ECHELON CORP
Form 10-Q/A
May 16, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q/A

AMENDMENT NO. 1

(Mark one)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2007

OR

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

000-29748

(Commission file number)

ECHELON CORPORATION

(Exact name of registrant as specified in its charter)

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

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

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨ (do not check if a smaller reporting company)	Smaller reporting company ¨

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

Yes ¨ No x

As of July 31, 2007, 39,779,015 shares of the registrant s common stock were outstanding.

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FOR THE QUARTER ENDED JUNE 30, 2007

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EXPLANATORY NOTE

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

The effects of all restatement adjustments on our condensed consolidated balance sheets as of June 30, 2007 and December 31, 2007 and 2006 are as follows:

		December 31,	
	June 30, 2007	2007	2006
Increase in total assets	$ 13.6 million	$ 12.3 million	$ 15.0 million
Increase in total liabilities	$ 16.6 million	$ 15.2 million	$ 17.9 million
Increase in additional paid-in-capital	$ 1.1 million	$ 2.0 million	$ 0.8 million
Increase in accumulated deficit	$ 4.1 million	$ 4.9 million	$ 3.7 million

The effects of all restatement adjustments on our condensed consolidated statements of operations for the three- and six-month periods ended June 30, 2007 and 2006 are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Decrease in rent expense	$ 1.0 million	$ 1.0 million	$ 2.0 million	$ 2.0 million
Increase in depreciation expense	$ 0.7 million	$ 0.7 million	$ 1.4 million	$ 1.4 million
Increase in stock-based compensation expense	$ 0.2 million	$ 0.2 million	$ 0.4 million	$ 0.3 million
Increase in interest expense	$ 0.3 million	$ 0.3 million	$ 0.6 million	$ 0.7 million
Increase in net loss	$ 0.2 million	$ 0.2 million	$ 0.4 million	$ 0.4 million

Included in Note 2 of Notes to Condensed Consolidated Financial Statements in this Report are tables that present the effects of all restatement adjustments on the condensed consolidated financial statements reconciling the previously reported data to the as restated data for the Condensed Consolidated Balance Sheets as of June 30, 2007 and December 31, 2006, and the Condensed Consolidated Statements of Operations and Cash Flows for the three- and six-month periods ended June 30, 2007 and 2006. The restatements are further discussed below.

Restatement of stock-based compensation expense: During the preparation of our financial results for the quarter ended March 31, 2008, we identified an error in our previously reported stock-based compensation expense for the years ended December 31, 2007, 2006 and 2005, and each of the quarterly periods in 2007 and 2006. The error was isolated to share awards and does not affect the other forms of our equity compensation awards, namely stock options and stock-settled stock appreciation rights. While the grant date fair value of the share awards was determined correctly in accordance with Statement of Financial Accounting Standard (SFAS) No. 123R (revised 2004), *Share-Based Payment*, the amount of expense associated with these awards that was recognized in 2007, 2006 and 2005 was not correct. The error was caused by a misapplication of the widely-used equity compensation software application we use to manage and account for our equity compensation awards. This misapplication caused the expense associated with these share awards to be calculated using the straight-line, single-option method rather than the accelerated, multiple-option method, which we had elected to use for all of our equity compensation awards. Use of the straight-line, single-option method resulted in understatements of stock-based compensation expense in 2007, 2006 and 2005 of $1.2 million, $535,000 and $263,000, respectively. For the three months ended June 30, 2007 and 2006, stock-based compensation expense was understated by $188,000 and $164,000, respectively. For the six months ended June 30, 2007 and 2006, stock-based compensation expense was understated by $341,000 and $309,000, respectively.

Restatement related to the leases of our San Jose, California headquarters facilities: In connection with the restatement of stock-based compensation expense, KPMG LLP, our independent registered public accounting firm, brought to our attention that we had inappropriately accounted for the leases of our corporate headquarters facilities that were entered into in 1999 and 2001. Under the guidance in Emerging Issues Task Force Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction* (EITF 97-10), and SFAS No. 98, *Accounting for Leases:*

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Sale-Leaseback transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; Initial Direct Costs of Direct Financing Leases; an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11 (SFAS 98), we should have reflected an asset on our balance sheet for the costs paid by the lessor to construct our headquarters facilities, as well as a corresponding liability, because we were the deemed owner of the headquarters facilities for accounting purposes during the construction periods. Upon completion of construction, we did not meet the sale-leaseback criteria under SFAS 98 and therefore should have treated the leases as financing obligations and the assets and corresponding liabilities would not be derecognized. We had historically accounted for these leases as operating leases under SFAS No. 13, *Accounting for Leases* (SFAS 13), whereby the total minimum lease payment obligations under the leases were recognized as monthly rent expense on a straight-line basis over the terms of the leases. The restatement adjustments do not affect the total cash payments we have made or are obligated to make under the lease agreements, nor do they change the total expense to be recognized over the lease terms. However, the timing and nature of expenses in the statement of operations is different under this treatment as compared to operating lease treatment. Specifically, we should have recognized land lease expense, depreciation expense on the assets we are deemed to own and interest expense on the associated lease financing obligations. For a more detailed description of the effects on our condensed consolidated financial statements, see Note 2 of Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this Report.

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

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

The Company will also file amendments to its 2007 Form 10-K and Forms 10-Q for each of the quarters ended March 31 and September 30, 2007. The amended 2007 filings will include restated information for periods affected by these restatements.

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

FORWARD-LOOKING INFORMATION

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

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

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PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ECHELON CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

	June 30, 2007 (As Restated)[1]	December 31, 2006 (As Restated)[1]
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 37,577	$ 37,412
Short-term investments	79,887	86,745
Accounts receivable, net	18,161	13,918
Inventories	9,466	11,359
Deferred cost of goods sold	7,370	19,060
Other current assets	2,113	2,138
Total current assets	154,574	170,632
Property and equipment, net	30,270	30,405
Goodwill	8,340	8,278
Other long-term assets	1,916	1,957
TOTAL ASSETS	$ 195,100	$ 211,272
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 7,122	$ 6,893
Accrued liabilities	5,498	4,796
Current portion lease financing obligations	2,736	2,579
Deferred revenues	16,518	26,843
Total current liabilities	31,874	41,111
LONG-TERM LIABILITIES:		
Lease financing obligations, net of current portion	14,643	16,052
Deferred rent	417	446
Total long-term liabilities	15,060	16,498
STOCKHOLDERS EQUITY:		
Common stock	421	416
Additional paid-in capital	288,972	283,728
Treasury stock	(19,259)	(19,259)

Accumulated other comprehensive income	1,118	997
Accumulated deficit	(123,086)	(112,219)
Total stockholders equity	148,166	153,663
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 195,100	$ 211,272

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

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007 (As Restated)[1]	2006 (As Restated)[1]	2007 (As Restated)[1]	2006 (As Restated)[1]
REVENUES:				
Product	$ 26,437	$ 19,209	$ 65,514	$ 29,783
Service	259	165	451	336
Total revenues	26,696	19,374	65,965	30,119
COST OF REVENUES:				
Cost of product [2]	15,331	7,306	43,965	11,871
Cost of service [2]	505	443	988	879
Total cost of revenues	15,836	7,749	44,953	12,750
GROSS PROFIT	10,860	11,625	21,012	17,369
OPERATING EXPENSES:				
Product development [2]	8,118	7,142	15,896	14,101
Sales and marketing [2]	4,968	5,108	10,395	10,270
General and administrative [2]	4,163	3,664	7,731	6,929
Total operating expenses	17,249	15,914	34,022	31,300
LOSS FROM OPERATIONS	(6,389)	(4,289)	(13,010)	(13,931)
INTEREST AND OTHER INCOME, NET	1,488	1,404	2,985	2,798
INTEREST EXPENSE ON LEASE FINANCING OBLIGATIONS	(308)	(350)	(627)	(710)
LOSS BEFORE PROVISION FOR INCOME TAXES	(5,209)	(3,235)	(10,652)	(11,843)
INCOME TAX EXPENSE	107	80	215	160
NET LOSS	$ (5,316)	$ (3,315)	$ (10,867)	$ (12,003)
NET LOSS PER SHARE:				
Basic	$ (0.13)	$ (0.08)	$ (0.28)	$ (0.30)
Diluted	$ (0.13)	$ (0.08)	$ (0.28)	$ (0.30)
SHARES USED IN COMPUTING NET LOSS PER SHARE:				
Basic	39,508	39,615	39,368	39,691
Diluted	39,508	39,615	39,368	39,691

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

[2] Amounts include stock-based compensation costs as follows (as restated) [1]:

Cost of product	$ 162	$ 119	$ 309	$ 246
Cost of service	11	14	27	30
Product development	510	550	992	1,219
Sales an				