ECHELON CORP
Form 10-Q
May 10, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended March 31, 2012

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 April 30, 2012, 42,620,489 shares of the registrant s common stock were outstanding.

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ECHELON CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2012

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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 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)

	March 31, 2012	December 31, 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 20,446	$ 17,658
Short-term investments	37,990	40,998
Accounts receivable, net	25,673	35,215
Inventories	18,372	11,125
Deferred cost of goods sold	1,100	6,536
Other current assets	2,568	4,044
Total current assets	106,149	115,576
Property and equipment, net	26,249	27,201
Goodwill	8,305	8,235
Other long-term assets	709	693
Total assets	$ 141,412	$ 151,705
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 16,298	$ 18,313
Accrued liabilities	5,260	7,755
Current portion of lease financing obligations	2,042	1,870
Deferred revenues	7,106	12,716
Total current liabilities	30,706	40,654
LONG-TERM LIABILITIES:		
Lease financing obligations, excluding current portion	19,701	20,193
Other long-term liabilities	1,706	1,750
Total long-term liabilities	21,407	21,943
STOCKHOLDERS EQUITY:		
Common stock	458	457
Additional paid-in capital	349,500	346,952
Treasury stock	(28,130)	(28,130)
Accumulated other comprehensive income	454	244
Accumulated deficit	(232,983)	(230,415)

Total stockholders equity	89,299	89,108
Total liabilities and stockholders equity	$ 141,412	$ 151,705

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
REVENUES:		
Product	$ 39,486	$ 27,679
Service	847	703
Total revenues [2]	40,333	28,382
COST OF REVENUES:		
Cost of product [1]	22,450	14,652
Cost of service [1]	585	587
Total cost of revenues	23,035	15,239
Gross profit	17,298	13,143
OPERATING EXPENSES:		
Product development [1]	8,801	9,598
Sales and marketing [1]	6,157	7,242
General and administrative [1]	4,346	4,890
Total operating expenses	19,304	21,730
Loss from operations	(2,006)	(8,587)
Interest and other income (expense), net	(264)	(360)
Interest expense on lease financing obligations	(351)	(377)
Loss before provision for income taxes	(2,621)	(9,324)
Income tax benefit	(53)	(5)
NET LOSS	$ (2,568)	$ (9,319)
Net loss per share:		
Basic	$ (0.06)	$ (0.22)
Diluted	$ (0.06)	$ (0.22)
Shares used in computing net loss per share:		
Basic	42,323	41,783
Diluted	42,323	41,783

[1] See Note 4 for summary of amounts included representing equity compensation expense.

[2] Includes related party amounts of $227 and $1,169 for the three months ended March 31, 2012 and 2011, respectively. See Note 11 for additional information on related party transactions.

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(In thousands)

(Unaudited)

	Three Months Ended March 31,	
	2012	2011
Net loss	$ (2,568)	$ (9,319)
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustments	210	476
Unrealized holding gains (losses) on available-for-sale securities	0	(5)
Comprehensive loss	$ (2,358)	$ (8,848)

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended March 31,	
	2012	2011
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net loss	$ (2,568)	$ (9,319)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,352	1,529
Reduction of allowance for doubtful accounts	(60)	(36)
Loss on disposal of fixed assets	0	8
Reduction of accrued investment income	13	17
Stock-based compensation	2,817	3,185
Change in operating assets and liabilities:		
Accounts receivable	9,570	2,665
Inventories	(7,267)	(1,240)
Deferred cost of goods sold	5,433	(1,401)
Other current assets	1,486	850
Accounts payable	(1,915)	(1,018)
Accrued liabilities	(2,567)	(926)
Deferred revenues	(5,573)	3,056
Deferred rent	(12)	14
Net cash provided by (used in) operating activities	709	(2,616)
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchases of available-for-sale short-term investments	(24,986)	(14,979)
Proceeds from maturities and sales of available-for-sale short-term investments	27,982	19,948
Change in other long-term assets	(8)	0
Capital expenditures	(360)	(594)
Net cash provided by investing activities	2,628	4,375
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Principal payments of lease financing obligations	(469)	(417)
Proceeds from exercise of stock options	0	118
Repurchase of common stock from employees for payment of taxes on vesting of restricted stock units and upon exercise of stock options	(246)	(508)
Net cash used in financing activities	(715)	(807)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	166	346
NET INCREASE IN CASH AND CASH EQUIVALENTS	2,788	1,298
CASH AND CASH EQUIVALENTS:		
Beginning of period	17,658	7,675

End of period	$ 20,446	$ 8,973
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest on lease financing obligations	$ 349	$ 375
Cash paid for income taxes	$ 56	$ 108

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Summary of Significant Accounting Policies:

Basis of Presentation

The condensed consolidated financial statements include the accounts of Echelon Corporation (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, 2011 included in its Annual Report on Form 10-K.

There have been no material changes to the Company s significant accounting policies as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Risks and Uncertainties

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

The Company s sales are currently concentrated with a relatively small group of customers, as approximately 66% of net revenues for the quarter ended March 31, 2012 was derived from three customers. Customers in any of the Company s target market sectors may experience unexpected reductions in demand for their products and consequently reduce their purchases from us, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. In addition, if any of these customers are unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to the Company.

The Company utilizes third-party contract electronic manufacturers to manufacture, assemble, and test its products. As a result of current credit market conditions, if any of these third-parties were unable to obtain the necessary capital to operate their business, they may be unable to provide the Company with timely services or to make timely deliveries of products.

Due to the continuing worldwide economic situation, coupled with the fact that the Company s Systems customers generally procure products that have been customized to meet their requirements, the Company has limited visibility into ultimate product demand, which makes sales forecasting more difficult. As a result, anticipated demand may not materialize, which could subject the Company to increased levels of excess and obsolete inventories.

The Company has historically experienced shortages or interruptions in supply for certain products or components used in the manufacture of the Company s products that have been or will be discontinued. In order to ensure an adequate supply of these items, the Company has occasionally purchased quantities of these items that are in excess of the Company s then current estimate of short-term requirements. If the long-term requirements do not materialize as originally expected, and the Company is not otherwise able to dispose of these excess

products or components, it could subject the Company to increased levels of excess and obsolete inventories. For example, to ensure supply, the Company procured a substantial quantity of a certain component used in one of its Systems products. If the long-term requirements do not materialize as originally expected, or if the Company develops alternative solutions that no longer employ these items and the Company is not able to dispose of these excess products or components, it could subject the Company to increased levels of excess and obsolete inventories.

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Use of Estimates

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

Recently Issued Accounting Standards

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-05, *Comprehensive Income (ASC Topic 220) Presentation of Comprehensive Income.* The amendments from this update will result in more converged guidance on how comprehensive income is presented under U.S. GAAP and International Financial Reporting Standards (IFRS). With this update to ASC 220, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In either option, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The amendments in this update do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor does it affect how earnings per share is calculated or presented. Previously, U.S. GAAP allowed reporting entities three alternatives for presenting other comprehensive income and its components in financial statements. One such alternative was to present the components of other comprehensive income as part of the statement of changes in stockholders equity. This ASU eliminates that option. The amended guidance also requires presentation of adjustments for items that are reclassified from other comprehensive income to net income in the statement where the components of net income and the components of other comprehensive income are presented. The amendments in this ASU should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. In December 2011 the FASB decided to defer the requirement to present reclassifications of other comprehensive income on the face of the income statement. The Company s adoption of this guidance as of January 1, 2012 did not have a material impact on its condensed consolidated financial position, results of operations or cash flows.

Revenue Recognition

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

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

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

The Company s multiple deliverable revenue arrangements are primarily related to sales of its Systems products, which may include, within a single arrangement, electricity meters and data concentrators (collectively, the Hardware); NES system software; Element Manager software; post-contract customer support (PCS) for the NES system and Element Manager software; extended warranties for the Hardware; and, occasionally, specified enhancements or upgrades to software used in the NES system. For arrangements originating or materially modified after December 31, 2009, with the exception of the NES system software, each of these deliverables is considered a separate unit of accounting. The NES system software functions together with an electricity meter to deliver its essential functionality and any related software license fee is

charged for on a per meter basis. Therefore, the NES system software and an electricity meter are combined and considered a single unit of accounting. The Element Manager software is not considered to be part of an electricity meter s essential functionality and, therefore, Element Manager software and any related PCS continues to be accounted for under industry specific software revenue recognition guidance. However, all other NES system deliverables are no longer within the scope of industry specific software revenue recognition guidance.

The Company allocates revenue to each element in a multiple-element arrangement based upon their relative selling price. The Company determines the selling price for each deliverable using vendor specific objective evidence (VSOE) of selling price or third party evidence (TPE) of selling price, if it exists. If neither VSOE nor TPE of selling price exists for a deliverable, the Company uses its best estimated selling price (BESP) for that deliverable. Since the use of the residual method is eliminated under the new accounting standards, any discounts offered by the Company are allocated to each of the deliverables. Revenue allocated to each element is then recognized when the basic revenue recognition criteria is met for the respective element.

Consistent with its methodology under previous accounting guidance, if available, the Company determines VSOE of fair value for each element based on historical stand-alone sales to third parties or from the stated renewal rate for the elements contained in the initial contractual arrangement. The Company currently estimates selling prices for its PCS and extended warranties based on VSOE of fair value.

In many instances, the Company is not currently able to obtain VSOE of fair value for all deliverables in an arrangement with multiple elements. This may be due to the Company infrequently selling each element separately or not pricing products within a narrow range. When VSOE cannot be established, the Company attempts to estimate the selling price of each element based on TPE. TPE would consist of competitor prices for similar deliverables when sold separately. Generally, the Company s offerings contain significant differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, the Company is unable to reliably determine the stand-alone selling prices for similar products of its competitors. Therefore, the Company is typically not able to obtain TPE of selling price.

When the Company is unable to establish a selling price using VSOE or TPE, which is generally the case for the Hardware and certain specified enhancements or upgrades to the Company s NES software, the Company uses its BESP in determining the allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. BESP is generally used for offerings that are not typically sold on a stand-alone basis or for new or highly customized offerings.

The Company establishes pricing for its products and services by considering multiple factors including, but not limited to, geographies, market conditions, competitive landscape, internal costs, gross margin objectives, and industry pricing practices. The determination of pricing also includes consultation with and formal approval by the Company s management, taking into consideration the Company s go-to-market strategy. These pricing practices apply to both the Company s Hardware and software products.

Based on an analysis of pricing stated in contractual arrangements for its Hardware products in historical multiple-element transactions and, to a lesser extent, historical standalone transactions, the Company has concluded that it typically prices its Hardware within a narrow range of discounts when compared to the price listed on the Company s standard pricing grid for similar deliverables (i.e., similar configuration, volume, geography, etc.). Therefore, the Company has determined that, for its current Hardware for which VSOE or TPE is not available, the Company s BESP is generally comprised of prices based on a narrow range of discounts from pricing stated in its pricing grid.

When establishing BESP for the Company s specified software enhancements or upgrades, the Company considers multiple factors including, but not limited to, the relative value of the features and functionality being delivered by the enhancement or upgrade as compared to the value of the software product to which the enhancement or upgrade relates, as well as the Company s pricing practices for NES system software PCS packages, which may include rights to the specified enhancements or upgrades.

The Company regularly reviews VSOE and has established a review process for TPE and BESP. The Company maintains internal controls over the establishment and updates of these estimates. There were no material impacts during the three months ended March 31, 2012, resulting from changes in VSOE, TPE, or BESP, nor does the Company expect a material impact from such changes in the near term.

For multiple element arrangements that were entered into prior to January 1, 2010 and that included NES system and/or Element Manager software, the Company deferred the recognition of all revenue until all software required under the arrangement had been delivered to the customer. Once the software was delivered, the Company recognized revenues for the Hardware and software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators was disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators was deferred until such time as additional deliveries of meters or data concentrators had occurred. Revenues for PCS on the NES system and Element Manager software, as well as for extended warranties on Systems Hardware products, were recognized ratably over the associated service period, which generally commenced upon the later of the delivery of all software, or the customer s acceptance of any given Hardware shipment.

As of March 31, 2012 and December 31, 2011, approximately $2.9 million and $9.4 million, respectively, of the Company s Systems revenue was deferred. This decrease in deferred revenues was primarily due to a change in the timing of revenue recognition for certain of the Company s Systems products, which resulted from the Company s ability to objectively demonstrate that the contractual acceptance criteria for these products was met at the time of delivery. All of the deferred revenue at March 31, 2012 and December 31, 2011 relates to revenue that is being accounted for under the revenue recognition guidance applicable to transactions entered into after December 31, 2009.

Deferred Revenue and Deferred Cost of Goods Sold

Deferred revenue consists substantially of amounts billed or payments received in advance of revenue recognition. Deferred cost of goods sold related to deferred product revenues includes direct product costs and applied overhead. Deferred cost of goods sold related to deferred service revenues includes direct labor costs and applied overhead. Once all revenue recognition criteria have been met, the deferred revenues and associated cost of goods sold are recognized.

2. Financial Instruments

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

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On a recurring basis, the Company measures certain of its financial assets, namely its cash equivalents and available-for-sale investments, at fair value. The Company does not have any financial liabilities measured at fair value on a recurring basis. The fair value of the Company s financial assets measured at fair value on a recurring basis was determined using the following inputs at March 31, 2012 (in thousands):

		Fair Value Measurements at Reporting Date Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds [1]	$ 5,218	$ 5,218	$	$
Fixed income available-for-sale securities: [2]				
U.S. government securities	42,990		42,990	
Total fixed income available-for-sale securities	42,990		42,990	
Total	$ 48,208	$ 5,218	$ 42,990	$

The fair value of the Company s financial assets measured at fair value on a recurring basis was determined using the following inputs at December 31, 2011 (in thousands):

		Fair Value Measurements at Reporting Date Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds [1]	$ 5,215	$ 5,215	$	$
Fixed income available-for-sale securities: [2]				
U.S. government securities	45,999		45,999	
Total fixed income available-for-sale securities	45,999		45,999	
Total	$ 51,214	$ 5,215	$ 45,999	$

(1) Included in cash and cash equivalents in the Company s condensed consolidated balance sheets

(2) Included in either cash and cash equivalents or short-term investments in the Company s condensed consolidated balance sheets

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

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

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As of March 31, 2012, the Company s available-for-sale securities had contractual maturities from three to seven months and an average remaining term to maturity of three months. As of March 31, 2012, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses of the Company s short-term investments by major security type were as follows (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. government and agency securities	$ 42,988	$ 42,990	$ 2	$ 0
Total investments in debt securities	$ 42,988	$ 42,990	$ 2	$ 0

Market values were determined for each individual security in the investment portfolio. Any decline in value of these investments is primarily related to changes in interest rates and is considered to be temporary in nature. The Company reviews its investments on a regular basis to evaluate whether or not any have experienced an other-than-temporary decline in fair value.

3. Earnings Per Share

The following is a reconciliation of the numerators and denominators of the basic and diluted net loss per share computations for the three months ended March 31, 2012 and 2011 (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2012	2011
Net loss (Numerator):		
Net loss, basic and diluted	$ (2,568)	$ (9,319)
Shares (Denominator):		
Weighted average common shares outstanding	42,323	41,783
Shares used in basic computation	42,323	41,783
Common shares issuable upon exercise of stock options (treasury stock method)		
Shares used in diluted computation	42,323	41,783
Net loss per share:		
Basic	$ (0.06)	$ (0.22)
Diluted	$ (0.06)	$ (0.22)

For the three months ended March 31, 2012 and 2011, 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, stock appreciation rights, restricted stock units (RSUs), and restricted stock awards (RSAs) excluded from this calculation for the three months ended March 31, 2012 and 2011 was 5,274,279, and 6,080,834, respectively.

4. Stockholders Equity and Employee Stock Option Plans:

Common Stock

In April 2008, the Company s board of directors approved a stock repurchase program, which authorized the Company to repurchase up to 3.0 million shares of the Company s common stock. Since inception, the Company repurchased a total of 750,000 shares under the program at a cost of $8.9 million. The stock repurchase program expired in April 2011.

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Stock-based Compensation Expense

The following table summarizes stock-based compensation expense for the three months ended March 31, 2012 and 2011 and its allocation within the condensed consolidated statements of operations (in thousands):

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Cost of revenues:		
Cost of product	$ 249	$ 294
Cost of service	36	22
Operating expenses:		
Product development	1,045	1,006
Sales and marketing	661	807
General and administrative	826	1,056
Total	$ 2,817	$ 3,185

Stock Award Activity

The total intrinsic value of options exercised during the three months ended March 31, 2012 was $0 as there were no options exercised during this period. The total intrinsic value of options exercised during the three months ended March 31, 2011 was approximately $349,000. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the shares.

The total fair value of RSUs vested and released during the quarter ended March 31, 2012 was approximately $676,000. The total fair value of RSUs vested and released during the quarter ended March 31, 2011 was approximately $848,000. The fair value is calculated by multiplying the fair market value of the Company s stock on the vesting date by the number of shares vested.

Equity Compensation Expense for Awards with Financial-Based Performance Vesting Requirements

As of March 31, 2012, there were 252,500 non-vested RSUs and RSAs that were subject to service-based vesting conditions as well as certain financial or other performance-based vesting requirements that must be achieved before vesting can occur. The following table contains pertinent information regarding these outstanding awards as of March 31, 2012 (in thousands except for number of awards granted):

Grant Date	# of Awards Granted	Fair Value on Grant Date	Cumulative Expense Recognized	Unearned Compensation Expense	Latest Date Achievement of Performance Condition Could be Met
Aug 2010	165,000	$ 1,225	$ 586	$ 639	April 2015
April 2011	17,500	156	56	100	April 2015
May 2011	20,000	212	71	141	April 2015
Nov 2011	50,000	276	48	228	April 2015
Total	252,500	$ 1,869	$ 761	$ 1,108	

Through March 31, 2012, cumulative compensation expense of $761,000 associated with these 252,500 unvested RSUs and RSAs has been recognized because the Company believes it is probable that the associated performance requirements will be achieved. If such requirements are not met, no compensation cost will be recognized and any previously recognized compensation cost will be reversed. For these 252,500 awards that are considered probable of achievement, the unearned compensation expense of $1.1 million is expected to be recognized over estimated service and performance periods ranging from 7.5 months to 3.7 years. To the extent the Company s estimate of the timing of achievement of the performance requirements changes in the future, the timing of recognition of the related compensation expense may change.

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5. Significant Customers:

The Company markets its products and services throughout the world to original equipment manufacturers (OEMs) and systems integrators in the building, industrial, transportation, utility/home, and other automation markets. During the three months ended March 31, 2012 and 2011, the Company had four customers that accounted for a significant portion of its revenues: EBV Electronik GmbH and Avnet Europe Comm VA (EBV/Avnet), the Company s primary distributors of its Sub-systems products in Europe, Duke Energy Corporation (Duke), a U.S. utility company; and Eltel Networks A/S (Eltel) and Telvent Energia y Medioambiente SA (Telvent), value added resellers of the Company s Systems products. For the three months ended March 31, 2012 and 2011, the percentage of the Company s revenues attributable to sales made to these customers was as follows:

	Three Months Ended March 31,	
	2012	2011
Telvent	38.2%	13.5%
Duke	20.1%	21.3%
EBV/Avnet	7.5%	13.4%
Eltel	2.4%	13.9%
Total	68.2%	62.1%

In April 2011, the Company s distributor agreement with EBV was assigned from EBV to Avnet Europe Comm VA, a limited partnership organized under the laws of Belgium (Avnet). Each of EBV and Avnet are indirect subsidiaries of Avnet, Inc., a New York corporation, which is a distributor of electronic parts, enterprise computing and storage products and embedded subsystems. At the time of the assignment, the term of the distributor agreement was extended and will now expire in June 2014.

6. Commitments and Contingencies:

Legal Actions

In April 2009, the Company received notice that the receiver for two companies that filed for the Italian law equivalent of bankruptcy protection in May 2004, Finmek Manufacturing SpA and Finmek Access SpA (collectively, the Finmek Companies), had filed a lawsuit under an Italian claw back law in Padua, Italy against the Company, seeking the return of approximately $16.7 million in payments received by the Company in the ordinary course of business for components sold by the Company to the Finmek Companies prior to the bankruptcy filing. The Finmek Companies were among Enel s third party meters manufacturers, and from time to time through January 2004, the Company sold components to the Finmek Companies that were incorporated into the electricity meters that were manufactured by the Finmek Companies and sold to Enel SpA for the Enel Project. The Company believes that the Italian claw back law is not applicable to its transactions with the Finmek Companies, and the claims of the Finmek Companies receiver are without merit, and it is defending the lawsuit. As such, no loss associated with this action is considered probable or reasonably possible at this time.

From time to time, in the ordinary course of business, the Company may be subject to other 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 March 31, 2012, 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.

Line of Credit

The Company maintains a $10.0 million line of credit with its primary bank, which expires on July 1, 2012. The letter of credit contains certain financial covenants requiring the Company to maintain an overall minimum tangible net worth level and to maintain a minimum level of liquid assets. As of March 31, 2012, the Company was in compliance with these covenants. As of March 31, 2012, the Company s primary bank has issued, against the line of credit, one standby letter of credit totaling $113,000. Other than issuing standby letters of credit, the Company has

never drawn against the line of credit, nor have amounts ever been drawn against the standby letters of credit issued by the bank.

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7. Inventories:

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

	March 31, 2012	December 31, 2011
Purchased materials	$ 2,028	$ 2,346
Work-in-process	94	86
Finished goods	16,250	8,693
	$ 18,372	$ 11,125

8. Accrued Liabilities:

Accrued liabilities consist of the following (in thousands):

	March 31, 2012	December 31, 2011
Accrued payroll and related costs	$ 3,494	$ 5,673
Warranty reserve	847	823
Restructuring charges	49	49
Customer deposits	15	101
Accrued taxes	2	170
Other accrued liabilities	853	939
	$ 5,260	$ 7,755

9. Segment Disclosure:

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company s chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer and his direct reports.

The Company operates in one principal industry segment, its reportable segment: the design, manufacture and sale of products for the controls network industry, and markets its products primarily to the building automation, industrial automation, transportation, and utility/home automation markets. The Company s products provide the infrastructure and support required to implement and deploy open, interoperable, control network solutions. All of the Company s products either incorporate or operate with the Neuron® Chip and/or the LonWorks protocol. The Company also provides a range of services to its customers that consist of technical support, training courses covering its LonWorks network technology and products, and custom software development. In total, the Company offers a wide ranging set of products and services that together constitute the LonWorks system. Any given customer purchases a small subset of such products and services that are appropriate for that customer s application.

The Company operates in three main geographic areas: the Americas; Europe, Middle East and Africa (EMEA); and Asia Pacific / Japan (APJ). Each geographic area provides products and services to the Company s customers located in the respective region. The Company s long-lived assets include property and equipment, goodwill, 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 March 31, 2012 and December 31, 2011, long-lived assets of approximately $32.2 million and $33.2 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements.

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The Company has two primary product lines: Systems and Sub-systems. Systems revenue is primarily composed of sales of meters and data concentrators to system integrators or utilities. The Company previously referred to this as Utility revenue. Sub-systems revenue is principally composed of sales of components, software, and sub-system modules to utilities, building energy, or street lighting customers. This was previously reported as Commercial and Enel Project revenues. Summary revenue information by product line for the three months ended

March 31, 2012 and 2011 is as follows (in thousands):

	Three Months Ended March 31,	
	2012	2011
Systems	$ 28,692	$ 14,623
Sub-systems	11,641	13,759
Total	$ 40,333	$ 28,382

In North America, the Company sells its products primarily through a direct sales organization and select third-party electronics representatives. Outside North America, the Company sells its products through direct sales organizations in EMEA and APJ, value-added resellers, and local distributors. Revenues are attributed to geographic areas based on the country where the products are shipped to or the services are delivered. Summary revenue information by geography for the three months ended March 31, 2012 and 2011 is as follows (in thousands):

	Three Months Ended March 31,	
	2012	2011
Americas	$ 12,678	$ 10,685
EMEA	25,006	14,811
APJ	2,649	2,886
Total	$ 40,333	$ 28,382

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

10. Income Taxes:

The income tax benefit for the three months ended March 31, 2012 and 2011 was $53,000 and $5,000, respectively. The difference between the statutory rate and the Company s effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits.

As of March 31, 2012 and December 31, 2011, the Company had gross unrecognized tax benefits of approximately $3.7 million and $4.4 million, respectively, of which $712,000 and $755,000, respectively, if recognized, would impact the effective tax rate on income from continuing operations. The Company s policy is to recognize interest and/or penalties related to unrecognized tax benefits in income tax expense. As of March 31, 2012 and December 31, 2011, the Company had accrued $226,000 and $201,000, respectively, for interest and penalties. The $623,000 reduction in gross unrecognized tax benefits during the three months ended March 31, 2012 was primarily attributable to the expiration of the statute of limitations in certain foreign jurisdictions.

11. Related Parties:

The law firm of Wilson Sonsini Goodrich & Rosati, P.C. acts as principal outside counsel to the Company. Mr. Sonsini, a director of the Company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

In June 2000, the Company entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of its common stock for $130.7 million. The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that

it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To the Company s knowledge, Enel has 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 the Company s board of directors. A representative of Enel served on the board until March 14, 2012; no Enel representative is presently on the board.

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At the time the Company entered into the stock purchase agreement with Enel, it also entered into a research and development agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, the Company cooperated with Enel to integrate its LonWorks technology into Enel s remote metering management project in Italy, the Contatore Elettronico. The Company completed the sale of its components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, the Company supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, the Company entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from the Company. Under the software enhancement agreement, the Company provides software enhancements to Enel for use in its Contatore Elettronico system. The software enhancement agreement expires in December 2012 and the development and supply agreement expires in December 2013, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

For the three months ended March 31, 2012 and 2011, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $227,000 and $1.2 million, respectively. As of March 31, 2012, and December 31, 2011, none of the Company s total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

12. Restructuring

In December 2010, in order to adjust the Company s operating cost structure to more closely align with its 2011 operating plan, the Company initiated a restructuring program consisting of a headcount reduction of 31 full-time employees worldwide. In connection with this restructuring plan, in the fourth quarter of 2010, the Company recorded restructuring charges of approximately $1.2 million related to termination benefits for these personnel.

The following table sets forth a summary of restructuring activities related to our restructuring program (in thousands):

	December 31, 2011	Costs Incurred	Cash Payments	March 31, 2012
Termination benefits	$ 49	$	$	$ 49

Accrued restructuring charges of approximately $49,000 as of March 31, 2012 comprise the remaining liability balance and are reflected in accrued liabilities on our Consolidated Balance Sheets. The Company expect to pay these accrued termination benefits prior to June 30, 2012.

13. Joint Venture

On March 23, 2012, the Company entered into an agreement with Holley Metering Limited (Holley), a designer and manufacturer of energy meters in China, to create a joint venture, Zhejiang Echelon-Holley Technology Co., Ltd. (Echelon-Holley). Echelon and Holley are expected to own 51% and 49%, respectively, of the equity interest of Echelon-Holley. The joint venture will focus on the development and sales of smart energy products for China and rest-of-world markets.

It is anticipated that Echelon-Holley will become operational during the second or third quarter of 2012. As of March 31, 2012, there were no active operations within Echelon-Holley and neither Echelon nor Holley had contributed any capital to the new entity.

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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. These statements may be identified by the use of words such as we believe, expect, anticipate, intend, plan, goal, continues, may and similar expressions. In addition, forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the Factors That May Affect Future Results of Operations section. Therefore, our actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to review or update publicly any forward-looking statements for any reason.

EXECUTIVE 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 eleven foreign countries throughout Europe and Asia. We develop, market, and sell energy control networking solutions, a critical element of incorporating action-oriented intelligence into the utility grid, buildings, streetlights, and other energy devices all components of the evolving smart grid, which encompasses everything from the power plant to the plug. Echelon s products can be used to make the management of electricity over the smart grid cost effective, reliable, survivable and instantaneous. Our products enable everyday devices such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves to be made smart and inter-connected.

Our proven, open standard, multi-application energy control networking platform powers energy-savings applications for smart grid, smart cities and smart buildings that help customers save on their energy usage, reduce outage duration or prevent them from happening entirely, reduce carbon footprint and more. Today, we offer, directly and through our partners worldwide, a wide range of innovative, fully integrated products and services. We classify these products and services into two primary categories: Systems, such as our smart metering solutions, which are targeted for use by utilities and that we previously referred to as our Utility products and services; and Sub-systems that include our components, control nodes and development software, which are sold typically to OEMs who build them into their smart grid, smart cities and smart buildings solutions. Revenues from our Sub-systems products and services were previously referred to as Commercial and Enel Project revenues.

Our total revenues increased significantly during the first quarter of 2012 as compared to the same period in 2011, driven principally by increased sales of our Systems products. Gross margins declined by 3.4 percentage points between the two periods, while overall operating expenses declined by 11.1%. The net effect was a first quarter loss in 2012 that decreased by $6.8 million, or 72.4% as compared to the first quarter of 2011.

The following tables provide an overview of key financial metrics for the quarters ended March 31, 2012 and 2011 that our management team focuses on in evaluating our financial condition and operating performance (in thousands, except percentages).

	Three Months Ended March 31,			
	2012	2011	$ Change	% Change
Net revenues	$ 40,333	$ 28,382	$ 11,951	42.1%
Gross margin	42.9%	46.3%		(3.4 ppt)
Operating expenses	$ 19,304	$ 21,730	$ (2,426)	(11.1%)
Net loss	$ (2,568)	$ (9,319)	$ (6,751)	(72.4%)

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	Balance as of			
	March 31, 2012	December 31, 2011	$ Change	% Change
Cash, cash equivalents, and short-term investments	$ 58,436	$ 58,656	$ (220)	(0.4%)

Net revenues: Our total revenues increased by 42.1% during the first quarter of 2012 as compared to the same period in 2011, driven primarily by a $14.1 million, or 96.2%, increase in sales of our Systems products and services. Net revenues from our Sub-systems products decreased by $2.1 million, or 15.4% between the two periods. The increase in our Systems revenues was primarily due to an overall increase in the level of large-scale deployments of our NES system products. In particular, the increase was primarily attributable to increased shipments of our NES products for projects in the United States and Finland, partially offset by reductions in shipments for projects in Denmark. To a lesser extent, the increase in Systems revenues in the first quarter of 2012 was affected by a change in the timing of revenue recognition for certain of our Systems products, which is discussed more fully below in our discussion of Results of Operations. With respect to our Sub-systems product line, the 15.4% reduction in revenues during the first quarter of 2012 was due to a $1.2 million decrease in sales to Sub-system customers other than Enel, primarily those located in Europe, and a $942,000 decrease in sales to Enel. Many of our Sub-systems customers produce products used in commercial or industrial buildings. The markets for these products were adversely affected by the recession that started in 2008. These markets have yet to recover to their pre-recession levels. In addition, the current macroeconomic conditions in Europe have also contributed to reduced Sub-system revenues from this region. The decrease in our Enel Project revenues was due principally to an anticipated reduction in the level of orders placed by Enel s meter manufacturers for metering kits.

Gross margin: Our gross margin declined by 3.4 percentage points during the first quarter of 2012 as compared to the same period in 2011, decreasing from 46.3% in the first quarter of 2011 to 42.9% in the first quarter of 2012. This decrease was primarily due to the relatively higher percentage of our revenues being attributable to our lower margin Systems products as well as product cost increases for these same products. In addition, during the first quarter of 2012, we delivered promised firmware to a customer that provided additional functionality to meters we had delivered to them in 2011. Revenues associated with this firmware were not recognized in 2011 as it had not yet been delivered to the customer. The recognition of this revenue in the first quarter of 2012 improved our gross margins by approximately 2.2 percentage points.

Operating expenses: Our operating expenses decreased by $2.4 million, or 11.1%, during the first quarter of 2012 as compared to the same period in 2011. These decreases were driven primarily by decreases in compensation costs as well as fees paid to third party service providers.

Net loss: Our net loss decreased by $6.8 million, or 72.4% during the first quarter of 2012 as compared to the same period in 2011. This reduction was directly attributable to the $12.0 million quarter-over-quarter increase in net revenues and reduced operating expenses, and was partially offset by the 3.4 percentage point reduction in gross margins. Excluding the impact of non-cash stock-compensation charges, our net loss decreased by approximately $6.4 million in the first quarter of 2012.

Cash, cash equivalents, and short-term investments: During the first quarter of 2012, our cash, cash equivalents, and short-term investment balance decreased by 0.4%, from $58.7 million at December 31, 2011 to $58.4 million at March 31, 2012. This $220,000 reduction was primarily the result of cash used for principal payments on our lease financing obligations, capital asset acquisitions, and for taxes paid in conjunction with equity compensation awards, and was partially offset by $709,000 of cash provided by operating activities.

As we look forward to the remainder of 2012, the smart energy market is in the midst of a challenging time. Macro conditions remain tentative amidst the European financial crisis, and competition is heightened as the industry faces slow growth and ongoing consolidation. New tender activity for smart metering deployments is down and pricing pressures are increasing. In this challenging environment, we remain committed to our goal of reducing our operating losses. However, this will require continued effective execution and near-term payoff from our sales and marketing activities.

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Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. Note 1, Significant Accounting Policies of Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2011, which we filed with the Securities and Exchange Commission in March 2012, describes the significant accounting policies and methods used in the preparation of our consolidated financial statements. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our revenues, stock-based compensation, allowance for doubtful accounts, inventories, and commitments and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

During the three months ended March 31, 2012, there were no material changes to our critical accounting policies or in the matters for which we make critical accounting estimates in the preparation of our condensed consolidated financial statements as compared to those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2011.

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RESULTS OF OPERATIONS

The following table reflects the percentage of total revenues represented by each item in our Condensed Consolidated Statements of Operations for the three months ended March 31, 2012 and 2011:

	Three Months Ended March 31,	
	2012	2011
Revenues:		
Product	97.9%	97.5%
Service	2.1	2.5
Total revenues	100.0	100.0
Cost of revenues:		
Cost of product	55.7	51.6
Cost of service	1.4	2.1
Total cost of revenues	57.1	53.7
Gross profit	42.9	46.3
Operating expenses:		
Product development	21.8	33.8
Sales and marketing	15.3	25.6
General and administrative	10.8	17.2
Total operating expenses	47.9	76.6
Loss from operations	(5.0)	(30.3)
Interest and other income, net	(0.6)	(1.3)
Interest expense on lease financing obligations	(0.9)	(1.3)
Loss before provision for income taxes	(6.5)	(32.9)
Provision for income taxes	(0.1)	(0.0)
Net loss	(6.4)%	(32.9)%

Revenues

Total revenues

	Three Months Ended			
(Dollars in thousands)	March 31, 2012	March 31, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Total revenues	$ 40,333	$ 28,382	$ 11,951	42.1%

The $12.0 million increase in total revenues for the quarter ended March 31, 2012 as compared to the same period in 2011 was primarily the result of a $14.1 million increase in Systems revenues, which was partially offset by a $2.1 million decrease in Sub-systems revenues.

Systems revenues

(Dollars in thousands)	Three Months Ended March 31, 2012	March 31, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Systems revenues	$ 28,692	$ 14,623	$ 14,069	96.2%

During the quarters ended March 31, 2012 and 2011, our Systems revenues were derived primarily from a relatively small number of customers who have undertaken large-scale deployments of our NES System products. These deployments generally come to fruition after an extended and complex sales process, and each is relatively substantial in terms of its revenue potential. They vary significantly from one another in terms of, among other things, the overall size of the deployment, the duration of time over which the products will be sold, the mix of products being sold, the timing of delivery of those products, and the ability to modify the timing or size of those projects. This relative uniqueness among each deployment results in significant variability and unpredictability in our Systems revenues.

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The $14.1 million increase in our Systems revenues during the quarter ended March 31, 2012 as compared to the same period in 2011 was due primarily to an overall increase in the level of large-scale deployments of our NES System products. In particular, the increase was attributable to increased shipments of our Systems products for projects in Finland and at Duke Energy. These increases were partially offset by a reduction in products shipped for our projects in Denmark. In addition, during the first quarter of 2012, we delivered to a customer a promised firmware update associated with a component within our meters that we had been shipping to them since the middle of 2011. During 2011, we did not recognize the revenue associated with this component since the firmware had not yet been delivered. Upon delivery in the first quarter of 2012, we were able to recognize approximately $1.5 million of revenue associated with firmware and associated components that were shipped to and accepted by the customer in 2011. Lastly, during the first quarter of 2012, we completed an evaluation of historical acceptance rates for certain of our newer generation Systems products and concluded that the contractual acceptance criteria for these products are met at the time of delivery. Thus, for these products that shipped during the first quarter, we were able to record revenue several weeks earlier than we historically would have. This had the effect of increasing our Systems revenues by approximately $4.8 million.

Our ability to recognize revenue for our Systems products depends on several factors, including, but not limited to, the impact on delivery dates of any modifications to existing shipment schedules included in the contracts that have been awarded to us thus far, and in some cases, certain contractual provisions, such as customer acceptance. For arrangements that contain contractual acceptance provisions, revenue recognition may be delayed until acceptance by the customer or the acceptance provisions lapse unless we can objectively demonstrate that the contractual acceptance criteria have been satisfied, which is generally accomplished by establishing a history of acceptance for the same or similar products. In the future, we will continue to evaluate historical acceptance rates for our Systems products and, when the data supports it, will recognize revenue at the point of delivery to the customer s carrier for those particular products (once all other revenue recognition criteria have been met), which could increase our Systems revenue in the period in which this determination is made. In addition, the revenue recognition rules relating to products such as our NES System may require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period.

Our Systems revenues have historically been concentrated with a relatively few customers. During the years ended December 31, 2011, 2010, and 2009, approximately 94.2%, 85.4%, and 82.5%, respectively, of our Systems revenues were attributable to four customers. While our Systems customers will change over time, given the nature of the Systems market, we expect our future Systems revenues will continue to be concentrated among a limited number of customers.

Sub-systems revenues

	Three Months Ended			
(Dollars in thousands)	March 31, 2012	March 31, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Sub-systems revenues	$ 11,641	$ 13,759	$ (2,118)	(15.4%)

Our Sub-systems revenues are primarily comprised of sales of our hardware products, and to a lesser extent, revenues we generate from sales of our software products and from our customer support and training offerings. Included in these totals are products and services sold to Enel.

Excluding sales of products and services sold to Enel, which are discussed more fully below, our Sub-systems revenues decreased by $1.2 million, or 9.3% during the three months ended March 31, 2012 as compared to the same period in 2011. This decrease was primarily due to an 18% decrease in revenues in the EMEA region and was attributable, we believe, to generally poor macroeconomic conditions in Europe during the first quarter of 2012. Within the Sub-systems family of products, the year-over-year decrease was driven primarily from decreased sales of our control and connectivity products, partially offset by an increase in sales of our SmartServer products.

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Our future Sub-systems revenues will also be subject to further fluctuations in the exchange rates between the United States dollar and the foreign currencies in which we sell these products and services. In general, if the dollar were to weaken against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would increase. Conversely, if the dollar were to strengthen against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would decrease. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in these currencies and the magnitude of the exchange rate fluctuation from year to year. The portion of our Sub-systems revenues conducted in currencies other than the United States dollar, principally the Japanese Yen, was about 7.7% for the quarter ended March 31, 2012 and 7.1% for the same period in 2011. To date, we have not hedged any of these foreign currency risks. We do not currently expect that, during 2012, the amount of our Sub-systems revenues conducted in these foreign currencies will fluctuate significantly from prior year levels. Given the historical and expected future level of sales made in foreign currencies, we do not currently plan to hedge against these currency rate fluctuations. However, if the portion of our revenues conducted in foreign currencies were to grow significantly, we would re-evaluate these exposures and, if necessary, enter into hedging arrangements to help minimize these risks.

Enel project revenues (included in Sub-systems)

	Three Months Ended			
(Dollars in thousands)	March 31, 2012	March 31, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Enel project revenues	$ 227	$ 1,169	$ (942)	(80.6%)

In October 2006, we entered into two agreements with Enel, a development and supply agreement and a software enhancement agreement. Under the development and supply agreement, Enel is purchasing additional metering kit and data concentrator products from us. Under the software enhancement agreement, we are providing software enhancements to Enel for use in its Contatore Elettronico system. The $227,000 and $1.2 million of Enel project revenue recognized during the quarters ended March 31, 2012 and 2011, respectively, related primarily to shipments under the 2006 development and supply agreement, and to a lesser extent, from revenues attributable to the software enhancement agreement. The software enhancement agreement expires in December 2012 and the development and supply agreement expires in December 2013.

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.

Gross Profit and Gross Margin

	Three Months Ended			
(Dollars in thousands)	March 31, 2012	March 31, 2011	2012 over 2011 $ Change	2012 over 2011 % Change
Gross Profit	$ 17,298	$ 13,143	$ 4,155	31.6%
Gross Margin	42.9%	46.3%		(3.4)

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.

Gross margin declined by approximately 3.4 percentage points during the first quarter of 2012 as compared to the same period in 2011. This reduction was primarily due to the mix of revenues reported. During the first quarter of 2012, approximately 71% of our revenues were attributable to sales of our Systems products and services, while the remaining 29% came from sales of our Sub-systems products and services. In the first quarter of 2011, approximately 52% of our revenues were attributable to sales of our Systems products and services, while the remaining 48% were attributable to sales of our Sub-systems products and services. In general, revenues from sales of our Systems products generate lower gross margins than do sales of our Sub-systems products. In addition, in June 2011, Jabil, one of our primary CEMs, notified us that they intended to increase the prices they charge us for manufacturing our Systems products. The new pricing became effective July 1, 2011, and was based on increased fees for Jabil s overhead and profit, cost increases for commodities contained in our products, and higher labor rates for Jabil s production personnel. The impact of these cost increases began to phase in during the third quarter of 2011 and became fully effective at the beginning of the fourth quarter. This negative impact is in addition to other cost increases we ve observed recently. In an effort to mitigate the effects of these price increases and thus improve our gross margins within the foreseeable future, we have commenced work on certain design modifications for these products intended to reduce their cost to manufacture. We are also working closely with Jabil to identify other opportunities to reduce their manufacturing costs associated with our products.

Partially offsetting the negative 2012 gross margin trend was the accounting treatment effect for a firmware deliverable we had previously committed to a customer and that was delivered during the first quarter of 2012. In this case, we agreed to provide a particular customer with firmware for a certain hardware component that was included within some of the meters we began delivering to them during the third quarter of 2011 and have continued since. This firmware enables the hardware component to become fully functional. Because this incremental hardware is not separable from the meters, we expensed its cost once the customer accepted the corresponding meter. However, we deferred the associated revenue for this additional hardware functionality until such time as we delivered the promised firmware. At the time the firmware was delivered, we recognized the deferred revenue for which the cost has already been recognized, which improved our first quarter 2012 gross margins by approximately 2.2 percentage points. Also partially offsetting the negative 2012 gross margin trends was the impact of indirect costs, which decrea