terms.

In addition to its corporate headquarters facility, the Company also leases facilities for its sales, marketing, distribution and product development personnel located elsewhere within the United States and in nine foreign countries throughout Europe and Asia. These operating leases are of shorter duration, generally one to three years, and in some instances are cancelable with advance notice.

#### *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 U.S. 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 our consolidated statements of income, was approximately \$102,000 during the quarter ended June 30, 2006, and \$116,000 for the same period in 2005. Royalty expense was approximately \$211,000 for the six months ended June 30, 2006, and \$247,000 for the same period in 2005.

The Company will continue to be obligated for royalty payments in the future. The Company is currently unable to estimate the cumulative 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.

#### *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 or related to the officer's or director's tenure with the Company. 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 could 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.

#### *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 is reflected in accrued liabilities. As of June 30, 2006, all amounts due Enel under the arbitration ruling have been paid. 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 June 30, 2006, 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.

## 7. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and manufacturing overhead. Inventories consist of the following (in thousands):

|                     | <b>June 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|---------------------|--------------------------|------------------------------|
| Purchased materials | \$ 936                   | \$ 1,064                     |
| Work-in-process     | 3                        | 61                           |
| Finished goods      | 3,521                    | 2,115                        |
|                     | \$ 4,460                 | \$ 3,240                     |

## 8. Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

|                                   | <b>June 30,<br/>2006</b> | <b>December 31,<br/>2005</b> |
|-----------------------------------|--------------------------|------------------------------|
| Accrued payroll and related costs | \$ 3,004                 | \$ 2,630                     |
| Accrued taxes                     | 1,243                    | 1,128                        |
| Other accrued liabilities         | 723                      | 3,715                        |
|                                   | \$ 4,970                 | \$ 7,473                     |

## 9. Segment Disclosure

In 1998, the Company adopted SFAS No. 131, or SFAS 131, *Disclosures about Segments of an Enterprise and Related Information*. 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.

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The Company operates its business as one reportable segment: the design, manufacture and sale of products for the control network industry, and markets its products primarily to the building automation, industrial automation, transportation, and utility/home automation markets. The Company's products are marketed under the LonWorks® brand name, which provides the infrastructure and support required to implement and deploy open, interoperable, control network solutions. All of the Company's products either incorporate or operate with the Neuron® Chip and/or the LonWorks protocol. The Company also provides services to customers that consist of technical support and training courses covering its LonWorks network technology and products. The Company offers about 90 products and services that together constitute the LonWorks system. In general, any given customer purchases a subset of such products and services that are appropriate for that customer's application.

The Company manages its business primarily on a geographic basis. The Company's geographic areas are comprised of three main regions: the Americas; Europe, Middle East and Africa ("EMEA"); and Asia Pacific/ Japan ("APJ"). Each geographic area provides products and services as further described in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations. The Company evaluates the performance of its geographic areas based on profit or loss from operations. Profit or loss for each geographic area includes sales and marketing expenses and other charges directly attributable to the area and excludes certain expenses that are managed outside the geographic area. Costs excluded from area profit or loss primarily consist of unallocated corporate expenses, which are comprised of product development costs, corporate marketing costs and other general and administrative expenses, each of which are separately managed. 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 June 30, 2006, and December 31, 2005, long-lived assets of about \$22.7 million and \$22.0 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements. Assets and the related depreciation and amortization are not reported by geography because that information is not reviewed by the Executive Staff when making decisions about resource allocation to the geographic areas based on their performance.

In North America, the Company sells its products 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, whose efforts are supplemented by local distributors. Revenues are attributed to geographic areas based on the country where the products are shipped. Summary information by geography for the three and six months ended June 30, 2006 and 2005 is as follows (in thousands):

|                                | <b>Three Months Ended June 30,</b> |             | <b>Six Months Ended June 30,</b> |             |
|--------------------------------|------------------------------------|-------------|----------------------------------|-------------|
|                                | <b>2006</b>                        | <b>2005</b> | <b>2006</b>                      | <b>2005</b> |
| Revenues from customers:       |                                    |             |                                  |             |
| Americas                       | \$ 4,695                           | \$ 4,134    | \$ 9,495                         | \$ 8,080    |
| EMEA                           | 13,595                             | 11,185      | 17,579                           | 27,476      |
| APJ                            | 1,084                              | 2,161       | 3,045                            | 3,607       |
| Total                          | \$ 19,374                          | \$ 17,480   | \$ 30,119                        | \$ 39,163   |
| Gross profit:                  |                                    |             |                                  |             |
| Americas                       | \$ 3,092                           | \$ 2,494    | \$ 5,741                         | \$ 4,966    |
| EMEA                           | 7,771                              | 5,758       | 9,955                            | 14,899      |
| APJ                            | 756                                | 1,315       | 1,660                            | 2,172       |
| Total                          | \$ 11,619                          | \$ 9,567    | \$ 17,356                        | \$ 22,037   |
| Income (loss) from operations: |                                    |             |                                  |             |
| Americas                       | \$ 1,908                           | \$ 1,359    | \$ 3,308                         | \$ 2,691    |
| EMEA                           | 6,359                              | 4,274       | 7,087                            | 11,887      |
| APJ                            | (266)                              | 27          | (489)                            | (123)       |
| Unallocated                    | (12,432)                           | (11,445)    | (24,140)                         | (23,463)    |

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|       |    |         |    |         |    |          |    |         |
|-------|----|---------|----|---------|----|----------|----|---------|
| Total | \$ | (4,431) | \$ | (5,785) | \$ | (14,234) | \$ | (9,008) |
|-------|----|---------|----|---------|----|----------|----|---------|

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Products sold to Enel and its designated manufacturers accounted for approximately \$6.9 million, or 35.4% of total revenues for the quarter ended June 30, 2006, and \$5.8 million, or 33.0% for the same period in 2005; and \$7.1 million, or 23.4% of total revenues for six months ended June 30, 2006, and \$16.2 million, or 41.3% for the same period in 2005. For the quarter ended June 30, 2006, 100.0% of the revenues under the Enel program were derived from products shipped to customers in EMEA. For the six months ended June 30, 2006, 97.2% of the revenues derived from products shipped under the Enel program were from customers in EMEA and the remaining 2.8% from customers in APJ.

EBV, the primary independent distributor of the Company's LonWorks infrastructure products in Europe, accounted for 22.0% of total revenues for the quarter ended June 30, 2006 and 21.9% for the same period in 2005; and 22.3% of total revenues for the six months ended June 30, 2006 and 19.6% for the same period in 2005.

## **10. Income Taxes**

The provision for income taxes for the three months and six months ended June 30, 2006 and 2005 includes a provision for Federal, state, and foreign taxes based on the annual estimated effective tax rate applied to the Company and its subsidiaries for the year. The difference between the statutory rate and the Company's effective tax rate is primarily due to the impact of foreign taxes.

## **11. Related Party**

During the quarter and six months ended June 30, 2006, and the years ended December 31, 2005, 2004, and 2003, 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. At the same time, the Company 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. For the quarter and six months ended June 30, 2006, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$6.9 million and \$7.1 million, respectively. For the quarter and six months ended June 30, 2005, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$5.8 million and \$16.2 million, respectively. As of June 30, 2006 and June 30, 2005, \$6.8 million and \$6.2 million, respectively, of the Company's total accounts receivable balance related to amounts owed by Enel and its designated 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. An arbitration award was issued on September 29, 2005. For additional information regarding the arbitration, please refer to the "Legal Actions" section of Note 6, Commitments and Contingencies.

## **12. 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 recorded at the time of shipment. 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 \$319,000 as of June 30, 2006 and \$469,000 as of December 31, 2005.

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

*The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business, including but not limited to: our belief that control networks based on our products can reduce life-cycle costs, save energy, are more flexible than centralized systems and permit control systems to be comprised of products and services from a variety of vendors; our belief that the NES system brings cost savings in a wide range of a utility's functions, from metering and customer services to distribution operations and value-added services; our belief that new products and product enhancements, such as our NES offering and Panoramix platform, will make it easier for our customers to aggregate and process information from remote LonWorks networks, thereby increasing overall network management capabilities; our belief that the benefits derived from our NES system deliver a more compelling return on investment than "traditional" AMR systems; our expectation that Enel will purchase spare parts from us with a value of approximately \$7.1 million in 2006 and our belief that we will be able to find one or more replacements for the Enel project revenue reduction; our expectation that shipments of our NES products will increase significantly; our belief that, in general, as long as the current worldwide economic recovery continues to gain momentum, overall revenues from our LonWorks Infrastructure business will continue to improve during 2006 as compared to 2005; our belief that market conditions in Asia, particularly Japan, will continue to be challenging in 2006; our belief that, during 2006, our gross margin will remain relatively flat as compared to 2005 levels; our belief that, during 2006, our sales and marketing and product development expenses will increase over 2005 levels; our belief that many of our customers will continue to refrain from purchasing our customer support and training offerings during 2006 in an effort to minimize their operating expenses; our belief 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; our belief that we will incur a substantial loss in 2006; our belief that the amount of our LonWorks Infrastructure revenues earned in foreign currencies will not fluctuate significantly between 2005 and 2006; our expectation that our initial NES system roll-out to Nuon will be completed in late 2006 or early 2007 and that Nuon will then issue a public tender for an even larger deployment; and our belief that the estimates and judgments made regarding future events in connection with the preparation of our financial statements are reasonable. These statements may be identified by the use of words such as "we believe," "expect," "anticipate," "intend," "plan," and similar expressions. In addition, forward-looking statements include, but are not limited to, statements about our beliefs, estimates, or plans about our ability to maintain low manufacturing and operating costs and costs per unit, our ability to estimate revenues, pricing pressures, returns, reserves, demand for our products, selling, general, and administrative expenses, taxes, research, development, and engineering expenses, spending on property, plant, and equipment, expected sales of our products and the market for our products generally and certain customers specifically, and our beliefs regarding our liquidity needs.*

*Forward-looking statements are estimates reflecting the best judgment of our senior management, and they involve a number of risks and uncertainties that could cause actual results to differ materially from those suggested by the forward-looking statements. Our business is subject to a number of risks and uncertainties. While this discussion represents our current judgment on the future direction of our business, these risks and uncertainties could cause actual results to differ materially from any future performance suggested herein. Some of the important factors that may influence possible differences are continued competitive factors, technological developments, pricing pressures, changes in customer demand, and general economic conditions, as well as those discussed above in "Factors That May Affect Future Results of Operations." We undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of such statements. Readers should review the Risk Factors in Part II Item 1A in this report, as well as other documents filed from time to time by us with the SEC.*

**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 nine foreign countries throughout Europe and Asia. We develop, market and support a wide array of products and services based on our LONWORKS technology that enable OEMs and systems integrators to design and implement open, interoperable, distributed control networks. We offer these hardware and software products to OEMs and systems integrators in the building, industrial, transportation, utility/home, and other automation markets.

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 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 increased to approximately \$883,000 in 2005. We refer to this revenue as networked energy services, or NES, revenue. We refer to all other revenue as LONWORKS Infrastructure 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.

We have a history of losses and, although we achieved profitability in past fiscal periods, we incurred a loss for the quarter and six months ended June 30, 2006 and expect to incur substantial operating losses for the remainder of 2006. This expectation is due primarily to two factors. First, we have already experienced, and we anticipate that, during 2006, we will experience a further reduction in the amount of Enel Project revenue as compared to 2005. This expected reduction is the result of the completion of our Enel Project shipments in 2005. Enel recently asked us to provide them with spare parts for use in their system in Italy. We have agreed to this request, and completed our shipments of these spare parts during the second quarter of 2006. The second factor contributing to our expectation for losses in 2006 relates 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.

During the first and second quarters of 2006, we revised our revenue recognition methodology for sales made to the distributors of our LONWORKS Infrastructure 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 will not have an impact on cash flows from operations or require any changes to 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.

### **Critical Accounting 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. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our revenues, allowance for doubtful accounts, inventories, commitments and contingencies, income taxes, and asset impairments. 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 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.





**Sales Returns and Allowances.** We sell our products and services to OEMs, systems integrators, and our other customers directly through our sales force and indirectly through distributors located in the geographic markets that we serve. Sales to certain distributors are made under terms allowing limited rights of return. Sales to EBV, our largest distributor, accounted for 22.0% of total net revenues for the quarter ended June 30, 2006, and 21.9% for the same period in 2005, and 22.3% of total revenues for the six months ended June 30, 2006 and 19.6% for the same period in 2005. Worldwide sales to distributors, including those to EBV, accounted for approximately 25.5% of total net revenues for the quarter ended June 30, 2006, and 30.7% for the same period in 2005; and 29.2% of total net revenues for the six months ended June 30, 2006 and 26.5% for the same period in 2005.

Net revenues consist of product and service revenues reduced by estimated sales returns and allowances. Provisions for estimated sales returns and allowances are recorded at the time of sale, and are based on management's estimates of potential future product returns and allowances related to product revenues in the current period. In evaluating the adequacy of our sales returns and other allowances, management analyzes historical returns, current and historical economic trends, contractual terms, and changes in customer demand and acceptance of our products.

Other than standard warranty repair work, Enel and its designated contract meter manufacturers do not have rights to return products we ship to them. However, our agreement with Enel contains an "acceptance" provision, whereby Enel is entitled to inspect products we ship to them to ensure the products conform, in all material respects, to the product's specifications. Once the product has been inspected and approved by Enel, or if the acceptance period lapses before Enel inspects or approves the products, the goods are considered accepted. Prior to shipping our products to Enel, we perform detailed reviews and tests to ensure the products will meet Enel's acceptance criteria. We do not ship products unless they have passed these reviews and tests. As a result, we record revenue for these products upon shipment to Enel. If Enel were to subsequently properly reject any material portion of a shipment for not meeting the agreed upon specifications, we would defer the revenue on that portion of the transaction until such time as Enel and we were able to resolve the discrepancy. Such a deferral could have a material impact on the amount and timing of our Enel related revenues.

Our allowances for sales returns and other sales-related reserves were approximately \$688,000 as of June 30, 2006, and \$1.2 million as of December 31, 2005.

**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 calculated 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 determine the calculated fair value of stock options. The determination of the calculated fair value of stock-based payment awards on the date of grant using the BSM option-pricing model is affected by our stock price on the date of grant, as well as a number of highly complex and subjective variables. These variables include the expected volatility of our stock price over the expected term of the option, actual and projected employee stock option exercise behaviors, 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 on the historical volatility of our common stock over the most recent period commensurate with the expected life of the option, and does not include any implied volatility as there are currently no market traded options on our stock that meet the criteria required for reliance on implied volatility in accordance with SAB 107. 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.

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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.

If factors change and we employ different assumptions for estimated 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 and earnings per share.

The BSM option-pricing model was developed for use in estimating the calculated 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. Existing valuation models, including the BSM and lattice binomial models, may not provide reliable measures of fair values of our stock-based compensation. Consequently, there is a risk that our estimates of the calculated fair values of our stock-based compensation awards on the grant dates may be significantly different from the actual values realized, if any, upon the exercise, expiration, early termination, or forfeiture of those stock-based payments in the future. For example, our employee stock options may expire worthless or otherwise result in zero intrinsic value as compared to the calculated fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that is significantly higher than the calculated fair values originally estimated on the grant date and reported in our financial statements. There currently is no market-based mechanism or other practical application to verify the reliability and accuracy of the estimated fair values resulting from these valuation models, nor is there a means to compare and adjust the estimates to actual values.

The guidance of SFAS 123R and SAB 107 is relatively new. The application of these principles may be subject to further interpretation and refinement over time. 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 materially affect the calculated fair value estimate of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods, and assumptions.

Further information regarding stock-based compensation can be found in Note 4 of our Notes to Condensed Consolidated Financial Statements contained in this report.

**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 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 \$250,000 as of June 30, 2006, and \$300,000 as of December 31, 2005.



**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 \$319,000 as of June 30, 2006, and \$469,000 as of December 31, 2005.

**Deferred Income Taxes.** We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Based on our historical net operating losses, and the uncertainty of our future operating results, we have recorded a valuation allowance that fully reserves our deferred tax assets. If we later determine that, more likely than not, some or all of the net deferred tax assets will be realized, we would then need to reverse some or all of the previously provided valuation allowance. Our deferred tax asset valuation allowance was \$52.2 million as of December 31, 2005.

**Valuation of Goodwill and Other Intangible Assets.** We assess the impairment of goodwill and identifiable intangible assets on an annual basis and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner or use of the acquired assets or the strategy for our overall business;
- significant negative industry or economic trends; and
- significant changes in the composition of the intangible assets acquired.

When we determine that the carrying value of goodwill and other intangible assets may not be recoverable based upon the existence of one or more of the above indicators, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. Net goodwill and other intangible assets amounted to \$8.0 million as of December 31, 2005.

When we adopted SFAS 142, *Goodwill and Other Intangible Assets*, in 2002, we ceased amortizing goodwill, which had a net unamortized balance of \$1.7 million as of December 31, 2001. Since then, primarily as a result of acquisitions in 2002 and 2003, the net balance of goodwill has grown to \$8.2 million as of June 30, 2006. We review goodwill for impairment annually during the quarter ending March 31. Our review during the quarter ended March 31, 2006 indicated no impairment. If, as a result of an annual or any other impairment review that we perform in the future, we determine that there has been an impairment of our goodwill or other intangible assets, we would be

required to take an impairment charge. Such a charge could have a material adverse impact on our financial position and/or operating results.

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**RESULTS OF OPERATIONS**

The following table reflects the percentage of total revenues represented by each item in our Consolidated Statements of Operations for the three and six month ended June 30, 2006 and June 30, 2005:

|  | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |         |
|--|--------------------------------|---------|------------------------------|---------|
|  | 2006                           | 2005    | 2006                         | 2005    |
| <b>Revenues:</b>                       |                                |         |                              |         |
| Product                                | 99.1%                          | 98.8%   | 98.9%                        | 99.0%   |
| Service                                | 0.9                            | 1.2     | 1.1                          | 1.0     |
| Total revenues                         | 100.0                          | 100.0   | 100.0                        | 100.0   |
| <b>Cost of revenues:</b>               |                                |         |                              |         |
| Cost of product                        | 37.7                           | 41.8    | 39.4                         | 40.9    |
| Cost of service                        | 2.3                            | 3.4     | 3.0                          | 2.8     |
| Total cost of revenues                 | 40.0                           | 45.2    | 42.4                         | 43.7    |
| Gross profit                           | 60.0                           | 54.8    | 57.6                         | 56.3    |
| <b>Operating expenses:</b>             |                                |         |                              |         |
| Product development                    | 37.0                           | 36.4    | 47.0                         | 32.1    |
| Sales and marketing                    | 26.2                           | 30.9    | 34.0                         | 26.6    |
| General and administrative             | 19.6                           | 20.5    | 23.9                         | 20.6    |
| Total operating expenses               | 82.8                           | 87.8    | 104.9                        | 79.3    |
| Loss from operations                   | (22.8)                         | (33.0)  | (47.3)                       | (23.0)  |
| Interest and other income, net         | 7.2                            | 7.3     | 9.3                          | 6.0     |
| Loss before provision for income taxes | (15.6)                         | (25.7)  | (38.0)                       | (17.0)  |
| Income tax expense                     | 0.4                            | 0.6     | 0.5                          | 0.5     |
| Net loss                               | (16.0%)                        | (26.3%) | (38.5%)                      | (17.5%) |

**Revenues****Total Revenues**

|                               | Three Months Ended |                  | 2006 over<br>2005<br>\$ Change | 2006 over<br>2005<br>% Change |
|-------------------------------|--------------------|------------------|--------------------------------|-------------------------------|
|                               | June 30,<br>2006   | June 30,<br>2005 |                                |                               |
| <i>(Dollars in thousands)</i> |                    |                  |                                |                               |
| Total Revenues                | \$ 19,374          | \$ 17,480        | \$ 1,894                       | 10.8%                         |
|                               | Six Months Ended   |                  | 2006 over<br>2005<br>\$ Change | 2006 over<br>2005<br>% Change |
|                               | June 30,<br>2006   | June 30,<br>2005 |                                |                               |
| <i>(Dollars in thousands)</i> |                    |                  |                                |                               |
| Total Revenues                | \$ 30,119          | \$ 39,163        | \$ (9,044)                     | (23.1%)                       |

The \$1.9 million increase in total revenues for the quarter ended June 30, 2006 as compared to the same period in 2005 was primarily the result of a \$1.1 million increase in Enel Project revenues, a \$521,000 increase in LonWorks Infrastructure revenues, and a \$294,000 increase in NES revenues. The \$9.0 million decrease in total revenues for the six months ended June 30, 2006 as compared to the same period in 2005 was primarily the result of a \$9.1 million reduction in Enel Project revenues partially offset by a \$107,000 increase in NES revenues.

*LonWorks Infrastructure revenues*

| <i>(Dollars in thousands)</i>    | Three Months Ended |                  | 2006 over<br>2005<br>\$ Change | 2006 over<br>2005<br>% Change |
|----------------------------------|--------------------|------------------|--------------------------------|-------------------------------|
|                                  | June 30,<br>2006   | June 30,<br>2005 |                                |                               |
| LonWorks Infrastructure Revenues | \$ 12,201          | \$ 11,680        | \$ 521                         | 4.5%                          |

  

| <i>(Dollars in thousands)</i>    | Six Months Ended |                  | 2006 over<br>2005<br>\$ Change | 2006 over 2005<br>% Change |
|----------------------------------|------------------|------------------|--------------------------------|----------------------------|
|                                  | June 30,<br>2006 | June 30,<br>2005 |                                |                            |
| LonWorks Infrastructure Revenues | \$ 22,581        | \$ 22,589        | \$ (8)                         | 0.0%                       |

Our LonWorks Infrastructure revenues are primarily comprised of sales of our hardware and software products, and to a lesser extent, revenues we generate from our customer support and training offerings. The \$521,000 increase in LonWorks Infrastructure revenues for the quarter ended June 30, 2006 as compared to the same period in 2005 was primarily attributable to an overall \$1.5 million increase in LonWorks Infrastructure revenues in all the geographic markets that we serve, partially offset by the one-time \$1.0 million impact of a revision we made to our revenue recognition methodology during the second quarter of 2006 for sales made to our distributor partners in Asia. We believe the overall \$1.5 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.

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 impact of the revenue recognition methodology revision during the second quarter was a one-time reduction in revenue of approximately \$1.0 million. To a much lesser extent, the unfavorable impact of exchange rates on sales made in foreign currencies, principally the Japanese Yen, resulted in a \$44,000 decrease between the two quarters.

The \$8,000 decrease in LonWorks Infrastructure revenue for the six months ended June 30, 2006 as compared to the same period in 2005 was primarily the result of the previously discussed revisions that were made to our revenue recognition methodology for sales made to EBV and our distributor partners in Asia. In total, these revisions resulted in a one-time decrease in our LonWorks Infrastructure revenues during the first six months of 2006 of approximately \$3.9 million. Also contributing to the year-over-year decrease was the unfavorable impact of exchange rates on sales made in foreign currencies, which resulted in a \$99,000 decrease between the two periods. Offsetting these reductions were increases in LonWorks Infrastructure revenues in all the geographic markets that we serve. As was the case for the quarter-over-quarter increase, we believe these increases are due, at least in part, to our customer's utilization of our products in new applications, as well as generally more favorable worldwide economic conditions.



Although we experienced a very slight decrease in our LonWorks Infrastructure revenues for the six months ended June 30, 2006 as compared to the same period in 2005, as long as current worldwide economic conditions do not deteriorate, we believe that full year 2006 revenues from our LonWorks Infrastructure business will improve from the \$46.6 million recorded in 2005. This expected improvement, however, will be subject to further fluctuations in the exchange rates between the U.S. dollar and the Japanese Yen. If the U.S. dollar were to strengthen against the Japanese Yen, our revenues would decrease. Conversely, if the U.S. dollar were to weaken against the Japanese Yen, our revenues would increase. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in Japanese Yen (or other foreign currencies) and the magnitude of the exchange rate fluctuation from year to year. Through the first six months of 2006, the portion of our LonWorks Infrastructure revenues conducted in currencies other than the U.S. dollar, principally the Japanese Yen, was about 6.3% as compared to 7.5% for the same period in 2005. We do not currently expect that, during the remainder of 2006, the amount of our LonWorks Infrastructure revenues conducted in these or other foreign currencies will fluctuate significantly from that experienced in 2005. 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 LonWorks Infrastructure 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*

| <i>(Dollars in thousands)</i> | Three Months Ended |                  | 2006 over         | 2006 over        |
|-------------------------------|--------------------|------------------|-------------------|------------------|
|                               | June 30,<br>2006   | June 30,<br>2005 | 2005<br>\$ Change | 2005<br>% Change |
| Enel Project Revenues         | \$ 6,850           | \$ 5,771         | \$ 1,079          | 18.7%            |
|                               | Six Months Ended   |                  | 2006 over         | 2006 over        |
| <i>(Dollars in thousands)</i> | June 30,<br>2006   | June 30,<br>2005 | 2005<br>\$ Change | 2005<br>% Change |
| Enel Project Revenues         | \$ 7,050           | \$ 16,193        | \$ (9,143)        | (56.5%)          |

The \$1.1 million increase in Enel Project revenues for the quarter ended June 30, 2006, as compared to the same period in 2005, was primarily attributable to an increase in the number of data concentrators sold during the period, partially offset by a reduction in the number of electricity metering components (also referred to as metering kit products) sold. Additionally, a slight increase in the average selling price of the data concentrators also contributed to the \$1.1 million increase. The \$9.1 million decrease in Enel Project revenues for the six months ended June 30, 2006, as compared to the same period in 2005, was primarily attributable to the completion of our sales of components and products for the deployment phase of Enel's Contatore Elettronico project during 2005. 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 recognized during the first six months of 2006 represents our shipments against this request.

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

Given our historical dependence on one customer, we continue to seek opportunities to expand our customer base. In 2002, we formed a sales and marketing organization that has since been tasked with identifying other customers for our NES system products. However, we can give no assurance that our efforts in the networked energy services area will be successful.

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*NES revenues*

|                               |    | Three Months Ended |          | 2006 over | 2006 over |
|-------------------------------|----|--------------------|----------|-----------|-----------|
|                               |    | June 30,           | June 30, | 2005      | 2005      |
| <i>(Dollars in thousands)</i> |    | 2006               | 2005     | \$ Change | % Change  |
| NES revenues                  | \$ | 323                | \$ 29    | \$ 294    | 1,013.8%  |
|                               |    | Six Months Ended   |          | 2006 over | 2006 over |
|                               |    | June 30,           | June 30, | 2005      | 2005      |
| <i>(Dollars in thousands)</i> |    | 2006               | 2005     | \$ Change | % Change  |
| NES revenues                  | \$ | 488                | \$ 381   | \$ 107    | 28.1%     |

For both the three and six-month periods ended June 30, 2006 and 2005, NES revenues have primarily related to the completion of system trials and, to a lesser extent, shipment of NES products.

During 2006, shipments of our NES products will increase significantly over 2005 levels, due primarily to the fact that in late 2005 and so far during 2006, we and our NES value-added reseller, or VAR, partners have won a number of utility tenders for intelligent metering systems in Sweden, the Netherlands, and Australia, and have also entered into a variety trials of our NES system in other countries. Our ability to recognize revenue on shipments made in conjunction with these projects, as well as shipments for other NES projects that we may win in the future, will depend on several factors, including, but not limited to, modification of the existing shipment schedules included in the contracts that have been awarded to us thus far, and certain contractual provisions, such as customer acceptance. In addition, the complex revenue recognition rules relating to products such our NES system could 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. 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 many 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. In the event of a contract award, we may hedge this additional 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.

*EBV revenues*

|                               |    | Three Months Ended |          | 2006 over | 2006 over |
|-------------------------------|----|--------------------|----------|-----------|-----------|
|                               |    | June 30,           | June 30, | 2005      | 2005      |
| <i>(Dollars in thousands)</i> |    | 2006               | 2005     | \$ Change | % Change  |
| EBV Revenues                  | \$ | 4,266              | \$ 3,836 | \$ 430    | 11.2%     |
|                               |    | Six Months Ended   |          | 2006 over | 2006 over |
|                               |    | June 30,           | June 30, | 2005      | 2005      |
| <i>(Dollars in thousands)</i> |    | 2006               | 2005     | \$ Change | % Change  |

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|              |    |       |    |       |    |       |         |
|--------------|----|-------|----|-------|----|-------|---------|
| EBV Revenues | \$ | 6,710 | \$ | 7,689 | \$ | (979) | (12.7%) |
|--------------|----|-------|----|-------|----|-------|---------|

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Sales to EBV, our largest distributor and the sole independent distributor of our products in Europe, accounted for 22.0% of our total revenues for the quarter ended June 30, 2006 and 21.9% of our total revenues for the same period in 2005; and 22.3% of our total revenues for the six months ended June 30, 2006 and 19.6% for the same period in 2005. We believe the \$430,000 increase between the two quarterly periods was due to an increase in demand for our products by EBV's customers, as well as changes in EBV's purchasing activity resulting from the new Restriction of Hazardous Substances, or RoHS, regulations. Under these new rules, which become effective in the European Union (and elsewhere) in mid-2006, manufacturers such as Echelon are required to eliminate certain hazardous substances (e.g., lead, cadmium, mercury, etc.) from the products they sell into the region. We believe that, in an effort to minimize any excess inventories of non-RoHS compliant products, EBV and EBV's customers have been tightly managing their inventory balances, which, in late 2005, resulted in reduced shipments to EBV until the RoHS compliant products became available. We began shipping the RoHS compliant versions of some of our products in volume quantities in late 2005, and expect to complete the transition for our remaining products during 2006.

The primary factor contributing to the \$979,000 decrease between the six-month periods 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, we now defer revenue, as well as cost of goods sold, 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. Partially offsetting the impact of the revenue recognition methodology revision was an increase in EBV's shipments to end-use customers for the reasons noted above.

Prior to 2006, we recognized revenue on sales made to EBV upon shipment, less estimated reserves for future sales discounts and returns as required under Statement of Financial Accounting Standards No. 48 ("SFAS 48"), *Revenue Recognition When Right of Return Exists*. This methodology required us to monitor EBV's quarter-end inventory balances, as well as forecasted future sales activity, and to defer revenue and cost of goods sold on those items in EBV's inventory that we considered to be excess to EBV's requirements, and thus subject to return under EBV's contractual stock rotation rights. In addition, at each quarter-end, a separate reserve was established to provide for estimated future sales discounts in the form of point-of-sale ("POS") credits. These POS credits would in turn be issued to EBV once EBV sold qualifying products to certain of its customers.

The revision made to our method of revenue recognition for sales made to EBV was done for a number of reasons, including, but not limited to, changes in both the demand for our products and the types of applications for which our products are being used by EBV's end-customers, as well as an increase in the breadth and mix of products sold to EBV for high volume applications. These changes caused our management to conclude that they could no longer reasonably and reliably estimate and reserve for both EBV's future returns of excess inventory and allowances for future POS credits, each of which is a required adjustment under SFAS 48 when revenue is recognized at the time of shipment.

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 2006. 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 future financial position could be harmed.

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*Product revenues*

|                               |    | Three Months Ended |           | 2006 over  | 2006 over |
|-------------------------------|----|--------------------|-----------|------------|-----------|
|                               |    | June 30,           | June 30,  | 2005       | 2005      |
| <i>(Dollars in thousands)</i> |    | 2006               | 2005      | \$ Change  | % Change  |
| Product Revenues              | \$ | 19,209             | \$ 17,268 | \$ 1,941   | 11.2%     |
|                               |    | Six Months Ended   |           | 2006 over  | 2006 over |
|                               |    | June 30,           | June 30,  | 2005       | 2005      |
| <i>(Dollars in thousands)</i> |    | 2006               | 2005      | \$ Change  | % Change  |
| Product Revenues              | \$ | 29,783             | \$ 38,784 | \$ (9,001) | (23.2%)   |

The \$1.9 million increase in product revenues for the quarter ended June 30, 2006 as compared to the same period in 2005 was primarily the result of a \$1.1 million increase in Enel Project revenues, a \$575,000 increase in LonWorks Infrastructure product revenues, and a \$289,000 increase in NES product revenues. The \$9.0 million decrease in product revenues for the six months ended June 30, 2006 as compared to the same period in 2005 was primarily the result of a \$9.1 million reduction in Enel Project revenues, partially offset by a \$97,000 increase in NES product revenues.

*Service revenues*

|                               |    | Three Months Ended |          | 2006 over 2005 | 2006 over 2005 |
|-------------------------------|----|--------------------|----------|----------------|----------------|
|                               |    | June 30,           | June 30, | \$ Change      | % Change       |
| <i>(Dollars in thousands)</i> |    | 2006               | 2005     |                |                |
| Service Revenues              | \$ | 165                | \$ 212   | \$ (47)        | (22.2%)        |
|                               |    | Six Months Ended   |          | 2006 over      | 2006 over      |
|                               |    | June 30,           | June 30, | 2005           | 2005           |
| <i>(Dollars in thousands)</i> |    | 2006               | 2005     | \$ Change      | % Change       |
| Service Revenues              | \$ | 336                | \$ 379   | \$ (43)        | (11.3%)        |

The \$47,000 decrease in LonWorks Infrastructure service revenues during the quarter ended June 30, 2006 as compared to the same period in 2005, and the \$43,000 decrease during the six months ended June 30, 2006 as compared to the same period in 2005, was the result of a continued decrease in our customers' use of our support and training services. We believe that the worldwide economic recession, which began in 2002 and continued through part of 2003, forced many of our customers to curtail their spending for training and support. Although worldwide economic conditions improved during the latter part of 2003, and currently remain reasonably strong, we do not expect our service revenues to increase over prior year levels. In fact, we believe that many of our customers will continue to refrain from purchasing our customer support and training offerings during 2006 in an effort to minimize their operating expenses.

**Gross Profit and Gross Margin**

|                               | Three Months Ended |                  | 2006 over<br>2005 \$<br>Change | 2006 over<br>2005 %<br>Change |
|-------------------------------|--------------------|------------------|--------------------------------|-------------------------------|
|                               | June 30,<br>2006   | June 30,<br>2005 |                                |                               |
| <i>(Dollars in thousands)</i> |                    |                  |                                |                               |
| Gross Profit                  | \$ 11,619          | \$ 9,567         | \$ 2,052                       | 21.4%                         |
| Gross Margin                  | 60.0%              | 54.7%            | --                             | 5.3                           |
|                               | Six Months Ended   |                  |                                |                               |
|                               | June 30,<br>2006   | June 30,<br>2005 | 2006 over<br>2005 \$<br>Change | 2006 over<br>2005 %<br>Change |
| <i>(Dollars in thousands)</i> |                    |                  |                                |                               |
| Gross Profit                  | \$ 17,356          | \$ 22,037        | \$ (4,681)                     | (21.2%)                       |
| Gross Margin                  | 57.6%              | 56.3%            | --                             | 1.3                           |

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 5.3 percentage point increase in gross margin during the second quarter of 2006 as compared to the same period in 2005 was due to several factors, one of which was the impact of higher overall 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 revenues increase, as they did in the quarter ended June 30, 2006 as compared to the same period in 2005, gross margins are favorably impacted. In addition, the mix of products sold and certain manufacturing variances also contributed to the improved gross margin between the two periods. Partially offsetting these favorable impacts during the second quarter of 2006 was the reduction in gross margin resulting from equity compensation charges recorded in accordance with SFAS 123R. We adopted SFAS 123R in the first quarter of 2006 and began recording compensation expense associated with stock options and other forms of equity compensation. This resulted in a \$106,000 increase in our total cost of revenues during the second quarter of 2006, which had a corresponding effect of reducing our gross margin by 0.5 percentage point.

The 1.3 percentage point increase in gross margin during the first half of 2006 as compared to the same period in 2005 was due primarily to the mix of products sold and favorable manufacturing variances experienced during the second quarter. Partially offsetting these favorable factors were the impact of lower overall revenues on gross margins and SFAS 123R equity compensation charges. Equity compensation expense recorded under SFAS 123R during the first half of 2006 increased our total cost of revenues by approximately \$223,000, which reduced our gross margin for the first six months of 2006 by 0.7 percentage point.

We expect that, for full year 2006, overall gross margin will remain relatively flat as compared to the 55.6% experienced in 2005.

**Operating Expenses****Product Development**

|                               | Three Months Ended |                  |                             | 2006 over<br>2005 %<br>Change |
|-------------------------------|--------------------|------------------|-----------------------------|-------------------------------|
| <i>(Dollars in thousands)</i> | June 30,<br>2006   | June 30,<br>2005 | 2006 over<br>2005 \$ Change |                               |
| Product Development           | \$ 7,163           | \$ 6,360         | \$ 803                      | 12.6%                         |
|                               | Six Months Ended   |                  |                             | 2006 over<br>2005 %<br>Change |
| <i>(Dollars in thousands)</i> | June 30,<br>2006   | June 30,<br>2005 | 2006 over<br>2005 \$ Change |                               |
| Product Development           | \$ 14,154          | \$ 12,577        | \$ 1,577                    | 12.5%                         |

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

The \$803,000 and \$1.6 million increases in product development expenses for the quarter and six month periods ended June 30, 2006 as compared to the same periods in 2005 were primarily due to an increase in compensation expenses for our product development personnel, which was comprised of stock-based compensation expenses resulting from our adoption of SFAS 123R during the first quarter of 2006 and, to a lesser extent, increases in our product development personnel headcount.

We expect that, for full year 2006, product development expenses will increase over 2005 levels due primarily to the impact of SFAS 123R and, to a lesser extent, increases in our product development personnel headcount.

**Sales and Marketing**

|                               | Three Months Ended |                  |          | 2006 over<br>2005<br>\$ Change | 2006 over<br>2005<br>% Change |
|-------------------------------|--------------------|------------------|----------|--------------------------------|-------------------------------|
| <i>(Dollars in thousands)</i> | June 30,<br>2006   | June 30,<br>2005 |          |                                |                               |
| Sales and Marketing           | \$ 5,089           | \$ 5,396         | \$ (307) |                                | (5.7%)                        |
|                               | Six Months Ended   |                  |          | 2006 over<br>2005<br>\$ Change | 2006 over<br>2005<br>% Change |
| <i>(Dollars in thousands)</i> | June 30,<br>2006   | June 30,<br>2005 |          |                                |                               |
| Sales and Marketing           | \$ 10,236          | \$ 10,421        | \$ (185) |                                | (1.8%)                        |

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

For both the quarter and six months ended June 30, 2006, as compared to the same periods in 2005, the decrease in sales and marketing expenses was primarily due to reductions in salaries and wages paid to our sales and marketing staff, travel and entertainment expenses, and fees paid to third parties for services provided to our sales and marketing organization. Partially offsetting these reductions were increases in equity compensation expenses resulting from our adoption of SFAS 123R during the first quarter of 2006. In addition, during the second quarter of 2006 our advertising and product promotion expenses increased over 2005 levels due to the timing of certain tradeshow and other marketing events. Lastly, approximately \$26,000 of the \$307,000 decrease between the two quarterly periods, and approximately \$182,000 of the \$185,000 decrease between the two six month periods was attributable to the impact of foreign currency exchange rate fluctuations between the U.S. Dollar and the local currencies in several of the foreign countries in which we operate, including the Euro, the Pound Sterling, and the Japanese Yen.

We expect that, for full year 2006, our sales and marketing expenses will increase slightly over 2005 levels. We believe that this increase will be primarily attributable to increases in compensation expenses due to the impact of SFAS 123R as well as sales incentive compensation plans. However, if the U.S. dollar were to strengthen against the foreign currencies where we do business, our sales and marketing expenses could decrease as compared to amounts incurred in 2005. Conversely, if the dollar were to weaken against these currencies, our expenses would rise.

#### *General and Administrative*

| <i>(Dollars in thousands)</i> | Three Months Ended |                  | 2006 over<br>2005<br>\$ Change | 2006 over<br>2005 %<br>Change |
|-------------------------------|--------------------|------------------|--------------------------------|-------------------------------|
|                               | June 30,<br>2006   | June 30,<br>2005 |                                |                               |
| General and Administrative    | \$ 3,798           | \$ 3,596         | \$ 202                         | 5.6%                          |
|                               | Six Months Ended   |                  |                                |                               |
| <i>(Dollars in thousands)</i> | June 30,<br>2006   | June 30,<br>2005 | 2006 over<br>2005 \$ Change    | 2006 over<br>2005 %<br>Change |
| General and Administrative    | \$ 7,200           | \$ 8,047         | \$ (847)                       | (10.5%)                       |

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 the company, facility costs, insurance, and other general corporate expenses.

The \$202,000 increase in general and administrative expenses during the quarter ended June 30, 2006 as compared to the same period in 2005 was primarily attributable to a \$348,000 increase in equity compensation expenses resulting from our 2006 adoption of SFAS 123R. Partially offsetting this increase were reductions in fees paid to third party service providers, travel and entertainment expenses, and other general and administrative costs. The \$847,000 decrease in general and administrative expenses during the six-months ended June 30, 2006 as compared to the same period in 2005 was primarily due to a \$1.3 million reduction in legal and other third party services rendered to the company. During the first half of 2005, these fees were unusually high due to our arbitration with Enel. Additionally, certain other expenses such as travel and entertainment and bad debts were lower during the first half of 2006 as compared to the same period in 2005. Partially offsetting these decreases was a \$594,000 increase associated with equity compensation expenses resulting from our 2006 adoption of SFAS 123R.



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We expect that, for full year 2006, general and administrative costs will be slightly lower than those incurred in 2005. Although we expect reduced 2006 spending for legal and other costs as a result of the conclusion of our Enel arbitration in 2005, we expect these savings will be partially offset by increases in stock-based compensation costs resulting from our adoption of SFAS 123R.

**Interest and Other Income, Net**

|                                |    | Three Months Ended |          | 2006 over | 2006 over |
|--------------------------------|----|--------------------|----------|-----------|-----------|
|                                |    | June 30,           | June 30, | 2005      | 2005      |
| <i>(Dollars in thousands)</i>  |    | 2006               | 2005     | \$ Change | % Change  |
| Interest and Other Income, Net | \$ | 1,404              | \$ 1,281 | \$ 123    | 9.6%      |
|                                |    | Six Months Ended   |          | 2006 over | 2006 over |
|                                |    | June 30,           | June 30, | 2005      | 2005      |
| <i>(Dollars in thousands)</i>  |    | 2006               | 2005     | \$ Change | % Change  |
| Interest and Other Income, Net | \$ | 2,798              | \$ 2,342 | \$ 456    | 19.5%     |

Interest and other income, net primarily reflects interest earned by our company on cash and short-term investment balances. In addition, foreign exchange translation gains and losses related to short-term intercompany balances are also reflected in this amount.

Of the \$123,000 increase in interest and other income, net during the quarter ended June 30, 2006 as compared to the same period in 2005, approximately \$548,000 was attributable to increased interest income. Similarly, of the \$456,000 increase in interest and other income, net during the six months ended June 30, 2006 as compared to the same period in 2005, approximately \$1.1 million was attributable to increased interest income. These increases are primarily attributable to an overall improvement in the average yield on our investment portfolio. Yields have been increasing since June 2004 as a result of the Federal Reserve's interest rate increases. As short-term investments we purchased in 2004 and 2005 have come to maturity, the proceeds have been re-invested in instruments with higher effective yields, thus increasing interest income. Partially offsetting these increases in interest income between the two three and six-month periods was the impact of foreign exchange translation losses on our short-term intercompany balances.

Although interest rates have been increasing steadily since June 2004, we expect that our anticipated operating losses for 2006 will require us to use a portion of our existing cash and short-term investment portfolio to fund ongoing business operations. In addition, we may decide to continue repurchasing our common stock in accordance with our board of directors approved stock repurchase program, which expires in March 2007. As a result, we expect that the average amount of our invested cash will decrease during 2006, which could result in reduced interest income. 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.

**Provision for Income Taxes**

|                               |    | Three Months Ended |          | 2006 over | 2006 over |
|-------------------------------|----|--------------------|----------|-----------|-----------|
|                               |    | June 30,           | June 30, | 2005      | 2005      |
| <i>(Dollars in thousands)</i> |    | 2006               | 2005     | \$ Change | % Change  |
| Provision for Income Taxes    | \$ | 80                 | \$ 100   | \$ (20)   | (20.0%)   |

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| <i>(Dollars in thousands)</i>    | Six Months Ended |                  | 2006 over<br>2005<br>\$ Change | 2006 over<br>2005<br>% Change |
|----------------------------------|------------------|------------------|--------------------------------|-------------------------------|
|                                  | June 30,<br>2006 | June 30,<br>2005 |                                |                               |
| Provision for Income Taxes<br>40 | \$ 160           | \$ 200           | \$ (40)                        | (20.0%)                       |

The provision for income taxes for 2006 includes a provision for federal, 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. Income taxes of \$80,000 and \$100,000 for the quarters ended June 30, 2006 and 2005, respectively, and \$160,000 and \$200,000 for the six months ended June 30, 2006 and 2005, respectively, consist primarily of taxes related to profitable foreign subsidiaries and various state minimum taxes.

Although we expect to generate a loss before provision for income taxes in 2006, we will be required to book income tax expense to cover, at a minimum, the foreign taxes owed on income generated by our profitable foreign subsidiaries as well as state minimum taxes. We currently expect our 2006 provision for income taxes will be slightly higher than the amounts provided for in 2005.

## **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.

*Operating Lease Commitments.* We lease our present corporate headquarters facility in San Jose, California, under two non-cancelable operating 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 \$6.5 million.

In addition to our corporate headquarters facility, we also lease facilities for our sales, marketing, distribution, and product development personnel located elsewhere within the United States and in nine foreign countries throughout Europe and Asia. These operating leases are of shorter duration, generally one to two years, and in some instances are cancelable with advance notice.

*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 six 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 could 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.

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*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 under our cost of products revenue on our consolidated statements of income, was approximately \$102,000 during the quarter ended June 30, 2006, and \$116,000 for the same period in 2005. Royalty expense was approximately \$211,000 for the six months ended June 30, 2006, and \$247,000 for the same period in 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.

*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. As of December 31, 2005, approximately \$3.0 million of the \$5.2 million award was unpaid and is reflected in accrued liabilities. As of June 30, 2006, all amounts due Enel under the arbitration ruling have been paid. 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 June 30, 2006, 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 June 30, 2006, our contractual obligations were as follows (in thousands):

|                      | Total     | Payments due by period |           |           | More than 5 years |
|----------------------|-----------|------------------------|-----------|-----------|-------------------|
|                      |           | Less than 1 year       | 1-3 years | 3-5 years |                   |
| Operating leases     | \$ 28,926 | \$ 4,999               | \$ 9,381  | \$ 9,462  | \$ 5,084          |
| Purchase commitments | 24,751    | 24,613                 | 138       | --        | --                |
| Total                | \$ 53,677 | \$ 29,612              | \$ 9,519  | \$ 9,462  | \$ 5,084          |

## 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 June 30, 2006, we raised \$278.1 million from the sale of preferred stock and common stock, including the exercise of stock options and warrants from our employees and directors.



In July 1998, we consummated an initial public offering of 5,000,000 shares of our common stock at a price to the public of \$7.00 per share. The net proceeds from the offering were about \$31.7 million. Concurrent with the closing of our initial public offering, 7,887,381 shares of convertible preferred stock were converted into an equivalent number of shares of common stock. The net proceeds received upon the consummation of the offering were invested in short-term, investment-grade, interest-bearing instruments.

In September 2000, we consummated a sale of 3.0 million shares of our common stock to Enel. The net proceeds of the sale were about \$130.7 million.

In September 2001, our board of directors approved a stock repurchase program which authorized us to repurchase up to 2.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. In September 2001, we repurchased 265,000 shares under the program at a cost of \$3.2 million. No additional repurchases were made subsequent to September 2001. The stock repurchase program expired in September 2003.

In March and August 2004, our board of directors approved a second 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. Since inception, we have repurchased a total of 1,727,454 shares under the program at a cost of \$12.3 million. As of June 30, 2006, 1,272,546 shares are available for repurchase. The stock repurchase program will expire in March 2007.

The following table presents selected financial information as of June 30, 2006 and for each of the last three fiscal years (dollars in thousands):

|  | June 30, 2006 | 2005       | 2004       | 2003       |
|--|---------------|------------|------------|------------|
| Cash, cash equivalents, and short-term investments | \$ 141,365    | \$ 154,480 | \$ 160,364 | \$ 144,923 |
| Trade accounts receivable, net                     | 16,789        | 11,006     | 17,261     | 20,110     |
| Working capital                                    | 146,020       | 157,474    | 173,391    | 160,745    |
| Stockholders' equity                               | 170,651       | 181,308    | 211,062    | 200,924    |

As of June 30, 2006, we had \$141.4 million in cash, cash equivalents, and short-term investments, a decrease of \$13.1 million as compared to December 31, 2005. Historically, our primary source of cash, other than stock sales, has been receipts from revenue, and to a lesser extent, proceeds from the exercise of stock options and warrants by our employees and directors. Our primary uses of cash have been cost of product revenue, payroll (salaries, commissions, bonuses, and benefits), general operating expenses (costs associated with our offices such as rent, utilities, and maintenance; fees paid to third party service providers such as consultants, accountants, and attorneys; travel and entertainment; equipment and supplies; advertising; and other miscellaneous expenses), acquisitions, capital expenditures, and purchases under our stock repurchase program.

**Net cash provided by (used in) operating activities.** Net cash provided by (used in) operating activities has historically been driven by net income (loss) levels, adjustments for non-cash charges such as depreciation, amortization, in-process research and development charges, and stock-based compensation, as well as fluctuations in operating asset and liability balances. Net cash used in operating activities was \$8.3 million for the six months ended June 30, 2006, an \$11.2 million increase from the same period in 2005. During the six months ended June 30, 2006, net cash used in operating activities was primarily a result of our net loss of \$11.6 million, offset by stock-based compensation expenses of \$2.7 million, depreciation and amortization expense of \$2.2 million, a reduction in our bad debt reserve balance of \$35,000, and changes in our operating assets and liabilities of \$1.5 million. During the six months ended June 30, 2005, net cash provided by operating activities was primarily the result of changes in our operating assets and liabilities of \$7.5 million, depreciation and amortization expense of \$2.1 million, and stock-based

compensation expenses of \$186,000, partially offset by our net loss of \$6.9 million.



**Net cash provided by (used for) investing activities.** Net cash provided by (used for) 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 used for investing activities was \$419,000 for the six months ended June 30, 2006, a \$7.8 million decrease from the same period in 2005. During the six months ended June 30, 2006, net cash used for investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of \$37.1 million, offset by purchases of available-for-sale short-term investments of \$34.5 million, capital expenditures of \$2.9 million, and changes in our other long-term assets of \$158,000. During the six months ended June 30, 2005, net cash used for investing activities was primarily the result of purchases of \$61.9 million of available-for-sale short-term investments and capital expenditures of \$826,000, offset by proceeds from sales and maturities of available-for-sale short-term investments of \$54.2 million, changes in our other long-term assets of \$224,000, and an \$89,000 reduction in our restricted investments.

**Net cash provided by (used in) financing activities.** Net cash provided by (used in) financing activities has historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase programs. Net cash used in financing activities was \$2.4 million for the six months ended June 30, 2006, a \$4.7 million decrease over the same period in 2005. During the six month period ended June 30, 2006, net cash used in financing activities was attributable to open-market purchases of our common stock under our stock repurchase program, partially offset by proceeds from issuance of common stock as a result of options exercised by our employees. During the six month period ended June 30, 2005, net cash used in financing activities was attributable to open-market purchases of our common stock under our stock repurchase program.

We use well-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, certificates of deposit, 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 2006 as a result of our anticipated operating losses. 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 later in this discussion in the section titled “*Factors That May Affect Future Results of Operations.*” 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 quarter and six months ended June 30, 2006, and the years ended December 31, 2005, 2004, and 2003, 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.



From time to time, M. Kenneth Oshman, our Chairman of the Board and Chief Executive Officer, uses private air travel services for business trips for himself and for any employees accompanying him. Prior to January 1, 2005, a company controlled by Armas Clifford Markkula, a director of our company, provided these private air travel services. Our net expense with respect to such private air travel services is no greater than comparable first class commercial air travel services. Such net outlays to date have not been material.

In September 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 condensed 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. As of July 31, 2006, to our knowledge Enel had 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. Enel appointed Mr. Francesco Tatò as its representative to our board of directors in September 2000. As a consequence of the expiration of Mr. Tatò's mandate as Enel's Chief Executive Officer, Mr. Tatò resigned his board memberships in all of Enel's subsidiaries and affiliates, including Echelon. His resignation from our board of directors was effective in June 2002. Enel has reserved its right to nominate a new member of our board of directors, although, as of July 31, 2006, it has not done so. During the term of service of Enel's representative on our board of directors from September 2000 to June 2002, Enel's representative abstained from resolutions on any matter relating to Enel.

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. Under the terms of the research and development agreement, we cooperated with Enel to integrate our LonWorks technology into Enel's remote metering management project in Italy. For the quarter and six months ended June 30, 2006, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$6.9 million and \$7.1 million, respectively. As of June 30, 2006, \$6.8 million of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers. For the quarter and six months ended June 30, 2005, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$5.8 million and \$16.2 million, respectively. As of June 30, 2005, \$6.2 million of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005, and, as of June 30, 2006, have also completed the \$7.1 million worth of spare parts Enel ordered from us in early 2006.

#### RECENTLY ISSUED ACCOUNTING STANDARDS

In July, 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in tax positions. This Interpretation requires that we recognize in our financial statements the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of our 2007 fiscal year, with the cumulative effect, if any, of the change in accounting principal recorded as an adjustment to opening retained earnings. We are currently evaluating the impact of adopting FIN 48 on our condensed consolidated financial statements.

In February 2006, the FASB issued SFAS No. 155 ("SFAS 155"), *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133 ("SFAS 133"), *Accounting for Derivative Instruments and Hedging Activities* and SFAS No. 140 ("SFAS 140"), *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. SFAS 155 is effective

for all financial instruments acquired, issued, or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. Earlier adoption is permitted, provided we have not yet issued financial statements, including for interim periods, for that fiscal year. As we do not currently engage in hedging activities, we do not currently expect the adoption of SFAS 155 will have a material impact on our consolidated financial position, results of operations, or cash flows.

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In June 2005, the FASB issued SFAS No. 154 (“SFAS 154”), *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for how an entity accounts for, and reports, a change in accounting principle. Previously, most voluntary changes in accounting principles were implemented by reflecting a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods’ financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements.

## **FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS**

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

**Now that the deployment phase of the Enel project has been completed, our overall revenue has declined. Due to the lengthy sales cycle and timing of revenues for our NES business, our revenues may decline further.**

We completed our deliveries under the deployment phase of the Enel project during 2005. We currently expect that our revenues from Enel and its meter manufacturers will decline significantly, from \$26.9 million in 2005 to approximately \$7.1 million in 2006, all of which has already been recognized during the first six months of 2006. We do not currently anticipate any material revenues from Enel for the remainder of 2006. Accordingly, we continue to seek new revenue opportunities with utility companies around the world.

We believe that utility companies generally require a lengthier sales cycle than do most of our other customers. For example, in December 2005 we announced the Swedish utility, Vattenfall AB, had selected our NES system for deployment in part of its service territory. Prior to this award, our VAR partner, Telvent, and we had been discussing the benefits of the NES system with Vattenfall for about three years. In addition, in many instances, one or more field trials of our NES system products may be required before a final decision is made by the utility. For example, a subsidiary of Nuon, a utility grid operator located in the Netherlands, completed a limited field trial of our NES system within its service territory in early 2005. In early 2006, Nuon selected our NES system for a small deployment in part of its service territory. Once that effort is completed, which we believe will occur in early 2007, we expect Nuon will issue a public tender for an even larger deployment within their service territory. However, there is no assurance that we will win that tender, if and when Nuon decides to issue it. In addition, there is generally an extended development and integration effort required in order to incorporate the new technology into the utility’s existing infrastructure.

Once a utility decides to move forward with a large-scale deployment of our NES system, the timing of, and our ability to recognize revenue on, our NES system product shipments will depend on several factors, including, but not limited to, the shipment schedules included in the contracts and certain contractual provisions, such as acceptance of all or any part of the system by the utility. For example, under the terms of our current arrangement with Nuon, there are significant customer acceptance provisions that will require us to defer revenue recognition until Nuon accepts the system, which we currently expect will happen in early 2007. In addition, the complex revenue recognition rules relating to products such as our NES system could 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. 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.

Due to the extended sales cycle and the additional development and integration time required, as well as the uncertainty of the timing of our NES revenue recognition, we do not currently believe we will be able to replace the expected \$19.8 million reduction in Enel revenues in 2006. As a result, our 2006 revenues, results of operations, and financial condition will be harmed.

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**Although we have invested substantial amounts of time and money into our NES system, our utility market product offerings may fail to meet customers' expectations, or may fail to meet our financial targets. If we incur penalties and/or damages with respect to sales of the NES system, such penalties and/or damages could have an adverse effect on our financial condition, revenues, and operating results.**

To be successful in our efforts to sell our NES system, we have invested and intend to continue investing significant resources in its development. For example, in April 2003 we acquired certain assets of Metering Technology Corporation, or MTC, for \$11.0 million in cash and the assumption of certain liabilities. Among the assets acquired was the right to use MTC's developed electricity meter technology. As we have integrated their technology into our NES system, we have incurred and expect to continue to incur significant development costs.

We cannot assure you that our NES system will be accepted in the utility market place to the extent required for us to realize a reasonable return on our investments in developing the system. For example, in order to realize all of the benefits of the NES system, a utility must replace a significant portion of its metering infrastructure with a homogenous population of intelligent, networked meters. In addition, even if the NES system meets a utility's technical specifications, we may not be able to meet all of the utility's contractual requirements. We also cannot assure you that, if accepted by the utilities, our NES system will generate economic returns that meet our financial targets. For example, revenues from our NES system offering may be lower than we currently anticipate, as was the case for actual versus targeted NES system revenues for both 2004 and 2005. The timing of these revenues could also fluctuate from our business plan for a variety of reasons, including changes in shipping schedules, contractual provisions such as customer acceptance, and complex revenue recognition rules related to sales of products consisting of multiple elements such as our NES system. Additionally, when we do recognize revenue on sales of our NES system products, we expect the gross margins generated from such sales will be lower than those generated by most of our other products.

Even if we are successful in penetrating the utility market with our NES system offering, we face competition from many companies. For example, Enel, our largest customer for the last several years, has designed a system that it may use to compete with our NES system using third party products instead of our products. Enel has significantly greater experience and financial, technical, and other resources than we have. Enel previously announced an alliance with IBM to market and sell metering systems worldwide. We do not currently believe that our company will contribute to that alliance. Other competitors, including Actaris, DCSI, Elster, Hunt Technologies, Itron, Iskraemeco, and Landis and Gyr, as well as our own customers such as Enermet, Horstmann Controls, Kamstrup, and Metrima, have also developed and are marketing their own multi-service metering systems that compete with our NES system offering. We believe that our NES system will compete with other offerings both in terms of technical capabilities as well as price, warranties, indemnities, penalties, and other contractual provisions.

In addition, we presently plan to sell our NES products to utilities either directly or through resellers or other partners. If we sell the NES system directly to a utility, the utility may require us 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. These are services that we generally would not be responsible for if we sold our NES products through a reseller or other partner, or if we sold directly to a utility that managed those activities on its own. To date, we do not have any significant experience with those services. As a result, if we sold directly to a utility that required us to provide those services, we may be required to contract with third parties to satisfy those obligations. We cannot assure you that we would find appropriate third parties to provide those 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.

Lastly, sales of the NES system will expose us to penalties, damages and other liabilities relating to late deliveries, late or improper installations or operations, failure to meet product specifications, failure to achieve performance specifications, indemnities or otherwise. If we are unsuccessful in deploying the NES system, or otherwise fail to meet

our financial targets for the NES system, our revenues, results of operations, and financial position will be harmed.

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**Compliance with new rules and regulations concerning hazardous materials is costly and time-consuming, and may result in increased costs and a reduction in, or changes in the timing of, our expected revenues.**

We are in the process of completing our implementation of programs necessary to comply with newly enacted Restrictions on Hazardous Substances, or RoHS, regulations that require certain manufacturers, such as Echelon, to eliminate hazardous substances (e.g., lead, cadmium, mercury, etc.) from the commercial products that are sold to customers in the European Union and Japan. These new rules became effective in Europe on July 1, 2006.

Transitioning our products from non-compliant to RoHS-compliant has been a complex, costly, and time-consuming process. As we complete the transition, we continue to face several risks, including, but not limited to, risks that our contract electronic manufacturers will not be able to produce our RoHS compliant products in a timely and cost effective manner. In addition, as all other suppliers in the market affected by the RoHS regulations attempt to make this transition, availability of RoHS compliant materials and expertise in RoHS compliant certifications is in great demand. Delays in availability of RoHS compliant materials and the certifications necessary to support their use may have a negative impact on our revenues for the balance of 2006 or until such time as our transition is complete. Lastly, we also face the risk that, in transitioning our products to comply with these new regulations, we could ourselves be left with excess quantities of non-RoHS compliant inventory for which an excess and obsolete inventory reserve would be required. If any of these risks materialize, our revenues, results of operations, and financial position could be harmed.

**Effective January 1, 2006, we began recording compensation expense for the calculated fair value of stock options and other compensatory equity-based awards that we issue to our employees, which has harmed our results of operations.**

We believe that stock options are a key element in our ability to attract and retain employees in the markets in which we operate. In December 2004, the Financial Accounting Standards Board issued SFAS 123R, *Share-Based Payment: an amendment of FASB Statements No. 123 and 95*. SFAS 123R requires a company to recognize, as an expense, the calculated fair value of stock options and other stock-based compensation granted to employees and other service providers. We adopted these new rules effective January 1, 2006.

Prior to 2006, we used the intrinsic value method to measure compensation expense for stock-based awards to our employees. Under this standard, we generally did not consider stock option grants issued under our employee stock option plans to be compensation when the exercise price of the stock option was equal to or greater than the fair market value on the date of grant. Effective January 1, 2006, we began recording a compensation charge as stock options or other stock-based compensation awards are issued or as they vest, including the unvested portion of options that were granted on or before December 31, 2005. This compensation charge is based on a calculated fair value of the option or other stock-based award using a complex methodology, and which may not correlate to the current market price of our stock. In addition, this calculation requires management to use several estimates, any one of which could have a significant impact on the option's calculated fair value. If any of these estimates prove to be different from actual results, the calculated fair value of the option could be significantly under or over stated. The additional compensation expense we are required to record under SFAS 123R has resulted in a reduction in our reported gross margins as compared to prior years as well as a material increase in our operating expenses from historical levels. This has, in turn, had, and will continue to have, a significant negative impact on our results of operations.

**Our markets are highly competitive. Many of our competitors have longer operating histories and greater resources than we do. If we are unable to effectively compete in the industry, our operating results would be harmed.**

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, and rapid changes in customer requirements. To maintain and improve our competitive position, we must continue to develop and introduce, in a timely and cost-effective manner, new products,

features and services that keep pace with the evolving needs of our customers. The principal competitive factors that affect the markets for our control network products include the following:

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- our ability to develop and introduce new products on a timely basis;
  - our product reputation, quality, and performance;
- the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;
  - our customer service and support; and
  - warranties, indemnities, and other contractual terms.

In each of our markets, we compete with a wide array of manufacturers, vendors, strategic alliances, systems developers and other businesses. For our LONWORKS Infrastructure products, our competitors include some of the largest companies in the electronics industry, such as Siemens in the building and industrial automation industries, and Allen-Bradley (a subsidiary of Rockwell Automation) and Groupe Schneider in the industrial automation industry. 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. 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. In addition, those competitors that manufacture and promote closed, proprietary control systems may enjoy a captive customer base dependent on such competitors for service, maintenance, upgrades and enhancements. Products from other companies such as Digi International, emWare, Ipsil, JumpTec, Lantronix, Microsoft, and Wind River Systems, as well as certain micro-controller manufacturers including Freescale (formerly Motorola), Texas Instruments, Micro Chip, and Philips, all of which promote directly connecting devices to the Internet, could also compete with our products. In addition, in the utilities market, products from companies such as Actaris, DCSI, Elster, Hunt Technologies, Itron, Iskraemeco, and Landis and Gyr, each of which offers automatic meter reading products for the utility industry, as well as metering systems from our customers such as Enel, Enermet, Horstmann Controls, Kamstrup, and Metrima, could compete with our NES system. For example, Enel, working with IBM, competes with our NES system using third party products instead of our products. Enel and IBM, as well as several other named competitors, have significantly greater experience and financial, technical, and other resources than we have. If we are unable to compete effectively in any of the markets we serve, our revenues, results of operations, and financial position could be harmed.

**As a result of our lengthy sales cycle, we have limited ability to forecast the amount and timing of revenue related to specific sales. If we fail to complete or are delayed in completing transactions, our revenues could vary significantly from period to period.**

The sales cycle between initial customer contact and execution of a contract or license agreement with a customer can vary widely. For example, OEMs, as well as utilities that may be interested in our NES system, typically conduct extensive and lengthy product evaluations before making initial purchases of our products. They may further delay subsequent purchases of our products due to their own prolonged product development, system integration, and product introduction periods. Delays in our sales cycle can also result from, among other things:

- changes in our customers' budgets;
- changes in the priority our customers assign to control network development;
- the time it takes for us to educate our customers about the potential applications of and cost savings associated with our products;
  - the deployment schedule for projects undertaken by our utility or systems integrator customers;
  - the actions of utility regulators or management boards regarding investments in metering systems;
    - delays in installing, operating, and evaluating the results of NES system field trials; and
- the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments.

We generally have little or no control over these factors, which may cause a potential customer to favor a competitor's products, or to delay or forgo purchases altogether. If any of these factors prevent or substantially delay our ability to complete a transaction, our revenues and results of

operations could be harmed.

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**If we do not maintain adequate distribution channels for our LONWORKS Infrastructure products or our NES system products, our revenues will be harmed significantly.**

Currently, significant portions of our revenues are derived from sales to distributors, including EBV, the primary independent distributor of our products to OEMs in Europe. Sales to EBV, our largest distributor, accounted for 22.0% of our total net revenues for the quarter ended June 30, 2006, and 21.9% for the same period in 2005; and 22.3% of our total net revenues for the six months ended June 30, 2006, and 19.6% for the same period in 2005. Worldwide sales to distributors, including those to EBV, accounted for approximately 25.5% of total net revenues for the quarter ended June 30, 2006, and 30.7% of our total net revenues for the same period in 2005; and 29.2% of total net revenues for the six months ended June 30, 2006, and 26.5% for the same period in 2005.

Our current agreement with EBV, which has been in effect since 1997, expires in December 2006. If EBV, or any other existing or future distributor, fails to dedicate sufficient resources and efforts to marketing and selling our products, our revenues could decrease. If EBV significantly reduces its inventory levels for our products, our customer service levels would decrease. If we do not maintain our agreement with EBV, we would be required to locate another distributor or add our own pan-European distribution capability to meet the needs of our customers. Any replacement distribution channel could prove less effective than EBV.

We market our NES system products directly, as well as through selected value added resellers, or 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 business with other companies, our NES system business may not be successful or may otherwise not meet our financial targets, which will harm our revenues and operating results.

**The undetermined market acceptance of our products makes it difficult to evaluate our future prospects.**

We face a number of risks as a company in a rapidly changing and developing market, and you must consider our prospects in light of the associated risks. This is true of both our LONWORKS Infrastructure products and our NES system products. Our future operating results are difficult to predict due to many factors, including the following:

- some of our targeted markets have not yet accepted many of our products and technologies;
- many of our customers do not fully support open, interoperable networks, and this reduces the market for our products;
- we may not anticipate changes in customer requirements and, even if we do so, we may not be able to develop new or improved products that meet these requirements in a timely manner, or at all;
- the markets in which we operate require rapid and continuous development of new products, and we have failed to meet some of our product development schedules in the past;
- potential changes in voluntary product standards around the world can significantly influence the markets in which we operate; and
- our industry is very competitive and many of our competitors have far greater resources and may be prepared to provide financial support from their other businesses in order to compete with us.

**Compliance with rules and regulations concerning corporate governance is costly, time-consuming, and difficult to achieve, which could harm our operating results and business.**

The Sarbanes-Oxley Act, or the Act, which was signed into law in 2002, mandates, among other things, that companies adopt corporate governance measures and imposes comprehensive reporting and disclosure requirements. The Act also imposes increased civil and criminal penalties on a corporation, its chief executive and chief financial officers, and members of its board of directors, for securities law violations. In addition, the Nasdaq National Market, on which our common stock is traded, has adopted and is considering the adoption of additional comprehensive rules and regulations relating to corporate governance. These rules, laws, and regulations have increased the scope, complexity, and cost of our corporate governance, reporting, and disclosure practices. Because compliance with these new rules, laws, and regulations is costly and time-consuming, our management's attention could be diverted from managing our day-to-day business operations, and our operating expenses could increase.

In addition, because of the inherent limitations in all financial control systems, it is possible that a material weakness may be found in our internal controls over financial reporting, which could affect our ability to insure proper financial reporting. For example, as described more fully in our Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, in October 2005 we identified a material weakness in our internal controls over revenue recognition at our Japanese subsidiary, although that weakness was remediated prior to the end of 2005.

In the future, these developments could make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Further, our board members, Chief Executive Officer, and Chief Financial Officer face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified board members and executive officers, which could harm our business.

**We depend on a limited number of key manufacturers and use contract electronic manufacturers for most of our products requiring assembly. If any of these manufacturers terminates or decreases its relationships with us, we may not be able to supply our products and our revenues would suffer.**

The Neuron Chip is an important component that our customers use in control network devices. In addition, the Neuron Chip is an important device that we use in many of our products. Neuron Chips are currently manufactured and distributed by Toshiba and Cypress Semiconductor under license agreements we maintain with them. These agreements, among other things, grant Toshiba and Cypress the worldwide right to manufacture and distribute Neuron Chips using technology licensed from us, and require us to provide support, as well as unspecified updates to the licensed technology, over the terms of the agreements. The Cypress agreement expires in April 2009 and the Toshiba agreement expires in January 2010. However, we cannot be certain that these manufacturers will continue to supply Neuron Chips until these contracts expire, and we currently have no other source of supply for Neuron Chips. If either Toshiba or Cypress were to cease designing, manufacturing, and distributing Neuron Chips, we could be forced to rely on a sole supplier for Neuron Chips. If both Toshiba and Cypress were to exit this business, we would attempt to find a replacement. This would be an expensive and time-consuming process, with no guarantee that we would be able to find an acceptable alternative source.

We also maintain manufacturing agreements with other semiconductor manufacturers for the production of key products, including those used in our NES system. For example, in 2003 we announced a new product family that we refer to as Power Line Smart Transceivers. A sole source supplier, ST Microelectronics, manufactures these products. We currently have no other source of supply for Power Line Smart Transceivers or the components manufactured by Cypress and AMI Semiconductor.

Our future success will also depend significantly on our ability to manufacture our products cost-effectively, in sufficient volumes and in accordance with quality standards. For most of our products requiring assembly, we use contract electronic manufacturers, including WKK Technology and TYCO TEPC/Transpower. These contract electronic manufacturers procure material and assemble, test, and inspect the final products to our specifications. This strategy involves certain risks. By using third parties to manufacture our products, we have reduced control over quality, costs, delivery schedules, product availability, and manufacturing yields. For instance, quality problems at a contract equipment manufacturer could result in missed shipments to our customers and unusable inventory. Such delays could, among other things, reduce our revenues, increase our costs by increasing our inventory reserves, and cause us to incur penalties. In addition, contract electronic manufacturers can themselves experience turnover and instability, exposing us to additional risks as well as missed commitments to our customers.

We will also face risks if and when we transition between contract electronic manufacturers. When we transition, we may have to move raw material and in-process inventory between locations in different parts of the world. Also, we would be required to reestablish acceptable manufacturing processes with a new work force. We could also be liable for excess or unused inventory held by contract manufacturers for use in our products. This inventory may become obsolete as a result of engineering changes that we make. In addition, we may no longer need this inventory because of factors such as changes in our production build plans, miscommunication between us and a contract manufacturer, or errors made by a contract manufacturer in ordering material for use in our products. Under our contracts with these contract electronic manufacturers, we would become liable for all or some of these excess or obsolete inventories.

The failure of any key manufacturer to produce 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.

**Because we depend on sole or a limited number of suppliers, and because our products may use components or materials that are subject to price fluctuations, any price increases, shortages, or interruptions of supply would adversely affect our revenues and/or gross profits.**

As previously discussed, we currently purchase several key products and components only from sole or limited sources. For some of these suppliers, we do not maintain signed agreements that would obligate them to supply to us on negotiated terms. In addition, our products may incorporate components or materials that are subject to price fluctuations. For example, we use copper in our NES meters and other products, and the price of copper has been very volatile recently. As a result, we may be vulnerable to price increases for products, components, or materials. In addition, in the past, we have occasionally experienced shortages or interruptions in supply for certain of these items, which caused us to delay shipments beyond targeted or announced dates. In some cases, these shortages were caused by the normal fluctuations in component lead times. Any future lengthening of component lead times may make it more difficult for us to meet our scheduled delivery dates and could adversely affect our revenues.

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 these products or components 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.

**Our business may suffer if it is alleged or found that our products infringe the intellectual property rights of others or if our customers are concerned about the potential for such infringement.**

Although we attempt to avoid infringing known proprietary rights of third parties in our product development efforts, from time to time we may receive notice that a third party believes that our products may be infringing certain patents or other intellectual property rights of that third party. We may also be contractually obligated to indemnify our customers or other third parties that use our products in the event they are alleged to infringe a third party's intellectual property rights. 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. Thus, even if our products do not infringe, we may elect to take a license or settle to avoid incurring such costs.

In the event our products are infringing upon the intellectual property rights of others, we may elect or be required to redesign our products so that they do not incorporate any intellectual property to which the third party has or claims rights. As a result, 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 for the third party's intellectual property, but it is possible that we would not be able to obtain such a license on reasonable terms, or at all. Any delays that we might then suffer or additional expenses that we might then incur could adversely affect our revenues, operating results and financial condition.

In addition, our customers may not pursue product opportunities based on their concerns regarding third party intellectual property rights, particularly patents, and this could reduce the market opportunity for the sale of our products and services.

**We have a history of losses and, although we achieved profitability in prior years, we expect to incur substantial losses again in 2006.**

During the first six months of 2006, we generated a loss of \$11.6 million. As of June 30, 2006, we had an accumulated deficit of \$95.7 million. We have invested and expect to continue investing significant financial resources in product development, marketing and sales. We believe we will incur a substantial loss in 2006. Consequently, we currently expect our cash and short-term investment balances to decline as a result of such losses.

Our future operating results will depend on many factors, including:

- adoption of our NES solution and other products by service providers for use in utility and/or other home automation projects;
  - the timing of revenue recognition related to sales of our NES system products;
  - revenue growth of our LONWORKS Infrastructure products;
- continuation of worldwide economic growth, particularly in certain industries such as semiconductor manufacturing equipment;
- the ability of our contract electronic manufacturers to provide quality products on a timely basis, especially during periods where excess capacity in the contract electronic manufacturing market is reduced;
  - growth in acceptance of our products by OEMs, systems integrators, service providers and end-users;
  - the effect of expensing stock option grants or other compensatory awards to our employees;
  - our ability to attract new customers in light of increased competition;
  - our ability to develop and market, in a timely and cost-effective way, new products that perform as designed;
- costs associated with any future business acquisitions, including up-front in-process research and development charges and ongoing amortization expenses related to other identified intangible assets;
  - ongoing operational expenses associated with any future business acquisitions;
- results of impairment tests that we will perform from time to time in the future, in accordance with SFAS 142, with respect to goodwill and other identified intangible assets that we acquired in the past or that we may acquire in the future. If the results of these impairment tests indicate that an impairment event has taken place, we will be required to take an asset impairment charge that could have a material adverse effect on our operating results; and
  - general economic conditions.



As of December 31, 2005, we had net operating loss carry forwards for federal income tax reporting purposes of approximately \$81.0 million and for state income tax reporting purposes of approximately \$16.5 million, which will expire at various dates through 2025. In addition, as of December 31, 2005, we had tax credit carry forwards of approximately \$12.4 million, \$6.7 million of which will expire at various dates through 2025. The Internal Revenue Code of 1986, as amended, contains provisions that limit the use in future periods of net operating loss and credit carry forwards upon the occurrence of certain events, including significant changes in ownership interests. We have performed an analysis of our ownership changes and have reported the net operating loss and credit carry forwards considering such limitations. As of December 31, 2005, our deferred tax assets, including our net operating loss carry forwards and tax credits, totaled approximately \$52.2 million. The Internal Revenue Code of 1986 also contains provisions requiring companies to fully utilize net operating losses before utilizing tax credits. As a result, depending on our future taxable income in any given year, some or all of the Federal increased research tax credits, as well as portions of our federal and state net operating loss carryforwards, may expire before being utilized. Consequently, we have recorded a valuation allowance for the entire deferred tax asset as a result of uncertainties regarding the realization of the asset balance, our history of losses, and the variability of our operating results.

**We face operational and financial risks associated with international operations.**

Our international sales and marketing operations are located in nine countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 75.9% of our total net revenues for the quarter ended June 30, 2006, and 76.3% of our total net revenues for the same period in 2005; and 68.7% of our total revenues for the six months ended June 30, 2006, and 79.4% for the same period in 2005. We expect that international sales will continue to constitute a significant portion of our total net revenues.

Our operations and the market price of our products may be directly affected by economic and political conditions in the countries where we do business. In addition, we may not be able to maintain or increase the international demand for our products. Additional risks inherent in our international business activities generally include the following:

- international terrorism and anti-American sentiment;
- currency fluctuations;
- unexpected changes in regulatory requirements, tariffs and other trade barriers;
- costs of localizing products for foreign countries and lack of acceptance of non-local products in foreign countries;
  - longer accounts receivable payment cycles;
  - difficulties in managing international operations;
- labor actions generally affecting individual countries, regions, or any of our customers which could result in reduced demand for our products;
  - potentially adverse tax consequences, including restrictions on repatriation of earnings; and
  - the burdens of complying with a wide variety of foreign laws.

Differing vacation and holiday patterns in other countries, particularly in Europe, may also affect the amount of business that we transact in other countries in any given quarter, the timing of our revenues, and our ability to forecast projected operating results for such quarter.

Fluctuations in the value of currencies in which we conduct our business relative to the U.S. dollar could cause currency translation adjustments. The portion of our revenues conducted in currencies other than the United States dollar, principally the Japanese Yen, was about 5.0% for the quarter ended June 30, 2006, and 5.9% for the same period in 2005; and 5.4% for the six months ended June 30, 2006, and 4.3% for the same period in 2005. In addition, much of our sales and marketing expenses, as well as certain other costs, are incurred in currencies other than the U.S. dollar. For example, in 2005 China revalued its currency, the Chinese Renminbi, against the U.S. dollar. Although the adjustment has not resulted in a material change to the costs for goods and services we obtain from our suppliers and contractors in China, any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases. 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.

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The use of the Euro as the standard currency in participating European countries may also impact our ability to transact sales in U.S. dollars. 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. We do not know when or if EBV will give such notice. If fewer of our sales in Europe are transacted in U.S. dollars, we may experience an increase in currency translation adjustments, particularly as a result of general economic conditions in Europe as a whole. We have not historically engaged in currency hedging transactions or otherwise covered our foreign currency exposures.

In addition, we expect that many 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. In most cases, in the event of a 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.

#### **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. For example, although we generated net income ranging from \$84,000 to \$16.8 million during the years from 2000 to 2004, in 2005 we generated a net loss of \$19.7 million, and during the first six months of 2006 we generated additional losses of \$11.6 million. We expect to incur a substantial loss again for the full year 2006, and our future results may continue to fluctuate and may not meet analysts' expectations in some future period. As a result, the price of our common stock could fluctuate or decline. Some factors that could cause this variability, many of which are outside of our control, include the following:

- the complex revenue recognition rules relating to products such our NES system could require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period;
- revenue recognition for sales of our NES system products may be dependent on acceptance criteria determined by our NES system customers;
- our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;
- our future operating results will continue to be materially adversely effected by the expense required to be recorded under SFAS 123R, *Share-Based Payment*, which became effective in 2006;
- we may fail to meet analysts' expectations relating to our NES system and additional utility customers and applications;
- we may fail to meet analysts' expectations for revenue growth in our sales of LONWORKS Infrastructure products to OEMs, systems integrators, and other customers;
  - market prices for components or materials that we use in our products could fluctuate;
    - the rates at which OEMs purchase our products and services may fluctuate;
  - we may fail to introduce new products on a timely basis or before the end of an existing product's life cycle;
- 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;
- we may face increased competition for both our LONWORKS Infrastructure products and our NES products;
  - market acceptance of our products may decrease;
  - our customers may delay or cancel their orders;
- the mix of products and services that we sell may change to a less profitable mix;
  - shipment and payment schedules may be delayed;
  - our pricing policies or those of our competitors may change;



- we could incur costs associated with future business acquisitions, including up-front in-process research and development charges and ongoing amortization expenses related to other identified intangible assets;
  - we could incur ongoing operational expenses associated with future business acquisitions;
- the results of impairment tests that we will perform from time to time in the future, in accordance with SFAS 142, with respect to goodwill and other identified intangible assets that we acquired in the past or that we may acquire in the future may indicate that an impairment event has taken place. If so, we will be required to take an asset impairment charge that could have a material adverse effect on our operating results;
  - our product distribution may change; and
- product ratings by industry analysts and endorsements of competing products by industry groups could hurt the market acceptance of our products.

In addition, our expense levels are based, in significant part, on the future revenues that we expect. Consequently, if our revenues are less than we expect, our expense levels could be disproportionately high as a percentage of total revenues, which would negatively affect our profitability and cause our stock price to decline.

**Many of our competitors develop, support, and promote alternative control systems. If we are unable to promote and expand acceptance of our open, interoperable control systems, our revenues and operating results may be harmed.**

Many of our current and prospective 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. In some cases, companies have established associations or cooperative relationships to enhance the competitiveness and popularity of their products, or to promote these different or incompatible technologies, protocols and standards. For example, in the building automation market, we face widespread reluctance by vendors of traditional closed or proprietary control systems, who enjoy a captive market for servicing and replacing equipment, to use our interoperable technologies. We also face strong competition by large trade associations that promote alternative technologies and standards in their native countries, such as the Konnex Association in Belgium, and the European Installation Bus Association in Germany, each of which has over 100 members and licensees. Other examples include various industry groups who promote alternative open standards such as BACnet in the building market, DALI in the lighting controls market, Echonet in the home control market, and a group comprised of ABB, Adtranz/Bombardier, Siemens, GEC Alstrom and other manufacturers that support an alternative rail transportation protocol to our LONWORKS protocol. Our technologies, protocols, or standards may not be successful in any of our markets, and we may not be able to compete with new or enhanced products or standards introduced by existing or future competitors.

**Defects in or misuse of our products or other liabilities not covered by insurance may delay our ability to generate revenues and may 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 process. For example, many of the products we have sold to Enel remain under warranty, and Enel may claim that some of them are defective. Also, in NES trials, undetected errors may hinder our ability to win a subsequent tender. In addition, our customers or their installation partners may improperly install or implement our products. 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. As a result, errors or failures in our products, or the improper installation or implementation of our products by third parties, could harm our reputation, reduce our revenues, increase our expenses, and negatively impact our operating results and financial condition.



To address these issues, the agreements we maintain with our customers typically 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. For example, utility customers purchasing our NES system may require that we agree to indemnities or penalties in excess of the provisions we typically employ with our LONWORKS Infrastructure products, or that are not limited at all. Also, local laws may impose liability for NES system or other product failures, including liability for harm to property or persons. Such failures could harm our reputation, expose our company to liability, and adversely affect our operating results and financial position.

We may also experience losses or potential losses in the event of property damage, liability for harm to a third party's property or person, claims against our directors or officers, and the like. To help reduce our exposure to these types of claims, 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. For example, during 2000, the total limit for claims under our errors and omissions insurance policy was \$17.0 million. Since then, we have reduced the total limit for this line of coverage to \$10.0 million because we believed the premiums our insurers requested were excessive. We believe that the premiums for the types of insurance we carry will continue to fluctuate from period to period. In times of significant cost increases, this could result in increased costs or reduced limits. Consequently, if we elect to reduce our coverage further, or if we do not carry insurance for a particular type of claim, we will face increased exposure to these types of claims. If liability for a claim exceeds our policy limits, our operating results and our financial position would be negatively affected.

**We promote an open technology platform that could increase our competition.**

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 capable of developing 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, all of the network management commands required to develop software that competes with our LNS software are published. This could decrease the demand for our products and increase the competition that we face.

**Downturns in the control network technology market and related markets may decrease our revenues and margins.**

The market for our products depends on economic conditions affecting the broader control network technology and related markets. Downturns in these markets may cause our OEMs and system integrators to delay or cancel projects, reduce their production or reduce or cancel orders for our products. In this environment, customers may experience financial difficulty, cease operations or fail to budget for the purchase of our products. This, in turn, may lead to longer sales cycles, delays in payment and collection, and price pressures, causing us to realize lower revenues and margins. In particular, capital spending in the technology sector has decreased in past years, and many of our customers and potential customers have experienced declines in their revenues and operations. In addition, concerns with respect to terrorism and geopolitical issues in the Middle East and Asia have added more uncertainty to the current economic environment. We cannot predict the impact of these events, or of any related military action, on our customers or business. We believe that, in light of these events, some businesses may further curtail or may eliminate capital spending on control network technology altogether. If capital spending in our markets declines, or does not increase, it may be necessary for us to gain significant market share from our competitors in order to achieve our financial goals and return to profitability.

**If our OEMs do not employ our products and technologies our revenues could decrease significantly.**





To date, a substantial portion of our product sales has been to OEMs. The product and marketing decisions made by OEMs significantly affect the rate at which our products are used in control networks. We believe that because OEMs in certain industries receive a large portion of their revenues from sales of products and services to their installed base, these OEMs have tended to moderate the rate at which they incorporate LONWORKS technology into their products. They may believe that a more rapid transition to LONWORKS technology could harm their installed base business. Furthermore, OEMs that manufacture and promote products and technologies that compete or may compete with us may be particularly reluctant to employ our products and technologies to any significant extent, if at all. We may not be able to maintain or improve the current rate at which our products are accepted by OEMs and others, which could decrease our revenues.

**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. As of July 31, 2006, we have 95 issued U.S. patents, 12 pending U.S. patent applications, and various foreign counterparts. It is possible that patents will not issue from these pending applications or from any future applications or that, if issued, any claims allowed will not be sufficiently broad to protect our technology. In addition, we may not apply for or obtain patents in each country in which our technology may be used. 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 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 take all necessary steps 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 to obtain and use information that we regard as proprietary. Any of the patents, trademarks, copyrights or intellectual property rights that have been or may be issued or granted to us could be challenged, invalidated or circumvented, and any of the rights granted may not provide protection for our proprietary rights. 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. We have licensed in the past and may license in the future our key technologies to third parties. 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. For example, certain 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 of this litigation, 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 copying or otherwise obtaining and using our products or technology.

**If OEMs fail to develop interoperable products or if our targeted markets do not accept our interoperable products, we may be unable to generate sales of our products.**

Our future operating success will depend, in significant part, on the successful development of interoperable products by OEMs and us, and the acceptance of interoperable products by systems integrators and end-users. We have expended considerable resources to develop, market and sell interoperable products, and have made these products a cornerstone of our sales and marketing strategy. We have widely promoted interoperable products as offering benefits such as lower life-cycle costs and improved flexibility to owners and users of control networks. However, OEMs that manufacture and market closed systems may not accept, promote or employ interoperable products, since doing so may expose their businesses to increased competition. In addition, OEMs might not, in fact, successfully develop interoperable products, or their customers might not accept their interoperable products. If OEMs fail to develop interoperable products, or our markets do not accept interoperable products, our revenues and operating results will suffer.

**Our executive officers and technical personnel are critical to our business, and if we lose or fail to attract key personnel, we may not be able to successfully operate our business.**

Our performance 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. 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 necessary to enable our business to succeed. Our product development and marketing functions are largely based in Silicon Valley, which is typically 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 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 markets for our products are rapidly evolving. If we are not able to develop or enhance products to respond to changing market conditions, our revenues will suffer.**

Customer requirements for control network products can change as a result of innovations or changes within the building, industrial, transportation, utility/home and other industries. For example, our NES system offering to utilities is new. Also, new or different standards within industry segments may be adopted, giving rise to new customer requirements. These customer requirements may or may not be compatible with our current or future product offerings. Our future success depends in large part on our ability to continually enhance our existing product offerings, lower the market price for our products, and develop new products that maintain technological competitiveness. We may not be successful in modifying our products and services to address these requirements and standards. For example, certain of our competitors may develop competing technologies based on Internet Protocols (IP) that could have, or could be perceived to have, advantages over our products in remote monitoring or other applications. As another example, many competitors promote media types, such as radio frequency (wireless) and fiber optics that, even if used with LONWORKS technology, could displace sales of certain of our transceiver products. If we are not able to develop or enhance our products to respond to these changing market conditions, our revenues and results of operations will suffer.

In addition, due to the nature of development efforts in general, we often experience delays in the introduction of new or improved products beyond our original projected shipping date for such products. Historically, when these delays have occurred, we experienced an increase in our development costs and a delay in our ability to generate revenues from these new products. We believe that similar new product introduction delays in the future could also increase our costs and delay our revenues.

**The trading price of our stock has been volatile, and may fluctuate due to factors beyond our control.**  
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The trading price of our common stock is subject to significant fluctuations in response to numerous factors, including:

- significant stockholders may sell some or all of their holdings of our stock. For example, Enel presently owns 3,000,000 shares, or approximately 7.6% of our outstanding common stock. Enel is generally free to sell these shares at its discretion. In the event Enel, or any other significant stockholder, elects to sell all or a portion of their holdings in our shares, such sale or sales could depress the market price of our stock during the period in which such sales are made;
- investors may be concerned about our ability to develop additional customers for our NES system products and the success we have selling our LONWORKS Infrastructure products and services to OEMs, systems integrators, and other customers;
- investors may be concerned about the expense that we will be required to record for stock options and other stock-based incentives provided to our employees;
  - competitors may announce new products or technologies;
  - our quarterly operating results may vary widely;
  - we or our customers may announce technological innovations or new products;
  - securities analysts may change their estimates of our financial results; and
- increases in market interest rates, which generally have a negative impact on stock prices.

In addition, the market price of securities of technology companies, especially those in rapidly evolving industries such as ours, has been very volatile in the past. This volatility in any given technology company's stock price has often been unrelated or disproportionate to the operating performance of that particular company.

**Voluntary standards that are established in our markets could limit our ability to sell our products and reduce our revenues.**

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. Some of our competitors have attempted to use voluntary standards to reduce the market opportunity for our products, or to increase the market opportunity for their own products, by lobbying for the adoption of voluntary standards that would exclude or limit the use of products that incorporate our technology. 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. The adoption of voluntary standards that are incompatible with our products or technology could limit the market opportunity for our products. If the markets we target were to adopt voluntary standards that are incompatible with our products or technology, either inadvertently or by design, our revenues, operating results, and financial condition would be adversely affected.

**Regulatory actions could limit our ability to market and sell our products.**

Many of our products and the industries in which they are used are subject to U.S. and foreign regulation. Government regulatory action could greatly reduce the market for our products. 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.

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

As of July 31, 2006, 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 36.0% of our outstanding stock.

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Under the stock purchase agreement with Enel, which transaction was completed September 11, 2000, Enel purchased 3.0 million newly issued shares of our common stock and was granted the right to nominate a director to our board of directors. As a condition to the closing of the stock purchase agreement, our directors and our Chief Financial Officer agreed to enter into a voting agreement with Enel in which each of them agreed to vote the shares of our company's common stock that they beneficially owned or controlled in favor of Enel's nominee to our board of directors. In addition, under the terms of the stock purchase agreement, Enel has agreed to (i) vote (and cause any of its affiliates that own shares of our common stock to vote) all of its shares in favor of the slate of director nominees recommended by the board of directors, and (ii) vote (and endeavor to cause any of its affiliates that own shares of our common stock to vote) a number of shares equal to at least that percentage of shares voted by all other stockholders for or against any specified matter, as recommended by the board of directors. The specified matters are the election of accountants, the approval of company option plans, and any proposal by any of our stockholders (unless the proposal could be prejudicial to Enel or the required voting would interfere with Enel's fiduciary duties to its own shareholders).

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.

**Potential conflicts of interest could limit our ability to act on opportunities that are adverse to a significant stockholder or its affiliates.**

From time to time, we may enter into a material contract with a person or company that owns a significant amount of our company's stock. As circumstances change, we may develop conflicting priorities or other conflicts of interest with the significant stockholder with regard to the contract, or the significant stockholder may exert or attempt to exert a significant degree of influence over our management and affairs. The significant stockholder might exert or attempt to exert this influence in its capacity as a significant stockholder or, if the significant stockholder has a representative on our board of directors, through that Board member.

For example, we entered into the Contatore Elettronico project with an affiliate of Enel. Enel currently owns 3.0 million shares of our common stock, representing approximately 7.6% of our outstanding common stock. Enel also has the right to nominate a member of our board of directors as long as Enel owns at least 2.0 million shares of our common stock. As a consequence of the expiration of his mandate as Enel's Chief Executive Officer, Mr. Francesco Tatò resigned his board membership in all of Enel's subsidiaries and affiliates, including Echelon. Mr. Tatò served on our board of directors as a representative of Enel from September 2000 until September 2002. Enel has reserved its right to nominate a new member of our board of directors, who must be approved by us, to fill the vacancy created by the resignation of Enel's former board representative to our board of directors. During the term of service of Enel's former board representative from September 2000 to September 2002, Enel's representative on our Board abstained from resolutions on any matter relating to Enel. A member of our board of directors who is also an officer of or is otherwise affiliated with Enel may decline to take action in a manner that might be favorable to us but adverse to Enel. Conflicts that could arise might concern the Contatore Elettronico project with Enel and other matters where Enel's interest may not always coincide with our interests or the interests of our other stockholders. Any of those conflicts could lead to litigation and could otherwise significantly and adversely affect our financial condition and results of operations.

**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. Many of our operations are subject to these risks, particularly our operations located in California. In past years, we experienced temporary power losses in our California facilities due to power shortages that have disrupted our operations, and we may in the future experience additional power losses that could disrupt our operations. While the impact to our business and operating results has not been material, it is possible that power losses will adversely affect our business in the future, or that the cost of acquiring sufficient power to run our business will increase significantly. Similarly, a natural disaster 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.

The outbreak of severe acute respiratory syndrome, or SARS, that began in China, Hong Kong, Singapore, and Vietnam in 2003 also had a negative impact on our business. Any future outbreak of SARS, or other widespread communicable disease pandemics such as avian influenza, more commonly known as bird flu, 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 SARS or other health-related disruptions at our third-party contract manufacturers or other key suppliers, many of whom are located in China and other parts of southeast Asia, could affect our ability to supply our customers with products in a timely manner, which would harm our results of operations.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

We have not experienced any material change in our exposure to interest rate and foreign currency risks since the date of our Annual Report on Form 10-K for the year ended December 31, 2005.

*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 currently 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 10 percent from levels at June 30, 2006 and June 30, 2005, the fair value of the portfolio would decline by an immaterial amount. We currently intend to hold our fixed income investments until maturity, 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. If necessary, we may sell 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. If foreign exchange rates were to fluctuate by 10% from rates at June 30, 2006, and June 30, 2005, our financial position and results of operations would not be materially affected. However, we could experience a material impact in the future.

### **ITEM 4. CONTROLS AND PROCEDURES**

Our review of our internal controls over financial reporting was made within the context of the relevant professional auditing standards defining “internal controls over financial reporting,” “reportable conditions,” and “material weaknesses.” As part of our evaluation of internal controls over financial reporting, we also address other, less significant control matters that we or our auditors identify, and we determine what revision or improvement to make, if any, in

accordance with our on-going procedures.

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***Limitations on the Effectiveness of Controls***

Since we began reviewing our internal controls over financial reporting, we have identified a number of procedures where an opportunity to improve our internal controls existed. As part of our ongoing effort to maximize our internal controls over financial reporting, each of these control improvement opportunities has been, or is in the process of being, remediated by management.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our “disclosure controls and procedures” (as defined in the Securities Exchange Act of 1934, or the Exchange Act, Rules 13a-15(e) and 15d-15(e)) or our internal controls over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected.

***Conclusions Regarding Disclosure Controls and Procedures and Internal Controls Over Financial Reporting***

Our CEO and our CFO have reviewed our disclosure controls and procedures and our internal controls over financial reporting in order to both evaluate their effectiveness and to ensure they have been designed to provide reasonable assurance of achieving their objectives, which is to make sure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms. Based on this evaluation, they have concluded that as of June 30, 2006, our disclosure controls and procedures and our internal controls over financial reporting are effective at this reasonable assurance level.

***Changes in Internal Controls Over Financial Reporting***

There were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended June 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

For a discussion regarding our legal proceedings and matters, please refer to the “Legal Actions” section of Note 6, Commitments and Contingencies, to our condensed consolidated financial statements included under Item 1 of Part I, Financial Information, which information is incorporated herein by reference.

**ITEM 1A. RISK FACTORS**

A restated description of the risk factors associated with our business is included under “Risk Factors” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” contained in Item 2 of Part I of this report. This restated description includes any material changes to and supersedes the description of the risk factors associated with our business previously disclosed in Part I Item 1A of our 2005 Annual Report on Form 10-K and in Part II Item 1A of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, and is incorporated herein by reference.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table provides information about the repurchase of our common stock during the quarter ended June 30, 2006:

| <b>Period</b>     | <b>Total Number of Shares Purchased</b> | <b>Average Price Paid per Share</b> | <b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b> | <b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b> |
|-------------------|---|-------------------------------------|---|---|
| April 1- April 30 | ---(1)                                  | ---                                 | 1,529,711(1)  | 1,470,289   |
| May 1- May 31     | 197,743                                 | \$ 7.97                             | 1,727,454   | 1,272,546   |
| June 1- June 30   | ---                                     | ---                                 | 1,727,454   | 1,272,546   |
| Total             | 197,743                                 | \$ 7.97                             | 1,727,454   | 1,272,546   |

(1) Shares repurchased in open-market transactions under the stock repurchase program approved by our board of directors in March 2004 and August 2004. The program 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. During the quarter ended June 30, 2006, we repurchased 197,743 shares under the program at a cost of \$1.6 million. Since inception, we have repurchased a total of 1,727,454 shares under the program at a cost of \$12.3 million. The stock repurchase program will expire in March 2007.

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

The Company held its annual meeting of stockholders on April 21, 2006. At such meeting, the following directors were elected: Robert J. Finocchio, Jr., Armas Clifford Markkula, Jr., and Robert R. Maxfield. Our incumbent directors, M. Kenneth Oshman, Richard M. Moley, Betsy Rafael, and Larry W. Sonsini will continue to serve on the Board. Voting results for the election of the directors were as follows:

|                              | Votes For  | Votes Withheld |
|------------------------------|------------|----------------|
| Robert J. Finocchio, Jr.     | 33,676,766 | 118,027        |
| Armas Clifford Markkula, Jr. | 32,906,215 | 888,578        |
| Robert R. Maxfield           | 32,912,640 | 882,153        |

The only other matter submitted to stockholder vote at the Annual Meeting was the ratification of the appointment of KPMG LLP as independent auditors of the Company for the fiscal year ending December 31, 2006. Voting results for the KPMG LLP appointment were as follows:

| Votes For: | Votes Against: | Abstain: |
|------------|----------------|----------|
| 33,697,343 | 64,842         | 32,607   |

**ITEM 6. EXHIBITS**

Exhibit

- | No.  | Description of Document   |
|------|---|
| 31.1 | <u>Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>  |
| 31.2 | <u>Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>  |
| 32   | <u>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, furnished herewith.</u> |

**SIGNATURE**

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.

Date: August 9, 2006

**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)

**EXHIBIT INDEX**

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