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, 2011

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	**(IRS Employer**
incorporation or organization)	**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 ¨ 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, 2011, 42,196,776 shares of the registrant s common stock were outstanding.

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ECHELON CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED MARCH 31, 2011

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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, 2011	December 31, 2010
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 8,973	$ 7,675
Short-term investments	51,966	56,957
Accounts receivable, net (1)	22,466	25,102
Inventories	10,225	8,993
Deferred cost of goods sold	3,998	2,588
Other current assets	3,445	3,962
Total current assets	101,073	105,277
Property and equipment, net	30,162	31,020
Goodwill	8,468	8,316
Other long-term assets	714	957
Total assets	$ 140,417	$ 145,570
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 9,476	$ 10,399
Accrued liabilities	5,743	6,713
Current portion of lease financing obligations	1,766	1,731
Deferred revenues	12,211	9,175
Total current liabilities	29,196	28,018
LONG-TERM LIABILITIES:		
Lease financing obligations, excluding current portion	21,610	22,062
Other long-term liabilities	1,514	1,501
Total long-term liabilities	23,124	23,563
STOCKHOLDERS EQUITY:		
Common stock	453	452
Additional paid-in capital	341,476	338,521
Treasury stock	(28,130)	(28,130)

Accumulated other comprehensive income	1,032	561
Accumulated deficit	(226,734)	(217,415)
Total stockholders equity	88,097	93,989
Total liabilities and stockholders equity	$ 140,417	$ 145,570

(1) Includes related party amounts of $525 as of March 31, 2011 and $0 as of December 31, 2010. 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 OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
REVENUES:		
Product	$ 27,679	$ 17,319
Service	703	827
Total revenues (2)	28,382	18,146
COST OF REVENUES:		
Cost of product (1)	14,652	9,167
Cost of service (1)	587	597
Total cost of revenues	15,239	9,764
Gross profit	13,143	8,382
OPERATING EXPENSES:		
Product development (1)	9,598	8,303
Sales and marketing (1)	7,242	6,497
General and administrative (1)	4,890	4,230
Total operating expenses	21,730	19,030
Loss from operations	(8,587)	(10,648)
Interest and other income (expense), net	(360)	435
Interest expense on lease financing obligations	(377)	(402)
Loss before provision for income taxes	(9,324)	(10,615)
Income tax benefit	(5)	(54)
NET LOSS	$ (9,319)	$ (10,561)
Net loss per share:		
Basic	$ (0.22)	$ (0.26)
Diluted	$ (0.22)	$ (0.26)
Shares used in computing net loss per share:		
Basic	41,783	41,072

Diluted	41,783	41,072

(1) See Note 4 for summary of amounts included representing equity compensation expense.

(2) Includes related party amounts of $1,169 and $362 for the three months ended March 31, 2011 and 2010, 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 CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended March 31, 2011	2010
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net loss	$ (9,319)	$ (10,561)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,529	1,622
Reduction of allowance for doubtful accounts	(36)	(39)
Loss on disposal of fixed assets	8	4
Reduction of (increase in) accrued investment income	17	(15)
Stock-based compensation	3,185	3,232
Change in operating assets and liabilities:		
Accounts receivable	2,665	7,877
Inventories	(1,240)	(3,599)
Deferred cost of goods sold	(1,401)	752
Other current assets	850	87
Accounts payable	(1,018)	(1,295)
Accrued liabilities	(926)	2,202
Deferred revenues	3,056	(1,931)
Deferred rent	14	(27)
Net cash used in operating activities	(2,616)	(1,691)
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchases of available-for-sale short-term investments	(14,979)	(14,951)
Proceeds from maturities and sales of available-for-sale short-term investments	19,948	9,970
Change in other long-term assets		(8)
Capital expenditures	(594)	(464)
Net cash provided by (used in) investing activities	4,375	(5,453)
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Principal payments of lease financing obligations	(417)	(383)
Proceeds from exercise of stock options	118	98
Repurchase of common stock from employees for payment of taxes on vesting of restricted stock units and upon exercise of stock options	(508)	(633)
Net cash used in financing activities	(807)	(918)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	346	(484)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(1,298)	(8,546)
CASH AND CASH EQUIVALENTS:		

Beginning of period		7,675		17,206
End of period	$	8,973	$	8,660
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:				
Cash paid for interest on lease financing obligations	$	375	$	400
Cash paid for income taxes	$	108	$	72

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, 2010 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, 2010.

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 affect 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 62% of net revenues for the quarter ended March 31, 2011 was derived from four customers. Customers in any of the Company s target market sectors may experience unexpected reductions in demand for their products and reduce their purchase orders 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 instability, coupled with the fact that the Company s Utility 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 Utility 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, stock-based compensation, allowance for doubtful accounts, inventory valuation, allowance for warranty costs, income taxes, 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

There have been no new recent accounting pronouncements or changes in accounting pronouncements during the three months ended March 31, 2011 that are of significance, or potential significance, to the Company.

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 (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 shipment. For sales made to the Company s distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer. 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 Utility 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, 2011 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 include NES System and/or Element Manager software, the Company defers the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, the Company recognizes revenues for the Hardware and software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. Revenues for PCS on the NES System and Element Manager

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software, as well as for extended warranties on Utility Hardware products, are recognized ratably over the associated service period, which generally commences upon the later of the delivery of all software, or the customer s acceptance of any given Hardware shipment.

As of March 31, 2011 and December 31, 2010, approximately $6.0 million and $3.7 million, respectively, of the Company s Utility revenue was deferred. Of the $3.7 million deferred as of December 31, 2010, approximately $1.5 million related to arrangements entered into prior to January 1, 2010. Virtually all of the $6.0 million of deferred revenue at March 31, 2011 relates to arrangements that were entered into subsequent to December 31, 2009.

Deferred Revenue and Deferred Cost of Goods Sold

Deferred revenue and deferred cost of goods sold result from transactions where the Company has shipped product or performed services for which all revenue recognition criteria have not yet been met. Deferred cost of goods sold related to deferred product revenues includes direct product costs and applied overhead. Deferred cost of goods sold related to deferred service revenues includes direct labor costs and applied overhead. Once all revenue recognition criteria have been met, the deferred revenues and associated cost of goods sold are recognized.

2. Cash Equivalents and Investments

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.

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, 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]	$ 5,251	$ 5,251	$	$
Fixed income available-for-sale securities: [2]				
U.S. government securities	51,966		51,966	
Total fixed income available-for-sale securities	51,966		51,966	
Total	$ 57,217	$ 5,251	$ 51,966	$

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, 2010 (in thousands):

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		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]	$ 5,246	$ 5,246	$	$
Fixed income available-for-sale securities: [2]				
U.S. government securities	56,957		56,957	
Total fixed income available-for-sale securities	56,957		56,957	
Total	$ 62,203	$ 5,246	$ 56,957	$

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

(2) Included in 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.

As of March 31, 2011, the Company s available-for-sale short-term investments had contractual maturities from three to twelve months and an average remaining term to maturity of five months. As of March 31, 2011, 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	$ 51,954	$ 51,966	$ 13	$ 1
Total investments in debt securities	$ 51,954	$ 51,966	$ 13	$ 1

Market values were determined for each individual security in the investment portfolio. The decline in value of these investments is primarily related to changes in interest rates and is considered to be temporary in nature. 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. As of March 31, 2011, none of the Company s investments had any material unrealized losses.

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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, 2011 and 2010 (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2011	2010
Net loss (Numerator):		
Net loss, basic and diluted	$ (9,319)	$ (10,561)
Shares (Denominator):		
Weighted average common shares outstanding	41,783	41,072
Shares used in basic computation	41,783	41,072
Common shares issuable upon exercise of stock options (treasury stock method)		
Shares used in diluted computation	41,783	41,072
Net loss per share:		
Basic	$ (0.22)	$ (0.26)
Diluted	$ (0.22)	$ (0.26)

For the three months ended March 31, 2011 and 2010, 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, and restricted stock units (RSUs) excluded from this calculation for the three months ended March 31, 2011 and 2010 was 6,080,834, and 7,180,410, 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 authorizes the Company to repurchase up to 3.0 million shares of the Company s common stock. During the quarter ended March 31, 2011, the Company did not repurchase any shares under the repurchase program. Since inception, the Company has repurchased a total of 750,000 shares under the program at a cost of $8.9 million. As of March 31, 2011, 2,250,000 shares were available for repurchase. The stock repurchase program expired in April 2011.

Stock-based Compensation Expense

The following table summarizes stock-based compensation expense for the three months ended March 31, 2011 and 2010 and its allocation within the condensed consolidated statements of operations (in thousands):

	Three Months Ended March 31,	
	2011	2010
Cost of revenues:		
Cost of product	$ 294	$ 326
Cost of service	22	30
Operating expenses:		

Product development	1,006	1,122
Sales and marketing	807	815
General and administrative	1,056	939
Total	$ 3,185	$ 3,232

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Comprehensive Loss

Comprehensive loss for the Company consists of net loss plus the effect of unrealized holding gains or losses on investments classified as available-for-sale and foreign currency translation adjustments. Comprehensive loss for the three months ended March 31, 2011 and 2010 is as follows (in thousands):

	Three Months Ended March 31,	
	2011	2010
Net loss	$ (9,319)	$ (10,561)
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustments	476	(581)
Unrealized holding gains (losses) on available-for-sale securities	(5)	9
Comprehensive loss	$ (8,848)	$ (11,133)

Stock Award Activity

The total intrinsic value of options exercised during the three months ended March 31, 2011 was approximately $349,000. The total intrinsic value of options exercised during the three months ended March 31, 2010 was approximately $255,000. 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, 2011 was approximately $848,000. The total fair value of RSUs vested and released during the quarter ended March 31, 2010 was approximately $1.6 million. 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 RSUs with Financial- Based Performance Vesting Requirements

As of March 31, 2011, there were 476,439 non-vested RSUs and restricted stock awards (RSAs) (with a grant date fair value of approximately $3.5 million) that were subject to certain financial-based performance requirements that must be achieved before vesting can occur. Of these 476,439 non-vested RSUs and RSAs, 111,439 (that were issued in May 2009 with a grant date fair value of approximately $823,000) contain financial-based performance conditions that must be achieved by May 2014, and the remaining 365,000 RSUs and RSAs (that were issued in August 2010 with a grant date fair value of approximately $2.7 million) contain financial-based performance conditions that must be achieved by April 2015.

Through March 31, 2011, cumulative compensation expense of $1.3 million associated with the 111,439 RSUs granted in May 2009 and the 365,000 RSUs and RSAs granted in August 2010 has been recognized because the Company believes it is probable that the associated financial performance requirements will be achieved. If such requirements are not met, no compensation cost will be recognized and any recognized compensation cost will be reversed. For these 476,439 awards that are considered probable of achievement, the unearned compensation expense of $2.2 million is expected to be recognized over estimated service periods ranging from 1.0 years to 2.8 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.

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, 2011 and 2010, the Company had four customers that accounted for a significant portion of its revenues: EBV Electronik GmbH (EBV), the Company s primary distributor of its Commercial 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 Utility products. For the three months ended March 31, 2011 and 2010, the percentage of the Company s revenues attributable to sales made to these customers was as follows:

	Three Months Ended March 31,	
	2011	2010
Duke	21.3%	6.7%
Eltel	13.9%	16.3%
Telvent	13.5%	0.9%
EBV	13.4%	18.1%
Total	62.1%	42.0%

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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.

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, 2011, 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, 2011. 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, 2011, the Company was in compliance with these covenants. As of March 31, 2011, 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.

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, 2011	December 31, 2010
Purchased materials	$ 4,277	$ 4,306
Work-in-process	43	48
Finished goods	5,905	4,639
	$ 10,225	$ 8,993

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8. Accrued Liabilities:

Accrued liabilities consist of the following (in thousands):

	March 31, 2011	December 31, 2010
Accrued payroll and related costs	$ 3,790	$ 3,727
Warranty reserve	954	877
Payments received toward design and development expenses	300	300
Restructuring charges	250	1,158
Accrued taxes	58	167
Customer deposits	13	197
Other accrued liabilities	378	287
	$ 5,743	$ 6,713

During the quarter ended June 30, 2010, the Company entered into a contractual arrangement whereby a third party is making payments to the Company in connection with certain design and development activities. As of March 31, 2011, the Company had received approximately $4.8 million, $300,000 of which relates to payments received in advance of the completion of certain of the design and development activities and is reflected in accrued liabilities as detailed above. The $300,000 will be used to offset current period Product Development expenses in the period during which the associated milestone is completed. The remaining $4.5 million was used to offset related Product Development expenses incurred during the year ended December 31, 2010.

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. For the electric utility industry, the Company has developed a smart grid system called the NES System. The NES System provides a two-way information and control path between the utility and its customer, which enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. All of the Company s products either incorporate or operate with the Neuron® Chip and/or the LonWorks protocol. The Company also provides a range of services to its customers that consist of technical support, training courses covering its LonWorks network technology and products, and custom software development. In total, the Company offers a wide ranging set of products and services that together constitute the LonWorks system. Any given customer purchases a small subset of such products and services that are appropriate for that customer s application.

The Company operates in three main geographic areas: the Americas; Europe, Middle East and Africa (EMEA); and Asia Pacific / Japan (APJ). Each geographic area provides products and services to the Company s customers located in the respective region. The Company s long-lived assets include property and equipment, goodwill, 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, 2011 and December 31, 2010, long-lived assets of approximately $36.1 million and $37.0 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 three primary product lines: Utility, Commercial, and products and services sold to Enel. Summary revenue information by product line for the three months ended March 31, 2011 and 2010 is as follows (in thousands):

	Three Months Ended March 31,	
	2011	**2010**
Utility	$ 14,623	$ 5,452