2011 Annual Report

Letter to Shareholders.
Notice of 2012 Annual Meeting.
Consolidated Financial Statements.

Dear Shareholder,

The close of 2011 marks the anniversary of my first full year with the company and I am pleased with the progress we made during the year towards many of the goals we laid out for ourselves. Going forward, we especially dedicate our efforts to Ken Oshman, the long-time chairman and CEO of Echelon, who passed away in August 2011. Ken was a brilliant, well-respected man and visionary leader. We all miss him dearly.

As we discussed throughout the year, Echelon is getting back to its roots as an energy control networking company, with one proven, open standard, multi-application platform. We sell complete systems – such as our NES smart metering system and Edge Control Node (ECN) – and embedded sub-systems – such as our Neuron protocol processors, SmartServer control nodes and NES system software – to the smart energy market. Our innovative technologies and solutions help customers improve their energy efficiency, reduce operational costs, enhance end-user satisfaction and safety, grow revenues, and prepare for a dynamic future. By focusing on innovation, we can more effectively leverage our existing technology, clearly differentiate our products, and create new ways to make our value-add available to the largest number of customers across our markets and geographies.

In 2011 we delivered 41% revenue growth, significantly outpacing the broader market. We also accelerated the rollout of large-scale projects in the United States and Europe, established an important sub-systems partnership in China and reached a key milestone with our sub-systems partner in Brazil. For the year, we reduced our non-GAAP operating loss to less than 1% of revenue from almost 15% in 2010 and achieved non-GAAP profitability in two of four quarters.

As we look to 2012 and beyond, our focus is on three specific opportunities within the smart energy market: smart grid, smart cities, and smart buildings.

In the smart grid, the majority of our revenue for 2012 will come from system deployments at Fortum, Finland (through Telvent) and at Duke Energy. Fortum is the first utility to introduce meter-connected in-home displays enabled by Echelon's COS software, which provide customers near-real-time usage data directly from the meter. This innovative product gives end-users information they need to control their energy usage and sets the stage for future applications. Our smart meter roll-out at Duke in Ohio continues to receive high praise for its outstanding performance and reliability, and we look forward to Duke moving ahead with other territories in the future. Currently, our sales pipeline of systems opportunities is 3x what it was a year ago. This includes the ECN, which will be increasingly important for delivering new distributed applications that offer utilities revenue protection, reliability improvements and operational savings at the edge of the distribution grid.

2012 will also be the first year that our sub-systems strategy begins to take hold. Brazil will be the first country where we are implementing this strategy since our project with Enel in Italy. Our Brazilian partner, ELO, serves 40 utilities in the country with a combined 55 million customers and also sells in other Latin American countries. ELO is the only manufacturer to receive Brazilian government approval for a comprehensive smart meter portfolio to-date and is currently installing a number of Echelon-powered production pilots with utilities that will be operational and providing usage and analytical data in 2012. We expect larger pilots in the second half of 2012 and volume shipments in 2013. Following closely on the heels of Brazil will be China, where we are also utilizing our sub-system strategy in partnership with Holley Metering. We recently announced the expansion of this partnership through the formation of a joint venture. The new entity, Echelon-Holley, will allow us to capitalize on the vast smart grid opportunity in China over the next several years. Having already set up two field trials of our power line technology in China with Holley, we will be submitting products for China State Grid approval through Echelon-Holley in Q2 and expect approval this year. This will broaden our reach to all meter manufacturers served by the State Grid and we anticipate pilots and deployments beginning in 2013. We also can envision a broader role for Echelon-Holley in the global smart grid market long-term.

Our smart city offerings continued to gain momentum in 2011, with street lighting wins in China, Japan, Norway and Vietnam. Echelon's solution allows city managers to architect multi-application, multi-vendor street lighting systems that can serve as the foundation for other smart city applications, eliminating the cost of duplicate infrastructure. We have a strong and growing pipeline of street lighting deals in Europe and Asia through OEMs like Philips, solution providers like Streetlight.Vision and Flashnet, and ESCOs like Rongwen in China. We remain enthusiastic about our prospects for street lighting in 2012 and beyond.

Finally, our smart buildings business continues to track reasonably well with the macro economy, particularly building occupancy rates and commercial construction. While the commercial sector is gradually improving and seeing some retrofit spending, the pace of growth is disappointing. We are working with our major OEM customers to transition them to our FT 5000 transceivers and are introducing products allowing us to co-exist with other building standards so that we can gradually increase the opportunities that are available to our partners. As these tactics take hold, we hope to regain some market share.

To focus our sales efforts across our three areas of opportunity, we continue to utilize our geographic ranking system to target geographies that are most ready for smart energy based on a list of criteria, such as the acuteness of electricity shortages, theft levels, consumer interest and political will. This has positioned Echelon well in two of the largest potential smart grid geographies over the next few years, Brazil and China. In 2012, our ranking system suggests that markets such as Japan, Korea and the Middle East will start to develop.

Of course, while our strategy and early results hold great promise, pipeline conversion, a sufficiently buoyant market, and ongoing good operational execution are imperative. On a micro basis, the regulatory delays at Duke in Indiana appear no closer to resolution. Additionally, macro conditions remain tentative in the smart energy market amidst the European financial crisis, and competition is heightened as the industry faces slow growth and ongoing consolidation. New tenders are fewer and farther between and pricing pressures are increasing. Countering these headwinds, our disciplined sales approach has significantly broadened and deepened our pipeline and our product cost reduction plans are proceeding well.

Against this backdrop, we plan to continue to sharpen our strategic focus, improve our execution throughout the year, and implement our system and sub-system strategies throughout our organization. Sales of our system solutions will remain an integral part of our strategy for metering and distribution automation applications. In our three opportunity areas, we will increase our emphasis on sales of sub-systems to partners, who utilize them in their own products to better penetrate our target markets. Innovation will be more directed towards our core platform and we will increasingly partner to leverage each other's core competencies.

We will make further operational improvements based on what we learned in 2011, and in particular focus on four refinements: i) we will more actively sell with our partners for large end-user projects; ii) we will dedicate field resources to design-in our sub-systems working with our local partners in our target geographies; iii) we will dedicate resources to develop partnerships with large multinationals; and iv) we will develop our platform to support the convergence we are seeing in applications across the smart grid, smart cities and smart buildings. This convergence is driven by utilities' interest in service businesses and by smart buildings becoming "grid-aware." Therefore, metering, low-voltage distribution automation, street lighting control and building automation applications become relevant across market segments. Echelon continues to be uniquely positioned to benefit from this convergence because of the breadth of our control networking solutions, the range of applications they support, and the strength of our customer base.

In closing, we made solid progress in 2011. We have a lot more to do in 2012 and beyond, but we believe that our increasing focus on the sub-systems business, on core innovation, on the most promising geographies, and on increasingly good execution will maximize value creation long term. I thank you, our valued shareholders, for your continued support. I also thank our employees around the world for their tireless efforts and contributions this past year.

Regards,

Ron Sege
Chairman and CEO
Echelon Corporation

The foregoing may contain statements relating to future plans, events or performance. These forward-looking statements may involve risks and uncertainties, including risks associated with uncertainties pertaining to anticipated growth in the control networks market and in Echelon's business; and other risks identified in our SEC filings. Actual results, events and performance may differ materially. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of this date. We undertake no obligation to release publicly the result of any revisions to these forward-looking statements that may be made to reflect events or circumstances after this date or to reflect the occurrence of unanticipated events.

ECHELON CORPORATION

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD ON MAY 22, 2012
10:00 A.M. PACIFIC TIME

We cordially invite you to attend the 2012 Annual Meeting of Stockholders of Echelon Corporation. The meeting will be held on Tuesday, May 22, 2012 at 10:00 a.m., Pacific Time, at 570 Meridian Avenue, San Jose, California 95126. At the meeting we will:

1. Elect three Class B directors for a term of three years and until their successors are duly elected and qualified;

2. Ratify the appointment of KPMG LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2012;

3. Transact any other business as may properly come before the meeting or any postponement or adjournment thereof.

These items are fully discussed in the following pages, which are made part of this Notice. Stockholders who owned our common stock at the close of business on Tuesday, March 27, 2012 are entitled to notice of and to vote at the annual meeting.

Your vote is important. Whether or not you plan to attend the annual meeting, please cast your vote, as instructed in the Notice of Internet Availability of Proxy Materials, via the Internet, as promptly as possible. You may also request a printed set of the proxy materials which will allow you to submit your vote by mail or by telephone, if you prefer. We encourage you to vote via the Internet. It is convenient, is more environmentally friendly, and saves us significant postage and processing costs.

Sincerely,

Ronald A. Sege
Chairman of the Board and Chief Executive Officer

San Jose, California
April 12, 2012

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2012 ANNUAL MEETING OF STOCKHOLDERS

NOTICE OF ANNUAL MEETING AND PROXY STATEMENT

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ECHELON CORPORATION

PROXY STATEMENT
FOR
2012 ANNUAL MEETING OF STOCKHOLDERS

INFORMATION CONCERNING SOLICITATION AND VOTING

General

Our Board of Directors is soliciting Proxies for the 2012 Annual Meeting of Stockholders to be held at 570 Meridian Avenue, San Jose, California 95126 on Tuesday, May 22, 2012, at 10:00 a.m., Pacific Time. The address of our principal executive office is 550 Meridian Avenue, San Jose, California 95126 and our telephone number at this address is 408-938-5200. This Proxy Statement contains important information for you to consider when deciding how to vote on the matters set forth in the attached Notice of Annual Meeting. Please read it carefully.

Beginning on April 12, 2012, we made copies of this Proxy Statement available to persons who were stockholders at the close of business on March 27, 2012, the record date for the annual meeting.

Notice of Internet Availability of Proxy Materials

Pursuant to rules adopted by the Securities and Exchange Commission, or the SEC, we have chosen to provide access to our proxy materials over the Internet. We are sending a Notice of Internet Availability of Proxy Materials (the "Notice") to our stockholders of record and our beneficial owners. All stockholders will have the option to access the proxy materials on a website referred to in the Notice or to request a printed set of the proxy materials. Instructions on how to access the proxy materials over the Internet or to request a printed copy of the proxy materials are included in the Notice. You may also request to receive proxy materials in printed form by mail or electronically by e-mail on an ongoing basis.

Electronic Access to Proxy Materials

The Notice will provide you with instructions on how to:

- View on the Internet our proxy materials for our annual meeting; and
- Instruct us to send our future proxy materials to you electronically by e-mail.

Choosing to receive future proxy materials by e-mail will save us the cost of printing and mailing the proxy materials to you and will reduce the environmental impact of our annual meeting. If you choose to receive future proxy materials by e-mail, you will receive an e-mail next year with instructions including a link to the proxy materials and a link to the proxy voting site. Your election to receive proxy materials by e-mail will remain in effect until you terminate it.

Costs of Solicitation

Echelon will pay the costs of soliciting proxies from stockholders. In addition, we may reimburse brokerage firms and other persons representing beneficial owners of shares for their expenses in forwarding solicitation material to such beneficial owners, including fees associated with:

- Forwarding the Notice to beneficial owners;
- Forwarding printed proxy materials by mail to beneficial owners who specifically request them; and
- Obtaining beneficial owners' voting instructions.

Certain of our directors, officers and employees may solicit proxies on our behalf, without additional compensation, personally or by written communication, telephone, facsimile or other electronic means. We may engage the services of a professional proxy solicitation firm to aid in the solicitation of proxies from certain brokers, bank nominees and other institutional owners. Our costs for such services, if retained, will not be significant.

Record Date and Shares Outstanding

Only stockholders of record at the close of business on March 27, 2012, are entitled to attend and vote at the annual meeting. On the record date, 42,604,213 shares of our common stock were outstanding and held of record. The closing price of our common stock on The Nasdaq Stock Market ("Nasdaq") on the record date was $4.59 per share.

QUESTIONS AND ANSWERS REGARDING OUR ANNUAL MEETING

Although we encourage you to read this Proxy Statement in its entirety, we include this question and answer section to provide some background information and brief answers to several questions you may have about the annual meeting or this Proxy Statement.

Q: Why am I receiving these proxy materials?

A: Our Board of Directors is providing these proxy materials for you in connection with our annual meeting of stockholders, which will take place on May 22, 2012. Stockholders are invited to attend the annual meeting and are requested to vote on the proposals described in this Proxy Statement.

Q: What is the Notice of Internet Availability?

A: In accordance with rules and regulations adopted by the SEC, instead of mailing a printed copy of our proxy materials to all stockholders entitled to vote at the annual meeting, we are furnishing the proxy materials to our stockholders over the Internet. If you received a Notice by mail, you will not receive a printed copy of the proxy materials. Instead, the Notice will instruct you as to how you may access and review the proxy materials and submit your vote via the Internet. If you received a Notice by mail and would like to receive a printed copy of the proxy materials, please follow the instructions included in the Notice for requesting such materials.

We expect to mail the Notice on or about April 12, 2012, to all stockholders entitled to vote at the annual meeting. On the date of mailing of the Notice, all stockholders and beneficial owners will have the ability to access all of our proxy materials on a website referred to in the Notice. These proxy materials will be available free of charge.

Q: ***What proposals will be voted on at the annual meeting?***

A: There are two proposals scheduled to be voted on at the annual meeting:

- Election of the three Class B nominees for director set forth in this Proxy Statement; and
- Ratification of the appointment of KPMG LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2012.

Q: ***What is Echelon's voting recommendation?***

A: Our Board of Directors unanimously recommends that you vote your shares "FOR" each of the three Class B nominees to our Board of Directors and "FOR" ratification of the appointment of KPMG LLP as our independent registered public accounting firm.

Q: ***Who can vote at the annual meeting?***

A: Our Board of Directors has set March 27, 2012 as the record date for the annual meeting. All stockholders who owned Echelon common stock at the close of business on March 27, 2012 may attend and vote at the annual meeting. Each stockholder is entitled to one vote for each share of common stock held as of the record date on all matters to be voted on. Stockholders do not have the right to cumulate votes. On March 27, 2012, 42,604,213 shares of our common stock were outstanding. Shares held as of the record date include shares that are held directly in your name as the stockholder of record and those shares held for you as a beneficial owner through a broker, bank or other nominee.

Q: ***What is the difference between holding shares as a stockholder of record and as a beneficial owner?***

A: Most stockholders of Echelon hold their shares through a broker, bank or other nominee rather than directly in their own name. As summarized below, there are some distinctions between shares held of record and those owned beneficially.

Stockholders of Record

If your shares are registered directly in your name with Echelon's transfer agent, Computershare, you are considered the stockholder of record with respect to those shares and the Notice has been sent directly to you. As the stockholder of record, you have the right to grant your voting proxy directly to Echelon or to vote in person at the annual meeting.

Beneficial Owners

If your shares are held in a stock brokerage account or by a bank or other nominee, you are considered the beneficial owner of shares held in "street name," and the Notice has been forwarded to you by your broker, bank or other nominee who is considered, with respect to those shares, the stockholder of record. As the beneficial owner, you have the right to direct your broker, bank or other nominee on how to vote and are also invited to attend the annual meeting. However, since you are not the stockholder of record, you may not vote these shares in person at the annual meeting unless you request a "legal proxy" from the broker, bank or other nominee who holds your shares, giving you the right to vote the shares at the annual meeting.

Q: ***How many votes does Echelon need to hold the annual meeting?***

A: A majority of Echelon's outstanding shares as of the record date must be present at the annual meeting in order to hold the meeting and conduct business. This is called a quorum. Both abstentions and broker "non-votes" are counted as present for the purpose of determining the presence of a quorum. A broker "non-vote" occurs when a nominee holding shares for a beneficial owner does not vote on a particular proposal because the nominee does not have discretionary voting power with respect to that item and has not received instructions from the beneficial owner.

Shares are counted as present at the meeting if you:

- are present and vote in person at the meeting; or
- have properly submitted a proxy card or voting instruction card or voted via the Internet or by telephone.

Q: ***What is the voting requirement to approve each of the proposals?***

A: *Proposal One* — Directors are elected by a plurality vote, and therefore the three individuals receiving the highest number of "FOR" votes will be elected. Votes of "WITHHOLD" and broker non-votes have no legal effect on the election of directors due to the fact that such elections are by a plurality. You may vote either "FOR" or "WITHHOLD" on each of the three Class B nominees for election as director.

Proposal Two — The affirmative vote of a majority of the votes duly cast is required to ratify the appointment of KPMG LLP as our company's independent registered public accounting firm. You may vote "FOR," "AGAINST" or "ABSTAIN" on Proposal Two. Abstentions are deemed to be votes cast and have the same effect as a vote against this proposal. However, broker non-votes are not deemed to be votes cast and, therefore, are not included in the tabulation of the voting results on this proposal.

Q: ***Who counts the votes?***

A: Voting results are tabulated and certified by Broadridge Financial Solutions, Inc.

Q: ***What happens if I do not cast a vote?***

A: *Stockholders of record* — If you are a stockholder of record and you do not cast your vote, no votes will be cast on your behalf on any of the items of business at the annual meeting. However, if you submit a signed proxy card with no further instructions, the shares represented by that proxy card will be voted as recommended by our Board of Directors.

Beneficial owners — If you hold your shares in street name it is critical that you cast your vote if you want it to count in the election of directors (Proposal One). In the past, if you held your shares in street name and you did not indicate how you wanted your shares voted in the election of directors, your bank, broker or other nominee was allowed to vote those shares on your behalf in the election of directors as they felt appropriate. Recent rule changes eliminate the ability of your bank, broker or other nominee to vote your uninstructed shares in the election of directors on a discretionary basis. Thus, if you hold your shares in street name and you do not instruct your bank, broker or other nominee how to vote in the election of directors, no votes will be cast on your behalf. For more information on this topic, see the SEC Investor Alert issued in February 2010 entitled "New Shareholder Voting Rules for the 2010 Proxy Season" at http://www.sec.gov/investor/alerts/votingrules2010.htm. Your bank, broker or other nominee will, however, continue to have discretion to vote any uninstructed shares on the ratification of the appointment of our company's independent registered public accounting firm (Proposal Two).

Q: How can I vote my shares in person at the annual meeting?

A: Shares held directly in your name as the stockholder of record may be voted in person at the annual meeting. If you choose to vote in person, please bring your proxy card or proof of identification to the annual meeting. Even if you plan to attend the annual meeting, Echelon recommends that you vote your shares in advance as described below so that your vote will be counted if you later decide not to attend the annual meeting. If you hold your shares in street name, you must request a legal proxy from your broker, bank or other nominee in order to vote in person at the annual meeting.

Q: How can I vote my shares without attending the annual meeting?

A: Whether you hold shares directly as the stockholder of record or beneficially in street name, you may direct how your shares are voted without attending the annual meeting. If you are a stockholder of record, you may vote by submitting a proxy; please refer to the voting instructions in the Notice or below. If you hold shares beneficially in street name, you may vote by submitting voting instructions to your broker, bank or other nominee; please refer to the voting instructions provided to you by your broker, bank or other nominee.

Internet — Stockholders of record with Internet access may submit proxies by following the "Vote by Internet" instructions on the Notice until 11:59 p.m., Eastern Time, on May 21, 2012 or by following the instructions at www.proxyvote.com. Most of our stockholders who hold shares beneficially in street name may vote by accessing the website specified in the voting instructions provided by their brokers, banks or other nominees. A large number of banks and brokerage firms are participating in Broadridge Financial Solutions, Inc.'s (formerly ADP Investor Communication Services) online program. This program provides eligible stockholders the opportunity to vote over the Internet or by telephone. Voting forms will provide instructions for stockholders whose bank or brokerage firm is participating in Broadridge's program.

Telephone — If you request a printed set of the proxy materials, you will be eligible to submit your vote by telephone.

Mail — If you request a printed set of the proxy materials, you may indicate your vote by completing, signing and dating the proxy card or voting instruction form where indicated and by returning it in the prepaid envelope that will be provided.

Q: How can I change or revoke my vote?

A: Subject to any rules your broker, bank or other nominee may have, you may change your proxy instructions at any time before your proxy is voted at the annual meeting.

Stockholders of record — If you are a stockholder of record, you may change your vote by (1) filing with our General Counsel, prior to your shares being voted at the annual meeting, a written notice of revocation or a duly executed proxy card, in either case dated later than the prior proxy relating to the same shares, or (2) attending the annual meeting and voting in person (although attendance at the annual meeting will not, by itself, revoke a proxy). Any written notice of revocation or subsequent proxy card must be received by our General Counsel prior to the taking of the vote at the annual meeting. Such written notice of revocation or subsequent proxy card should be hand delivered to our General Counsel or should be sent so as to be delivered to our principal executive offices, Attention: General Counsel.

Beneficial owners — If you are a beneficial owner of shares held in street name, you may change your vote (1) by submitting new voting instructions to your broker, bank or other nominee, or (2) if you have obtained, from the broker, bank or other nominee who holds your shares, a legal proxy giving you the right to vote the shares, by attending the annual meeting and voting in person.

In addition, a stockholder of record or a beneficial owner who has voted via the Internet or by telephone may also change his, her or its vote by making a timely and valid later Internet or telephone vote no later than 11:59 p.m., Eastern Time, on May 21, 2012.

Q: Where can I find the voting results of the annual meeting?

A: The preliminary voting results will be announced at the annual meeting. The final results will be reported in a current report on Form 8-K filed within four business days after the date of the annual meeting.

Q: Who are the proxies and what do they do?

A: The two persons named as proxies on the proxy card, Kathleen B. Bloch, our Senior Vice President and General Counsel, and William R. Slakey, our Executive Vice President and Chief Financial Officer, were designated by our Board of Directors. All properly executed proxies will be voted (except to the extent that authority to vote has been withheld) and where a choice has been specified by the stockholder of record as provided in the proxy card, it will be voted in accordance with the instructions indicated on the proxy card. If you are a stockholder of record and submit a signed proxy card, but do not indicate your voting instructions, your shares will be voted as recommended by our Board of Directors.

Q: What should I do if I receive more than one Notice or set of proxy materials?

A: If you received more than one Notice or set of proxy materials, your shares are registered in more than one name or brokerage account. Please follow the voting instructions on each Notice or voting instruction card that you receive to ensure that all of your shares are voted.

Q: How may I obtain a separate Notice or a separate set of proxy materials?

A: If you share an address with another stockholder, each stockholder may not receive a separate Notice or a separate copy of the proxy materials. Stockholders who do not receive a separate Notice or a separate copy of the proxy materials may request to receive a separate Notice or a separate copy of the proxy materials by contacting our Investor Relations department (i) by mail at 550 Meridian Avenue, San Jose, California 95126, (ii) by calling us at 408-938-5252 or (iii) by sending an email to mlarsen@echelon.com. Alternatively, stockholders who share an address and receive multiple Notices or multiple copies of our proxy materials may request to receive a single copy by following the instructions above.

Q: What happens if additional proposals are presented at the annual meeting?

A: Other than the two proposals described in this Proxy Statement, Echelon does not expect any additional matters to be presented for a vote at the annual meeting. If you are a stockholder of record and grant a proxy, the persons named as proxy holders, Kathleen B. Bloch, our Senior Vice President and General Counsel, and William R. Slakey, our Executive Vice President and Chief Financial Officer, will have the discretion to vote your shares on any additional matters properly presented for a vote at the annual meeting. If for any unforeseen reason any of Echelon's Class B nominees is not available as a candidate for director, the persons named as proxy holders will vote your proxy for such other candidate or candidates as may be nominated by our Board of Directors.

Q: ***Is my vote confidential?***

A: Proxy instructions, ballots and voting tabulations that identify individual stockholders are handled in a manner that protects your voting privacy. Your vote will not be disclosed either within Echelon or to third parties except (1) as necessary to meet applicable legal requirements, (2) to allow for the tabulation of votes and certification of the vote or (3) to facilitate a successful proxy solicitation by our Board of Directors. Occasionally, stockholders provide written comments on their proxy cards, which are then forwarded to Echelon's management.

DEADLINE FOR RECEIPT OF STOCKHOLDER PROPOSALS

Our stockholders may submit proposals that they believe should be voted upon at our next year's annual meeting or nominate persons for election to our Board of Directors. Stockholders may also recommend candidates for election to our Board of Directors (See *"Corporate Governance and Other Matters—Consideration of Stockholder Recommendations and Nominations of Board Members"*). Pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, as amended, some stockholder proposals may be eligible for inclusion in our 2013 proxy statement and proxy. Any such stockholder proposals must be submitted in writing to the attention of Kathleen B. Bloch, Senior Vice President, General Counsel and Secretary, Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126, no later than December 13, 2012, which is the date 120 calendar days prior to the one-year anniversary of the mailing date of this Proxy Statement. Stockholders interested in submitting such a proposal are advised to contact knowledgeable legal counsel with regard to the detailed requirements of applicable securities laws. The submission of a stockholder proposal does not guarantee that it will be included in our 2013 proxy statement.

Alternatively, under our Bylaws, a proposal or a nomination that the stockholder does not seek to include in our 2013 proxy statement pursuant to Rule 14a-8 may be submitted in writing to Kathleen B. Bloch, Senior Vice President, General Counsel and Secretary, Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126, for the 2013 annual meeting of stockholders not less than 20 days nor more than 60 days prior to the date of such meeting. Note, however, that in the event we provide less than 30 days notice or prior public disclosure to stockholders of the date of the 2013 annual meeting, any stockholder proposal or nomination not submitted pursuant to Rule 14a-8 must be submitted to us not later than the close of business on the tenth day following the day on which notice of the date of the 2013 annual meeting was mailed or public disclosure was made. For example, if we provide notice of our 2013 annual meeting on April 23, 2013 for a 2013 annual meeting on May 21, 2013, any such proposal or nomination will be considered untimely if submitted to us after May 3, 2013. For purposes of the above, "public disclosure" means disclosure in a press release reported by the Dow Jones News Service, Associated Press or a comparable national news service, or in a document publicly filed by us with the SEC. As described in our Bylaws, the stockholder submission must include certain specified information concerning the proposal or nominee, as the case may be, and information as to the stockholder's ownership of our common stock. If a stockholder gives notice of such a proposal after the deadline computed in accordance with our Bylaws, or the Bylaw Deadline, the stockholder will not be permitted to present the proposal to our stockholders for a vote at the 2013 annual meeting.

The rules of the SEC also establish a different deadline for submission of stockholder proposals that are not intended to be included in our 2013 proxy statement with respect to discretionary voting, or the Discretionary Vote Deadline. The Discretionary Vote Deadline for the 2013 annual meeting is February 26, 2013, the date which is 45 calendar days prior to the one-year anniversary of the mailing date of this Proxy Statement. If a stockholder gives notice of such a proposal after the Discretionary Vote Deadline, our proxy holders will be allowed to use their discretionary voting authority to vote against the stockholder proposal when and if the proposal is raised at the 2013 annual meeting.

Because the Bylaw Deadline is not capable of being determined until we publicly announce the date of our 2013 annual meeting, it is possible that the Bylaw Deadline may occur after the Discretionary Vote Deadline. In such a case, a proposal received after the Discretionary Vote Deadline but before the Bylaw Deadline would be eligible to be presented at the 2013 annual meeting and we believe that our proxy holders at such meeting would be allowed to use the discretionary authority granted by the proxy to vote against the proposal at such meeting without including any disclosure of the proposal in the proxy statement relating to such meeting.

CORPORATE GOVERNANCE AND OTHER MATTERS

Corporate Governance

Corporate Governance Guidelines

Our Board of Directors adopted Corporate Governance Guidelines in November 2002 that outline, among other matters, the role and functions of our Board of Directors and the composition and responsibilities of various committees of our Board of Directors. The Corporate Governance Guidelines are available, along with other important corporate governance materials, at the investor relations section of our website at www.echelon.com.

The Corporate Governance Guidelines provide, among other things, that:

- A majority of the directors must meet the independence criteria established by Nasdaq.
- If the Chairman of the Board is not an independent director, then a Presiding Director must be appointed by the outside directors to assume the responsibility of chairing the regularly scheduled meetings of outside directors.
- Our Board of Directors shall have a policy of holding separate meeting times for outside directors.
- All of the members of the Nominating and Governance Committee, Audit Committee and Compensation Committee must meet the criteria for independence established by Nasdaq, except that our Board of Directors may make exceptions to this policy with respect to the Nominating and Governance Committee that are consistent with regulatory requirements.
- Our Board of Directors shall have responsibility over such matters as overseeing our Chief Executive Officer and other senior management in the competent and ethical operation of our company, gathering and analyzing information obtained from management, retaining counsel and expert advisors, and overseeing and monitoring the effectiveness of governance practices.

In April, 2008, our Board of Directors appointed Robert J. Finocchio, Jr. as Presiding Director. Pursuant to the Corporate Governance Guidelines, the Presiding Director was selected by our non-employee directors and assumed the responsibilities of chairing meetings of non-employee directors, serving as the liaison between our Chief Executive Officer, Chairman of the Board and our independent directors, approving Board of Directors meeting agendas and schedules and information flow to our Board of Directors and such further responsibilities that the non-employee directors as a whole designate from time to time.

As the operation of our Board of Directors is a dynamic process, our Board of Directors regularly reviews changing legal and regulatory requirements, evolving best practices and other developments. Accordingly, our Board of Directors may modify the Corporate Governance Guidelines from time to time, as it deems appropriate.

In addition, in November 2009, we announced that M. Kenneth Oshman, Echelon's Chairman of the Board and Chief Executive Officer had stepped down as our Chief Executive Officer, but would continue to serve as Executive Chairman of the Board. Mr. Oshman served as Executive Chairman of the Board until his death on August 6, 2011. In October, 2011, our Board appointed Ronald A. Sege, our Chief Executive Officer and President, to also serve as Chairman of the Board. At the same time, our Board reaffirmed Mr. Finocchio's appointment as our Presiding Director.

Board Leadership Structure and Role in Risk Management

Our company's management is responsible for the day to day assessment and management of the risks we face, while our Board of Directors administers its risk oversight function directly and through the Audit Committee and the Compensation Committee. Management regularly reports to our Board of Directors and/or the relevant Committee regarding identified or potential risks. The areas of material risk to our company include strategic, operational, financial, regulatory and legal risks. Our Board of Directors regularly reviews our company's strategies and attendant risks, and provides advice and guidance with respect to strategies to manage these risks while attaining long- and short-terms goals. Operational risks, including supply risks that might cause, and reputational risks that might result from, operational issues, and financial risks, including internal controls and credit risk associated with our customers, as well as overall economic risks, are the purview of our Audit Committee. The Audit Committee's review is accompanied by regular reports from management and assessments from our company's internal and external auditors. In assessing legal or regulatory risks, our Board of Directors and the Audit Committee are advised by management, counsel and experts, as appropriate. The Compensation Committee is responsible for overseeing the management of risks associated with executive and employee compensation plans and retention, to ensure that our company's compensation programs remain consistent with our stockholders' interests, that such programs do not encourage excessive risk-taking, and that such programs are designed to retain valued executives and employees.

Consideration of Stockholder Recommendations and Nominations of Board Members

The Nominating and Corporate Governance Committee of our Board of Directors will consider both recommendations and nominations from stockholders for candidates to our Board of Directors. A stockholder who desires to recommend a candidate for election to our Board of Directors shall direct the recommendation in writing to the Company Corporate Secretary, Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126, and must include the candidate's name, home and business contact information, detailed biographical data and qualifications, information regarding any relationships between the candidate and our company within the last three years and evidence of the nominating person's ownership of our stock and amount of stock holdings. For a stockholder recommendation to be considered by the Nominating and Corporate Governance Committee as a potential candidate at an annual meeting, nominations must be received on or before the deadline for receipt of stockholder proposals.

If, instead, a stockholder desires to nominate a person directly for election to our Board of Directors, the stockholder must follow the rules set forth by the SEC (see "*Deadline for Receipt of Stockholder Proposals*" above) and meet the deadlines and other requirements set forth in our Bylaws, including, (1) as to each person, if any, whom the stockholder proposes to nominate for election or re-election as a director: (a) the name, age, business address and residence address of such person, (b) the principal occupation or employment of such person, (c) the class and number of shares of our company which are beneficially owned by such person, (d) any other information relating to such person that is required by law to be disclosed in solicitations of proxies for election of directors and (e) such person's written consent to being named as a nominee and to serving as a director if elected; and (2) as to the stockholder giving the notice: (a) the name and address, as they appear on our company's books, of such stockholder, (b) the class and number of shares of our company which are beneficially owned by such stockholder and (c) a description of all arrangements or understandings between such stockholder and each nominee and any other person or persons (naming such person or persons) relating to the nomination.

Identifying and Evaluating Nominees for our Board of Directors

The Nominating and Corporate Governance Committee shall use the following procedures to identify and evaluate the individuals that it selects, or recommends that our Board of Directors select, as director nominees:

- The Committee shall review the qualifications of any candidates who have been properly recommended or nominated by stockholders, as well as those candidates who have been identified by management, individual members of our Board of Directors or, if the Committee determines, a search firm. Such review may, in the Committee's discretion, include a review solely of information provided to the Committee or may also include discussions with persons familiar with the candidate, an interview with the candidate or other actions that the Committee deems proper.

- The Committee shall evaluate the performance and qualifications of individual members of our Board of Directors eligible for re-election at the annual meeting of stockholders.

- The Committee shall consider the suitability of each candidate, including the current members of our Board of Directors, in light of the current size and composition of our Board of Directors. In evaluating the suitability of the candidates, the Committee considers many factors, including, among other things, issues of character, judgment, independence, age, expertise, diversity of experience, length of service, other commitments and the like. Diversity is also an important factor for the Committee to consider, as evidenced by the fact that two of the more recent additions to our company's Board of Directors have added to its diversity. The Committee evaluates such factors, among others, and considers each individual candidate in the context of the current perceived needs of our Board of Directors as a whole. Except as may be required by rules promulgated by Nasdaq or the SEC, it is the current sense of the Committee that there are no specific minimum qualifications that must be met by each candidate for our Board of Directors, nor are there specific qualities or skills that are necessary for one or more of the members of our Board of Directors to possess.

- After such review and consideration, the Committee selects, or recommends that our Board of Directors select, the slate of director nominees, either at a meeting of the Committee at which a quorum is present or by unanimous written consent of the Committee.

- The Committee will endeavor to notify, or cause to be notified, all director candidates of its decision as to whether to nominate such individual for election to our Board of Directors.

Standards of Business Conduct

We have adopted a Code of Business Conduct and Ethics that applies to all directors, officers and employees of Echelon. The Code of Business Conduct and Ethics can be viewed at the investor relations section of our website at www.echelon.com. We will post any amendments to, or waivers from, our Code of Business Conduct and Ethics at that location on our website.

Stockholder Communications

Any stockholder may contact any of our directors by writing to them by mail or express mail c/o Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126.

Any stockholder communications directed to our Board of Directors (other than concerns regarding questionable accounting or auditing matters directed to the Audit Committee or otherwise in accordance with our Financial Information Integrity Policy, which Financial Information Integrity Policy can be viewed at the investor relations section of our website at www.echelon.com) will first go to our General Counsel, who will log the date of receipt of the communication as well as (for non-confidential communications) the identity of the correspondent in our stockholder communications log.

Unless the communication is marked "confidential," our General Counsel will review, summarize and, if appropriate, draft a response to the communication in a timely manner. The summary and response will be in the form of a memo, which will become part of our stockholder communications log that our General Counsel maintains with respect to all stockholder communications.

At least quarterly, or more frequently as our General Counsel deems appropriate, our General Counsel will forward all such original stockholder communications along with the related memos to our Board of Directors for review.

Any stockholder communication marked "confidential" will be logged by our General Counsel as "received" but will not be reviewed, opened or otherwise held by our General Counsel. Such confidential correspondence will be immediately forwarded to the addressee(s) without a memo or any other comment by our General Counsel.

Meetings and Attendance of our Board of Directors and Committees of our Board of Directors

Attendance of Directors at 2011 Annual Meeting of Stockholders

It is the policy of our Board of Directors to strongly encourage board members to attend the annual meeting of stockholders. Seven members of our Board of Directors attended in person our annual meeting of stockholders on May 24, 2011, including M. Kenneth Oshman, who passed away on August 6, 2011.

Attendance at Board and Committee Meetings

Our Board of Directors held eight meetings in 2011. Each director is expected to attend each meeting of our Board of Directors and those committees on which he or she serves. During 2011, no director attended fewer than 75% of the aggregate of (i) the total number of meetings of our Board of Directors (held during the period for which he or she was a director) and (ii) the total number of meetings held by all committees of our Board of Directors on which such director served (held during the periods that he or she served), except for Livio Gallo, who attended 40% of applicable meetings. Mr. Gallo resigned from our Board, for personal reasons, as of March 14, 2012. During 2011, certain matters were approved by our Board of Directors or a committee of our Board of Directors by unanimous written consent.

Committees of our Board of Directors

Our Board of Directors currently has a standing Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee. Each of the Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee has a written charter that has been approved by our Board of Directors, copies of which can be viewed at the investor relations section of our website at www.echelon.com. Pursuant to our 1997 Stock Plan, our Board of Directors delegated authority to our Chief Executive Officer, Ronald A. Sege, to grant stock options, performance shares, and stock settled stock appreciation rights (SARs), to employees who are not executive officers of up to a maximum of 25,000 shares per person per year and, generally, up to an aggregate of 250,000 shares per year. The Compensation Committee, Audit Committee, and Nominating and Corporate Governance Committee are described as follows:

Compensation Committee

In 2011, the Compensation Committee consisted of directors Armas Clifford Markkula, Jr., Richard M. Moley and Betsy Rafael. The current members of the Compensation Committee are Armas Clifford Markkula, Jr., Richard M. Moley (Chair) and Betsy Rafael. The Compensation Committee held four meetings in 2011. The purposes of the Compensation Committee are to:

- discharge the responsibilities of our Board of Directors relating to compensation of our executive officers;
- approve and evaluate executive officer compensation plans, policies and programs; and
- produce an annual report on executive compensation for inclusion in our proxy statement.

The responsibilities of the Compensation Committee include annually reviewing and approving, for our Chief Executive Officer and our other executive officers, (1) annual base salary, (2) annual incentive bonus, including the specific goals and amount, (3) equity compensation, (4) employment agreements, severance arrangements and change in control agreements and provisions and (5) any other benefits, compensation or arrangements. In addition, the Compensation Committee will conduct an annual review of the performance of our Chief Executive Officer, and will oversee the management of risks associated with executive and employee compensation and plans to ensure that our company's compensation programs remain consistent with our stockholders' interests and that such programs do not encourage excessive risk-taking. The Compensation Committee also approves our company-wide pay-for-performance evaluation plan, as well as general metrics for employee base salaries when compared to peer companies and the scope of our annual equity compensation grant to employees.

Audit Committee

In 2011, the Audit Committee consisted of directors Robyn M. Denholm, Robert J. Finocchio, Jr. and Betsy Rafael. The current members of the Audit Committee are Robyn M. Denholm, Robert J. Finocchio, Jr. (Chair) and Betsy Rafael. Our Board of Directors has determined that directors Denholm, Finocchio and Rafael are "audit committee financial experts," as that term is defined in Item 401(h) of Regulation S-K of the Securities Act of 1933, as amended, and that all members of our Audit Committee are independent within the meaning of Rule 5605(a)(2) of the listing standards of the Marketplace Rules of Nasdaq. The Audit Committee held four meetings in 2011. The purposes of the Audit Committee are to:

- oversee our accounting and financial reporting processes and the internal and external audits of our financial statements;
- assist our Board of Directors in the oversight and monitoring of (1) the integrity of our financial statements, (2) our compliance with legal and regulatory requirements, (3) the independent auditor's qualifications, independence and performance and (4) our internal accounting and financial controls;
- outline to our Board of Directors the results of its monitoring and recommendations derived therefrom and improvements made, or to be made, in internal accounting controls;
- prepare the report that the rules of the SEC require to be included in our annual proxy statement;
- appoint our independent registered public accounting firm; and
- provide to our Board of Directors such additional information and materials as it may deem necessary to make our Board of Directors aware of significant financial matters that require the attention of our Board of Directors.

The responsibilities of the Audit Committee include the continuous review of the adequacy of our system of internal controls; oversight of the work of our independent registered public accounting firm, including a post-audit review of the financial statements and audit findings; oversight of compliance with SEC requirements regarding audit related matters; review, in conjunction with counsel, of any legal matters that could significantly impact our financial statements; and oversight and review of our information technology and management information systems policies and risk management policies, including our investment policies.

Nominating and Corporate Governance Committee

In 2011, the Nominating and Corporate Governance Committee consisted of directors Armas Clifford Markkula, Jr., Richard M. Moley and Larry Sonsini. The current members of the Nominating and Corporate Governance Committee are Armas Clifford Markkula, Jr., Richard M. Moley and Larry Sonsini (Chair). The Nominating and Corporate Governance Committee held two meetings in 2011. The purpose of the Nominating and Corporate Governance Committee is to ensure that our Board of Directors is properly constituted to meet its fiduciary obligations to stockholders and our company and that our company has and follows appropriate governance standards. To carry out this purpose, the Nominating and Corporate Governance Committee shall:

- assist our Board of Directors by identifying prospective director nominees and to recommend to our Board of Directors the director nominees for the next annual meeting of stockholders;
- develop and recommend to our Board of Directors the governance principles applicable to our company;
- oversee the evaluation of our Board of Directors and management; and
- recommend to our Board of Directors director nominees for each committee.

The responsibilities of the Nominating and Corporate Governance Committee include evaluating the composition, organization and governance of our Board of Directors and its committees, including determining future requirements; overseeing the performance evaluation process of our Board of Directors; making recommendations to our Board of Directors concerning the appointment of directors to committees, selecting Board committee chairs and proposing the slate of directors for election; and making recommendations to our Board of Directors regarding compensation for non-employee directors and Board committee members.

Director Independence

Our Board of Directors has affirmatively determined that each of its members, other than Robert R. Maxfield and Ronald A. Sege, are independent directors under the listing standards of the Marketplace Rules of Nasdaq and applicable SEC rules, and that all of its members, other than Mr. Maxfield and Mr. Sege, were independent directors under the listing standards of the Marketplace Rules of Nasdaq in the three prior years.

Our Board of Directors has also determined that all directors serving as members of our Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee are independent under the Nasdaq listing standards and the rules of the SEC. Additionally, our Board of Directors has determined that all members of the Compensation Committee meet the non-employee director definition of Rule 16b-3 promulgated under Section 16 of the Securities Exchange Act of 1934, as amended, and the outside director definition of Section 162(m) of the Internal Revenue Code of 1986, as amended.

Director Compensation

In February 2007, our Board of Directors determined that in consideration for service on our Board of Directors, each non-employee director shall receive a cash payment of $40,000 per fiscal year, to be paid quarterly. In addition, in consideration for service on our Board of Directors or on one or more of our Compensation and/or Nominating and Corporate Governance Committees of our Board of Directors, each non-employee director shall receive a cash payment of $1,000 per Board of Directors meeting or Committee meeting attended, to be payable on the date of each such meeting so attended. We also determined that in consideration of the significantly greater time commitment and potential risk exposure for serving as a member of our Audit Committee, each director shall receive a cash payment of $2,000 per Audit Committee meeting attended, to be payable on the date of each such meeting so attended.

Furthermore, non-employee directors are eligible to participate in our 1997 Stock Plan. Our Board of Directors has adopted a program, effective as of the July 27, 2008 expiration date of the 1998 Director Option Plan, for automatically granting awards of nonqualified stock options to non-employee directors under the 1997 Stock Plan on the same terms as grants previously made under the 1998 Director Option Plan. Such program provides for the automatic grant of an option to purchase 25,000 shares of common stock on the date on which such person first becomes a non-employee director. Additionally, each non-employee director shall automatically be granted a 10,000 share option on the date of each annual meeting of stockholders, provided he or she is re-elected to our Board of Directors or otherwise remains on our Board of Directors on such date and provided that on such date he or she shall have served on our Board of Directors for at least the preceding six months. All options granted under this program are fully vested at grant. On May 24, 2011, the date of our 2011 annual meeting of stockholders, directors Denholm, Finocchio, Maxfield, Markkula, Moley, Rafael and Sonsini were each granted a 10,000 share option at a per share exercise price of $9.08.

Director Summary Compensation Table for Fiscal 2011

The table below summarizes the compensation paid by our company to non-employee directors for the fiscal year ended December 31, 2011.

Name	Fees Earned or Paid in Cash ($)	Option Awards ($) (1)(2)(3)	Total ($)
Robyn M. Denholm	54,000	38,999	92,999
Robert J. Finocchio, Jr.	54,000	38,999	92,999
Livio Gallo (4)	--	--	--
Armas Clifford Markkula, Jr.	53,000	38,999	91,999
Robert R. Maxfield	48,000	38,999	86,999
Richard M. Moley	53,000	38,999	91,999
Betsy Rafael	58,000	38,999	96,999
Larry W. Sonsini	49,000	38,999	87,999

(1) Amounts shown do not reflect compensation actually received by the directors. Instead, the amounts shown are the grant date fair value of the stock awards (disregarding an estimate of forfeitures) as determined in accordance with FASB ASC Topic 718, which were recognized for financial statement purposes. The assumptions used in the valuation of these awards are set forth in the notes to our consolidated financial statements, which are included in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on March 15, 2012. These amounts do not correspond to the actual value that will be recognized by the directors upon exercise or sale of such awards.

(2) On May 24, 2011, the date of our annual meeting of stockholders, each non-employee director serving in such capacity for at least the prior six months was granted a fully vested option to purchase 10,000 shares at a per share exercise price of $9.08, the closing price of our common stock on that date.

(3) As of December 31, 2011, the aggregate number of shares underlying options outstanding for each of our non-employee directors was:

Name	Aggregate Number of Shares
Robyn M. Denholm	55,000
Robert J. Finocchio, Jr.	50,000
Livio Gallo	--
Armas Clifford Markkula, Jr.	50,000
Robert R. Maxfield	30,000
Richard M. Moley	50,000
Betsy Rafael	40,000
Larry W. Sonsini	50,000

(4) Mr. Gallo was appointed to Echelon's Board of Directors effective June 30, 2011 and resigned effective March 14, 2012. Mr. Gallo elected not to receive any equity or cash compensation during his tenure citing rules imposed by his employer, Enel Distribuzione.

PROPOSAL ONE

ELECTION OF DIRECTORS

General

We currently have eight members on our Board of Directors. Our Board of Directors is divided into three classes, with each director serving a three-year term and one class being elected at each year's annual meeting of stockholders. Robert J. Finocchio, Jr., Armas Clifford Markkula, Jr. and Robert R. Maxfield are the Class B directors whose terms will expire at the 2012 Annual Meeting of Stockholders and they have been nominated by our Board of Directors for reelection at the Annual Meeting of Stockholders to be held May 22, 2012. Robyn M. Denholm, Richard M. Moley and Betsy Rafael are the Class C directors whose terms will expire at the 2013 Annual Meeting of Stockholders and Ronald A. Sege and Larry W. Sonsini are the Class A directors whose terms will expire at the 2014 Annual Meeting of Stockholders. M. Kenneth Oshman served as a Class A director until his death on August 6, 2011. Livio Gallo served as a Class B director from the date of his appointment to our Board of Directors on June 30, 2011 until his resignation from our Board of Directors on March 14, 2012. All of the directors, including the Class B nominees, are incumbent directors. There are no family relationships among any of our directors or executive officers, including any of the nominees mentioned above. Unless otherwise instructed, the holders of proxies solicited by this Proxy Statement will vote the proxies received by them for the three Class B nominees. In the event that any nominee is unable or declines to serve as a director at the time of the annual meeting, the proxy holders will vote for a nominee designated by the present Board of Directors to fill the vacancy. We are not aware of any reason that any nominee will be unable or will decline to serve as a director. Our Board of Directors recommends a vote "FOR" the election of each of the Class B nominees listed above.

Director Information

Current Directors

The names of the members of our Board of Directors, including the Class B nominees, their ages as of March 27, 2012 and certain information about them, are set forth below.

Name	Age	Principal Occupation
Robyn M. Denholm (1)	48	Chief Financial Officer and Executive Vice President of Juniper Networks, Inc.
Robert J. Finocchio, Jr. (1) (2)	60	Corporate director, private investor and part time professor
Armas Clifford Markkula, Jr. (2) (3) (4)	70	Vice Chairman of the Board of Directors of Echelon
Robert R. Maxfield (2)	70	Private investor
Richard M. Moley (3) (4)	73	Private investor
Betsy Rafael (1) (3)	50	Vice President, Corporate Controller and Principal Accounting Executive of Apple Inc.
Ronald A. Sege (5)	54	Chairman of the Board, President and Chief Executive Officer of Echelon
Larry W. Sonsini (4)	71	Chairman of Wilson Sonsini Goodrich & Rosati, P.C.

(1) Member of the Audit Committee.
(2) Denotes nominee for election at the 2012 Annual Meeting of Stockholders.
(3) Member of the Compensation Committee.
(4) Member of the Nominating and Corporate Governance Committee.
(5) Sole member of the stock option committee.

Director Biographies

The business experience and other specific skills, attributes and qualifications of each of the nominees is as follows:

Robyn M. Denholm has been a director of our company since 2008. Ms. Denholm is currently Chief Financial Officer and Executive Vice President of Juniper Networks. Prior to joining Juniper Networks in August 2007, Ms. Denholm was employed at Sun Microsystems where she served as Senior Vice President, Corporate Strategic Planning. In that role, she was responsible for Sun's corporate operating system, and the global sales and service administration function and she served as the leader of Sun's business transformation initiative. Ms. Denholm joined Sun in 1996 and served in executive assignments that included Senior Vice President, Finance; Vice President and Corporate Controller (Chief Accounting Officer); Vice President, Finance; Service Division, Director, Shared Financial Services APAC and Controller, Australia/New

Zealand. Prior to joining Sun, Ms. Denholm served at Toyota Motor Corporation Australia for seven years and at Arthur Andersen and Company for five years, in various finance assignments. Ms. Denholm is a Fellow of the Institute of Chartered Accountants of Australia and holds a Bachelors degree in Economics from the University of Sydney and a Masters of Commerce degree from the University of New South Wales.

Our Nominating and Corporate Governance Committee has reviewed Ms. Denholm's qualifications and background and has determined that based on her extensive executive and financial experience, Ms. Denholm is well qualified to serve as a director of our company in light of our company's business activities.

Robert J. Finocchio, Jr. has been a director of our company since 1999. Mr. Finocchio served as Chairman of the Board of Informix Corporation, an information management software company, from August 1997 to September 2000. Since September 2000, Mr. Finocchio has been a dean's executive professor at Santa Clara University's Leavey School of Business. From July 1997 until July 1999, Mr. Finocchio served as President and Chief Executive Officer of Informix. From December 1988 until May 1997, Mr. Finocchio was employed with 3Com Corporation, a global data networking company, where he held various positions, most recently serving as President, 3Com Systems. Mr. Finocchio also serves as a director of Broadcom Corporation and served as a director of Altera Corp. from 2002 to December 2011 and as a director of Sun Microsystems from 2006 to January 2010. Mr. Finocchio is Chair of the Board of Trustees of Santa Clara University. Mr. Finocchio holds a B.S. degree in Economics from Santa Clara University and an M.B.A. degree from the Harvard Business School.

Our Nominating and Corporate Governance Committee has reviewed Mr. Finocchio's qualifications and background and has determined that based on his extensive executive and financial experience, Mr. Finocchio is well qualified to serve as a director of our company in light of our company's business activities.

Armas Clifford Markkula, Jr. is the founder of our company and has served as a director since 1988. He has been Vice Chairman of our Board of Directors since 1989. Mr. Markkula was Chairman of the Board of Apple Computer from January 1977 to May 1983 and from October 1993 to February 1996 and was a director from 1977 to 1997. A founder of Apple, he held a variety of positions there, including President/Chief Executive Officer and Vice President of Marketing. Prior to founding Apple, Mr. Markkula was with Intel Corporation as Marketing Manager, Fairchild Camera and Instrument Corporation as Marketing Manager in the Semiconductor Division, and Hughes Aircraft as a member of the technical staff in the company's research and development laboratory. Mr. Markkula is a former trustee of Santa Clara University and served as Chair of the Board of Trustees from 2003 through 2009. Mr. Markkula received B.S. and M.S. degrees in Electrical Engineering from the University of Southern California.

Our Nominating and Corporate Governance Committee has reviewed Mr. Markkula's qualifications and background and has determined that based on his extensive executive experience, Mr. Markkula is well qualified to serve as a director of our company in light of our company's business activities.

Robert R. Maxfield has been a director of our company since 1989 and served as President and Chief Executive Officer of our company from November 2009 until August 18, 2010 and as assistant to the CEO/President from August 19, 2010 to November 4, 2010. He also served as our company's Senior Vice President of Products from April 2008 through September 2008 and a consultant to our company from October 2008 through April 2009. He was a co-founder of ROLM in 1969, and served as Executive Vice President and a director until ROLM's merger with IBM in 1984. Following the merger, he continued to serve as Vice President of ROLM until 1988. Since 1988, he has been a private investor. Mr. Maxfield was a venture partner with Kleiner, Perkins, Caufield & Byers, a venture capital firm, from 1989 to 1992. Mr.

Maxfield received B.A. and B.S.E.E. degrees from Rice University, and M.S. and Ph.D. degrees in Electrical Engineering from Stanford University.

Our Nominating and Corporate Governance Committee has reviewed Mr. Maxfield's qualifications and background and has determined that based on his extensive executive experience, Mr. Maxfield is well qualified to serve as a director of our company in light of our company's business activities.

Richard M. Moley has been a director of our company since 1997. Since August 1997, Mr. Moley has been a private investor. From July 1996 to August 1997, he served as Senior Vice President, Wide Area Business Unit and as a director of Cisco Systems, following Cisco Systems' purchase of StrataCom, where he was Chairman of the Board, Chief Executive Officer and President. Mr. Moley also serves as a director of Linear Technology. Mr. Moley received a B.S. degree in Electrical Engineering from Manchester University, an M.S. degree in Electrical Engineering from Stanford University and an M.B.A. degree from Santa Clara University.

Our Nominating and Corporate Governance Committee has reviewed Mr. Moley's qualifications and background and has determined that based on his extensive executive experience, Mr. Moley is well qualified to serve as a director of our company in light of our company's business activities.

Betsy Rafael has been a director of our company since 2005. Since August 2007, Ms. Rafael has held the position of Vice President and Corporate Controller for Apple Inc. and was appointed to the additional role of Principal Accounting Executive in January 2008. From September 2006 to August 2007, Ms. Rafael held the position of Vice President, Corporate Finance for Cisco Systems. From April 2002 to September 2006, she served as Vice President, Corporate Controller and Principal Accounting Officer of Cisco Systems. From December 2000 to April 2002, Ms. Rafael was the Executive Vice President, Chief Financial Officer, and Chief Administrative Officer of Aspect Communications, Inc., a provider of customer relationship portals. From April 2000 to November 2000, Ms. Rafael was Senior Vice-President and CFO of Escalate Inc., an enterprise e-commerce application service provider. From 1994 to 2000, Ms. Rafael held a number of senior positions at Silicon Graphics, culminating her career at Silicon Graphics as Senior Vice President and Chief Financial Officer. Prior to SGI, Ms. Rafael held senior management positions in finance with Sun Microsystems and Apple Computer. Ms. Rafael began her career with Arthur Young & Company. Ms. Rafael received a B.S.C. degree in Accounting from Santa Clara University.

Our Nominating and Corporate Governance Committee has reviewed Ms. Rafael's qualifications and background and has determined that based on her extensive executive and financial experience, Ms. Rafael is well qualified to serve as a director of our company in light of our company's business activities.

Ronald A. Sege has been President, Chief Executive Officer and a member of our Board of Directors since August 19, 2010. Our Board of Directors appointed Mr. Sege as Chairman of the Board on October 12, 2011. Mr. Sege served as President and Chief Operating Officer and a member of the board of directors of 3Com Corporation ("3Com") from April 2008 until the acquisition of 3Com by Hewlett-Packard Company effective April 12, 2010. Prior to re-joining 3Com, Mr. Sege served as President and Chief Executive Officer of Tropos Networks, Inc., a provider of wireless broadband networks, from 2004 to 2008. Prior to Tropos, Mr. Sege was President and Chief Executive Officer of Ellacoya Networks, Inc., a provider of broadband service optimization solutions based on deep packet inspection technology, from 2001 to 2004. Prior to Ellacoya, Mr. Sege was Executive Vice President of Lycos, Inc., an internet search engine, from 1998 to 2001. Prior to Lycos, Mr. Sege spent nine years at 3Com, from 1989 to 1998, serving in a variety of senior management roles including Executive Vice President, Global Systems Business Unit. Mr. Sege holds an M.B.A. from Harvard University and a B.A. degree from Pomona College.

Our Nominating and Corporate Governance Committee has reviewed Mr. Sege's qualifications and background and has determined that based on his extensive executive experience, Mr. Sege is well qualified to serve as a director of our company in light of our company's business activities.

Larry W. Sonsini has been a director of our company since 1993. Mr. Sonsini serves as Chairman of the law firm of Wilson Sonsini Goodrich & Rosati, P.C., where he has practiced since 1966. Mr. Sonsini received an A.B. degree in Political Science and Economics and an L.L.B. degree from the University of California at Berkeley. Mr. Sonsini served as a director of LSI Logic Corporation (currently LSI Corporation), from 2000 to 2006, as a director of Pixar from 1995 to 2006 and as a director of Silicon Valley Bancshares from 2003 to 2006.

Our Nominating and Corporate Governance Committee has reviewed Mr. Sonsini's qualifications and background and has determined that based on his extensive executive and legal experience, Mr. Sonsini is well qualified to serve as a director of our company in light of our company's business activities.

Class B Director Nominees

Robert J. Finocchio, Jr.
Armas Clifford Markkula, Jr.
Robert R. Maxfield

Vote Required

Directors shall be elected by a plurality vote. The three Class B nominees for director receiving the highest number of affirmative votes of the shares entitled to be voted for them shall be elected as directors. Votes against, abstentions and broker non-votes have no legal effect on the election of directors due to the fact that such elections are by a plurality.

Board Recommendation

OUR BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE "FOR" THE PROPOSED SLATE OF CLASS B DIRECTORS.

PROPOSAL TWO

RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

With authority granted by our Board of Directors, the Audit Committee of our Board of Directors has appointed KPMG LLP as our independent registered public accounting firm to audit our consolidated financial statements for the fiscal year ending December 31, 2012, and our Board of Directors recommends that our stockholders vote "FOR" ratification of such appointment.

KPMG LLP was originally appointed as our independent registered public accounting firm on March 21, 2002, when we retained the firm to perform the annual audit of our financial statements for the fiscal year ended December 31, 2002. A representative of KPMG LLP is expected to be present at the annual meeting, will have an opportunity to make a statement if he or she so desires and is expected to be available to respond to appropriate questions from our stockholders.

Audit and Non-Audit Fees

The following table sets forth fees for services KPMG LLP provided during fiscal years 2011 and 2010:

	2011	2010
Audit fees (1)	$ 982,564	$ 972,500
Audit-related fees (2)	$ —	$ 32,500
Tax fees	$ —	$ —
All other fees (3)	$ 12,725	$ 15,445
Total	$ 995,289	$ 1,020,445

(1) Represents fees for professional services provided in connection with the audit of our annual financial statements and our internal control over financial reporting, the review of our quarterly financial statements, and other advice on accounting matters. The audit fees for 2011 represent the amount billed to our company as of the date of this Proxy Statement.

(2) Audit-related fees during 2010 represent fees for services provided in connection with our Registration Statements on Forms S-3 and S-8.

(3) All other fees in 2011 and 2010 represent fees for due diligence services provided in connection with contemplated business transactions.

Our Audit Committee has considered whether the non-audit services provided by KPMG LLP are compatible with maintaining the independence of KPMG LLP and has concluded that the independence of KPMG LLP is maintained and is not compromised by the services provided. In accordance with its charter, the Audit Committee approves in advance all audit and non-audit services to be provided by KPMG LLP. During fiscal year 2011, 100% of the services were pre-approved by the Audit Committee in accordance with this policy.

Stockholder ratification of the selection of KPMG LLP as our independent registered public accounting firm is not required by our Bylaws or other applicable legal requirement. However, our Board of Directors is submitting the selection of KPMG LLP to our stockholders for ratification as a matter of good corporate practice. If our stockholders fail to ratify the selection, the Audit Committee will reconsider whether or not to retain that firm. Even if the selection is ratified, the Audit Committee at its discretion may direct the appointment of a different independent accounting firm at any time during the year if it determines that such a change would be in our best interests and the best interests of our stockholders.

Board Recommendation

OUR BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS THAT YOU VOTE "FOR" RATIFICATION OF THE APPOINTMENT OF KPMG LLP AS OUR INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM.

SHARE OWNERSHIP BY PRINCIPAL STOCKHOLDERS AND MANAGEMENT

To our knowledge, the following table sets forth certain information with respect to beneficial ownership of our common stock, as of March 27, 2012, for:

- each person who we know beneficially owns more than 5% of our common stock;
- each of our directors;
- each of our Named Executive Officers; and
- all of our directors and executive officers as a group.

Beneficial ownership is determined in accordance with the rules of the SEC and includes voting or investment power with respect to the securities. Except as indicated by footnote, and subject to applicable community property laws, each person identified in the table possesses sole voting and investment power with respect to all shares of common stock shown held by them. The number of shares of common stock outstanding used in calculating the percentage for each listed person includes shares of common stock underlying options or other rights held by such person that are exercisable within 60 calendar days of March 27, 2012, but excludes shares of common stock underlying options or other rights held by any other person. Percentage of beneficial ownership is based on 42,604,213 shares of common stock outstanding as of March 27, 2012.

Name	Shares Beneficially Owned	Percentage Beneficially Owned
5% Stockholders:		
Barbara S. Oshman (1)	4,652,054	10.9%
ENEL Investment Holding BV (2)	3,000,000	7.0%
Riverbridge Partners LLC (3)	2,388,969	5.6%
Tocqueville Asset Management LP (4)	2,339,000	5.5%
BlackRock, Inc. (5)	2,168,727	5.1%
Directors and Executive Officers:		
Armas Clifford Markkula, Jr. (6) (7)	1,827,038	4.3%
Oliver R. Stanfield (6) (8)	711,514	1.7%
Robert R. Maxfield (6) (9)	403,983	*
Ronald A. Sege (6) (10)	301,038	*
Richard M. Moley (6) (11)	225,589	*
Robert J. Finocchio, Jr. (6) (12)	115,000	*
Michael T. Anderson (6)	83,524	*
Larry W. Sonsini (6)	64,261	*
Robyn M. Denholm (6)	55,000	*
Betsy Rafael (6)	50,000	*
Varun Nagaraj (6)	47,000	*
Robert W. Hon (6)	42,500	*
William R. Slakey	0	--
All directors and executive officers as a group (17 persons) (6)	4,591,933	10.5%

* Less than 1%.

(1) Barbara S. Oshman's address is c/o 545 Middlefield Road, Suite 165, Menlo Park, CA 94025. As set forth in a Schedule 13G filed by Ms. Oshman with the SEC on February 10, 2012, as of December 31, 2011 and following the death of M. Kenneth Oshman on August 6, 2011, includes shares held by the following trusts, of which Barbara S. Oshman serves as sole trustee: (i) 2,671,778 shares held by the M. Kenneth and Barbara S. Oshman Trusts dated July 10, 1979, (ii) 268,638 shares held by the M. Kenneth Oshman 2011 Annuity Trust #1 dated February 25, 2011; (iii) 268,638 shares held by the Barbara S. Oshman 2011 Annuity Trust #1 dated February 25,

2011; (iv) 98,107 shares held by the M. Kenneth Oshman 2010 Annuity Trust dated February 23, 2010; (v) 98,107 shares held by the Barbara S. Oshman 2010 Annuity Trust dated February 23, 2010; (vi) 123,393 shares held by the M. Kenneth Oshman 2010A Annuity Trust dated August 18, 2010; (vii) 123,393 shares held by the Barbara S. Oshman 2010A Annuity Trust dated August 18, 2010; (viii) 500,000 shares held by the Peter Lawrence Oshman 2010 Trust; and (ix) 500,000 shares held by the David Ross Oshman 2010 Trust. Barbara S. Oshman disclaims beneficial ownership of the shares held by the Peter Lawrence Oshman 2010 Trust and the David Ross Oshman 2010 Trust.

(2) Affiliate of Enel S.p.A. The principal address is Viale Regina Margherita 137, Rome, Italy 00198.

(3) The number of shares beneficially owned is as reported in a Schedule 13G filed by Riverbridge Partners LLC with the SEC on February 6, 2012. The address of Riverbridge Partners LLC is 801 Nicollet Mall, Suite 600, Minneapolis, MN 55402. Riverbridge Partners LLC has sole voting power as to 1,727,883 shares and sole dispositive power as to 2,388,969 shares.

(4) The number of shares beneficially owned is as reported in a Schedule 13G filed by Tocqueville Asset Management LP with the SEC on January 30, 2012. The address of Tocqueville Asset Management LP is 40 West 57th Street, 19th Floor, New York, NY 10019.

(5) The number of shares beneficially owned is as reported in a Schedule 13G filed by BlackRock, Inc. with the SEC on February 9, 2012. The address of BlackRock, Inc. is 40 East 52nd Street, New York, NY 10022.

(6) Includes, for the applicable director or executive officer, the following shares exercisable within 60 days of March 27, 2012 upon the exercise of options, performance shares and/or SARs. The number of performance shares assumes, with respect to certain grants, that 50% vesting has occurred based upon our Company having achieved specified performance milestones (see *"Executive Compensation and Related Matters—Outstanding Equity Awards at 2011 Fiscal Year-End,"* footnotes (4) and (7)). Confirmation that such performance milestones have been achieved will not occur until such determination is finally made following the end of our first quarter of fiscal year 2012. The number of shares issued upon the exercise of SARs will be reduced at the time of exercise by (i) a number of shares sufficient to cover the grant price times the number of shares with respect to which the SAR is being exercised plus (ii) a number of shares sufficient to cover the amount of certain minimum withholding taxes due at the time of exercise. The number of shares withheld to cover the grant price and withholding taxes will be calculated based on the fair market value of our common stock on the date of exercise.

	Options	Performance Shares	SARs
• Armas Clifford Markkula, Jr.	50,000	0	0
• Oliver R. Stanfield	0	36,875	53,438
• Robert R. Maxfield	30,000	0	0
• Ronald A. Sege	0	0	62,500
• Richard M. Moley	50,000	0	0
• Robert J. Finocchio, Jr.	50,000	0	0
• Michael T. Anderson	0	31,250	37,500
• Larry W. Sonsini	50,000	0	0
• Robyn M. Denholm	55,000	0	0
• Betsy Rafael	40,000	0	0
• Varun Nagaraj	0	28,750	18,250
• Robert W. Hon	0	25,000	17,500
• All directors and executive officers as a group	475,000	222,094	427,211

(7) Includes 1,655,110 shares held by Armas Clifford Markkula, Jr. and Linda Kathryn Markkula, Trustees of the Restated Arlin Trust Dated December 12, 1990, and 121,928 shares held by the Markkula Family Limited Partnership. Mr. Markkula and his spouse disclaim beneficial ownership of all but 27,500 of the shares held by the Markkula Family Limited Partnership.

(8) Includes (i) 548,684 shares held by Oliver Rueben Stanfield and Janet Helen Stanfield, Trustees of the Stanfield Family Trust UDT dated February 2, 2001, (ii) 250 shares held by Mr. Stanfield's spouse and (iii) 11,000 shares held by the Calvin Family Trust (the "Calvin Trust"). Mr. Stanfield was appointed Co-Trustee of the Calvin Trust, which is for the benefit of his step-parent. Mr. Stanfield disclaims beneficial ownership of the shares held by the Calvin Trust except to the extent of his pecuniary interest.

(9) Includes 373,983 shares held by Robert R. Maxfield, Trustee UA DTD 12/14/87.
(10) Includes 19,788 shares held by R. A. Sege & E. Sege Co-TTEE Ronald A. and Eugenia Sege TR U/T/A DTD 10/19/2010. See *"Executive Compensation and Related Matters— Compensation Discussion and Analysis," "—Outstanding Equity Awards at 2011 Fiscal Year-End,"* footnotes (1), (2) and (3), and *"—Potential Payments Upon Termination or Change in Control—Employment Agreement with Ronald A. Sege"* for information regarding vesting criteria applicable to the outstanding shares held by Mr. Sege. If a determination is made following the end of our first quarter of fiscal year 2012 that our company has achieved specified performance milestones (*see "Executive Compensation and Related Matters – Outstanding Equity Awards at 2011 Fiscal Year-End"* footnote (4), then Mr. Sege's restricted stock award dated August 19, 2010 for a total of 125,000 would vest as to 50% of the shares.
(11) Includes 175,589 shares held by the Richard Michael Moley and Elizabeth Moley 1989 Revocable Trust dtd 9/29/89, as amended 8/23/02.
(12) Includes 65,000 shares held by the Robert J. and Susan H. Finocchio Family Trust dated January 9, 1990.

EXECUTIVE COMPENSATION AND RELATED MATTERS

Compensation Discussion and Analysis

This section discusses the principles underlying our policies and our Compensation Committee's decisions concerning the compensation of our executive officers and the reasons those decisions were made.

Executive Summary

Pay for Performance

The cornerstone of our executive compensation program is pay for performance. Accordingly, while we pay competitive base salaries and other benefits, the majority of our Named Executive Officers' compensation opportunity is based on variable pay.

Corporate Governance Best Practices

Our Compensation Committee, assisted by Compensia, its independent compensation consultant, stays informed of developing executive compensation best practices and strives to implement them. In this regard, our stockholders should note:

- Of our Named Executive Officers, only our Chief Executive Officer, Mr. Sege has any contractual severance protection outside of a change of control;
- If a change of control occurs, all of our Named Executive Officers have double-trigger, not single-trigger, equity vesting acceleration protection;
- None of our Named Executive Officers or other employees has any golden parachute excise tax gross-up benefits;
- We have adopted share ownership guidelines for our executive officers and for our Board of Directors;
- Under our management bonus plan for 2011, 100% of the targeted bonus for our Chief Executive Officer, Chief Financial Officer and other key executive officers was tied to our company's ability to generate revenue and control spending;

- Under our 2012 management bonus plan, 100% of the targeted bonus for our Chief Executive Officer, Chief Financial Officer and other key executive officers and director level managers is tied to our company's ability to generate revenue, control spending and improve our non-GAAP operating income;
- Providing no single-trigger vesting acceleration in any of our equity awards; and
- Not providing any club memberships, private travel on executive aircraft, or similar excessive perquisites to any of our Named Executive Officers.

Executive Compensation Questions and Answers

Q. ***What is our company's overall executive compensation philosophy?***

A. Our executive compensation programs are designed to meet the following objectives:

- Attract and retain motivated and talented employees with a view to the competitive nature of the marketplace in Silicon Valley and other areas in which we seek talent;
- Motivate our employees to perform to their best abilities through a compensation strategy that includes meaningful pay for performance;
- Position base salary, targeted variable compensation and equity compensation to the 50th to 65th percentile of competitive ranges when compared to similarly situated companies;
- Link executive compensation to our company's performance and the individual's performance;
- Align the interests of our executives with those of our stockholders by (i) providing our executive officers with incentives to attain our company's long-term goals, (ii) specifically linking our financial and operating results to compensation paid to executive officers, and (iii) with respect to long-term equity compensation, keeping within industry guidelines for dilution; and
- Provide a compensation structure that is not only competitive in our geographic and industry areas, but is internally equitable and consistent based on level of responsibilities.

These objectives fit within our overall compensation philosophy by giving incentive to our executives to continuously improve our company's performance, while recognizing the need to secure the future potential of our business. Our compensation philosophy is also intended to enhance stockholder value, provide proper compliance with regulatory and related requirements, and create a cohesive executive team.

To meet these objectives, we have implemented an executive compensation program based on the following general policies:

- Pay cash compensation in the form of executive base pay that is competitive with the practices of other comparable high technology companies in our area; and
- Pay for performance:
    - through an annual management bonus plan that is based upon our company's performance when compared to strategic business objectives; and

- by providing significant long-term incentives in the form of equity compensation awards, which may include performance shares (also referred to as "restricted stock units"), stock appreciation rights (also referred to as "SARs"), restricted stock and/or stock options, in order to retain those individuals with the leadership abilities necessary to increase long-term stockholder value.

Q. Who are the officers on our company's executive team?

A. Our executive team is currently comprised of the following individuals:

Title	Name
Chairman of the Board, Chief Executive Officer and President	Ronald A. Sege
Executive Vice President and Chief Financial Officer	William R. Slakey
Senior Vice President of Worldwide Markets	Michael T. Anderson
Senior Vice President of Strategic Accounts and Business Development	Anders Axelsson
Senior Vice President and General Counsel	Kathleen B. Bloch
Senior Vice President of Operations	Russell Harris
Senior Vice President, Engineering	Robert Hon
Senior Vice President, Product Management and Product Marketing	Varun Nagaraj
Vice President, Principal Accounting Officer and Controller	C. Michael Marszewski

M. Kenneth Oshman served as our Executive Chairman of the Board until his passing in August 2011. Oliver R. Stanfield served as our Executive Vice President and Chief Financial Officer until his retirement in November 2011, and served as an Executive Vice President of our company until April 2012.

Throughout this proxy statement, our executive team is referred to as the "executive officers" and includes our "Named Executive Officers," who are listed in the Summary Compensation Table on p. 41 of this proxy statement.

Q. What is the role of our company's Compensation Committee?

A. The Compensation Committee is responsible for ensuring compliance with our company's executive compensation objectives and policies. Accordingly, the Compensation Committee reviews and approves our company's annual executive compensation arrangements, including approving specific performance objectives. These arrangements include annual base salary, annual incentive bonus, equity compensation, and other benefits or compensation. In performing these duties, the Compensation Committee is assisted by our Human Resources Department and receives input from our executive management, particularly our Chief Executive Officer. Management provides the Compensation Committee with information about our company and individual executive performance, market data, and management's perspective and recommendations on compensation matters. The Compensation Committee is authorized to obtain the assistance of compensation consultants at any time, and may also rely on consultants retained by our company. In 2011 our company retained the services of Compensia, a management compensation consulting firm that provides executive compensation advisory services, to provide input regarding executive compensation, including base salary, bonuses and long-term equity incentives.

Our Compensation Committee approves and interprets our executive compensation and benefits plans and policies, including our stockholder-approved 1997 Stock Plan. Our Compensation Committee is appointed by our Board of Directors, and consists entirely of directors who are independent for purposes of the listing standards of the Nasdaq Stock Market, "outside directors" for purposes of Section 162(m) of the Internal Revenue Code of 1986, as amended, and "non-employee directors" for purposes of Rule 16b-3 under the Securities Exchange Act of 1934, as amended. The members of our Compensation Committee currently are Armas Clifford Markkula, Jr., Richard M. Moley and Betsy Rafael, and the Compensation Committee is chaired by Mr. Moley. Our Compensation Committee operates under a written charter adopted by our Board of Directors which is available at the Investor Relations section of our website at www.echelon.com. The Compensation Committee held four meetings during 2011. Our Compensation Committee regularly meets in executive session without management present.

Q. What is the role of our Chief Executive Officer in compensation decisions?

A. Our Chief Executive Officer sets individual performance objectives, in line with the corporate objectives, for each executive officer at the beginning of the calendar year and reviews the performance of our executive officers during the year as well as during a formal annual review period following the end of the calendar year. Our CEO then presents his findings to our Compensation Committee, together with recommendations for their compensation structures. In 2011, our Chief Executive Officer also obtained input about compensation practices within comparator high technology companies from Compensia and East West Consulting.

In 2011, we implemented an employee performance management appraisal program under which each employee, including each of our executive officers, is charged with annually establishing specific, measurable performance objectives that are consistent with our company's overall goals, as well as professional development goals. Each employee's objectives are approved by his or her manager and the employee is evaluated periodically against those objectives. In evaluating each executive officer, it is the view of our Chief Executive Officer and the Compensation Committee that each executive officer is expected to perform at a very high level and to also function as an integral part of a cohesive team. The goals of the performance management appraisal program are to provide objective criteria against which to evaluate the performance of our executive officers and support a "pay for performance" culture.

The Compensation Committee alone or in consultation with the full Board of Directors (other than our Chief Executive Officer) reviews the performance of our Chief Executive Officer. As with the other executive officers, our Chief Executive Officer is expected to perform at a very high level.

The Compensation Committee considers these findings and recommendations, but makes its own final determinations. This review process is generally conducted twice each year: first, in advance of annual salary adjustments, if any, and the adoption of the annual management bonus program described below, and second, in connection with the annual equity compensation award.

Q: What is the role of compensation consultants and benchmarking in determining executive compensation?

A. In 2011, our company engaged Compensia, a management compensation consulting firm, to provide input regarding key trends in executive compensation practices, including base salary, bonuses and long-term equity, by our peer companies. In 2011, as part of the process of evaluating competitiveness of our company's executive pay programs, this independent compensation consultant was also requested to develop a peer group that was closely aligned with Echelon's business profile and reflected a reasonable comparator group for executive jobs of similar scope and complexity. For compensation purposes, the comparability was based in part on the following principles:

- When other variables are held constant, revenue is generally the best indicator of cash compensation levels;
- A best practice is to keep the peers within a range of roughly 0.5x to 2.0x our company's revenue. This is consistent with the approach of certain institutional investor advisors in developing peer groups;
- Market capitalization generally has the greatest influence on equity compensation level;
- Industry is an important factor, particularly where it reflects the general profitability of the business model or the complexity of successfully running the organization; and
- Other considered factors were revenue growth, profitability, valuation and number of employees.

In 2011 the Compensation Committee reviewed and approved this list of peer companies:

Bigband Networks, Inc.	Falconstor Software, Inc.	Radisys Corporation
Blue Coat Systems, Inc.	Globecomm Systems Inc.	Silver Spring Networks, Inc.
DDi Corp	Infinera Corporation	Sonus Networks, Inc.
Demandtec, Inc.	Internap Network Services Corporation	Tessera Technologies, Inc.
Digi International Inc.	Maxwell Technologies Inc.	TiVo Inc.
Emulex Corporation	OPNET Technologies, Inc.	Zygo Corporation
Extreme Networks, Inc.	Powersecure International, Inc.	

The overall competitive market framework represented a 50/50 blend of survey data from the July 2011 Radford Executive Compensation Report's broad industry data set of companies with revenues between $50MM-$200MM and the proxy data from the 20 above-listed peer companies recommended by Compensia and approved by the Compensation Committee.

Q. What are the elements of our company's executive compensation program?

A. Our executive officers' compensation has three primary components:

- Base salary;
- Participation in the management bonus plan; and
- Participation in the annual equity compensation award.

In addition, we provide our executive officers with employee benefits that are generally available to all salaried employees in the geographical location in which they are based. Except for post-termination payments that may be payable to our Chief Executive Officer under the employment agreement described below, we do not provide pension arrangements, post-termination payments, deferred compensation or other similar benefits to our current executive officers.

We believe that this combination of elements provides an appropriate mix of fixed and variable pay, balances short-term operational performance with long-term stockholder value, and is conducive to executive recruitment and retention.

Q. When are decisions concerning executive compensation made?

A. The Compensation Committee typically makes its decisions concerning executive officer base salaries early in the year, as was the case in 2011. Decisions regarding executive compensation may also be made at other times of the year.

The management bonus plan is also typically established early in the year. The management bonus plan was implemented in February of 2011. This plan is described below.

Our Company's equity compensation grant guidelines, which are described below, call for annual equity compensation grants to be made effective on the date of our company's annual meeting of stockholders. In 2011 because of the newly instituted performance management program with a retention and pay-for-performance philosophy and process the annual grant date was delayed from the date of our Annual Stockholders' Meeting in May until August 2011. This delay was to provide managers with the opportunity to complete mid-year performance reviews. The Compensation Committee granted 2011 annual awards on August 10, 2011.

Q: How are individual performance and other factors taken into consideration when making executive compensation decisions?

A: As noted above, the Compensation Committee relies on input from our Chief Executive Officer to evaluate the performance of the executive officers. For example, our Chief Executive Officer meets frequently with each of the executive officers, enabling him to develop in-depth knowledge of each executive officer's performance. In 2011, we implemented an employee performance management appraisal program under which each employee, including each of our executive officers, is charged with annually establishing specific, measurable performance objectives that are consistent with our company's overall goals, as well as professional development goals. Each executive officer's objectives reflect the applicable department's overall objectives and have been approved by our Chief Executive Officer. Our Chief Executive Officer and each executive officer meet periodically to evaluate the executive officer's performance against those objectives. The Chief Executive Officer then reviews the strengths, accomplishments and areas for growth of each executive with the Compensation Committee.

In establishing executive compensation, the Compensation Committee may consider previous award amounts, length of service or expected pay-outs under prior awards or the management bonus plan.

Q: How are base salaries determined?

A: Base salary fits into our overall compensation program as a means to attract and retain qualified Named Executive Officers, and to be competitive in our geographic and industry areas. Base salaries are designed to compensate our executive officers for services rendered during the year, and to meet competitive norms and reward performance on an annual basis. As outlined above, we rely on data from compensation consultants, the Radford survey, as well as general market sources, to keep our base salaries competitive when compared to our peer companies. Adjustments to salaries, if any, may be made based on an individual's current and expected future performance, pay relative to competitors and internal equity.

For 2011, given the continued challenging economic environment for our company, the Compensation Committee again made no adjustment to the base salaries of our executive officers, with two exceptions. First, following a review of salary levels at the peer companies referenced above and among our company's executive officers, the Compensation Committee approved an increase in annual salary for our company's Senior Vice President of Utilities Sales and Market Development (who is now our Senior Vice President of Worldwide Markets), Michael T. Anderson, from $300,000 to $325,000. Our company also reimbursed Mr. Anderson, who is a resident of the state of Washington, for California state income taxes paid on his salary. Second, the Compensation Committee increased the salary of our company's Executive Chairman, M. Kenneth Oshman, from $110,000 to $150,000 per year.

Summary. The following table summarizes the actual annual base salaries paid for 2011 for our Named Executive Officers:

Named Executive Officer	Title	2011 Annual Salary
Ronald A. Sege	Chairman of the Board, President and Chief Executive Officer	$400,000
Oliver R. Stanfield	Executive Vice President and Chief Financial Officer (served as Chief Financial Officer until November 7, 2011)	$360,000
Michael T. Anderson	Senior Vice President of Worldwide Markets	$322,917
William R. Slakey	Executive Vice President and Chief Financial Officer (commencing November 7, 2011)	$47,273 (1)
Robert Hon	Senior Vice President, Engineering (commencing March 31, 2011)	$195,781 (2)
Varun Nagaraj	Senior Vice President, Product Management and Product Marketing (commencing May 3,	$198,750 (3)

Named Executive Officer	Title	2011 Annual Salary
	2011)	

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(1) William R. Slakey joined our company in November 2011; his annualized salary was $312,000.

(2) Hon joined our company in March 2011; his annualized salary was $255,000.

(3) Nagaraj joined our company in May 2011; his annualized salary was $300,000.

Q: How is the management bonus plan generally determined?

A: Each year we adopt a management bonus plan that is intended to motivate key members of management, including our executive officers, to perform well and achieve important company objectives. The amount of the targeted management bonus is determined based on each manager's expected contribution to the overall outcome of our company's performance objectives, and also reflects market conditions. The management bonus may be paid in cash or other forms of compensation, including performance shares, and specific performance vesting requirements may be imposed on any shares delivered, as determined by the Compensation Committee in its discretion.

In May 2004, our stockholders approved a management bonus plan, which was re-approved at our 2009 Annual Meeting of Stockholders. The management bonus plan was implemented, and stockholder approval was originally obtained, to comply with Section 162(m) of the Internal Revenue Code. Section 162(m) limits the tax deductibility by a corporation of compensation paid in cash in excess of $1.0 million paid to its chief executive officer and the other three most highly compensated executive officers other than the chief financial officer. However, if such compensation qualifies as "performance based," it is excluded from the $1.0 million limit. To qualify as performance-based, among other requirements, such compensation may only be payable following the Compensation Committee's certification as to the achievement of pre-established, objective performance goals under a plan approved by the corporation's stockholders. Our Board of Directors may amend or terminate the management bonus plan at any time and for any reason. Any such amendment will be submitted for stockholder approval if required to maintain the bonus plan's compliance with Section 162(m).

After reviewing the recommendations of our Chief Executive Officer, the Compensation Committee selects which of our employees will be eligible to receive awards under the management bonus plan. The actual number of employees who will be eligible to receive an award under the bonus plan in any year cannot be determined in advance because our Chief Executive Officer and the Compensation Committee have the discretion to select the participants. However, it is expected that approximately twenty employees would participate in the management bonus plan in any year, for each performance period. The Compensation Committee approves performance goals that must be achieved before an award will actually be paid to a participant. The award may be expressed as a percentage of the participant's salary, or may be designated as a dollar amount or based on some other metric as determined by the Compensation Committee. Performance metrics might include cash position, earnings per share, individual objectives, net income, operating cash flow, operating income, expenses, return on assets, return on equity, revenue, total stockholder return, or other metrics. Service-based vesting may also be required before the award vests. From time to time, the Compensation Committee may be called upon to exercise its discretion to make determinations with respect to the performance goals under the management bonus plan, the metrics or limitations that apply under the plan, the effect on the plan of unanticipated transactions or occurrences, or other matters relevant to the plan.

Q: ***What determinations were made for the management bonus plan in 2011?***

A: ***2011 Management Bonus Plan***. For 2011, our management determined that the key imperatives for our company were to increase revenues and control spending. As a result, our Chief Executive Officer and other management reviewed the structure of the management bonus plans for the prior several years and proposed a management bonus plan that would be tied to, and would reward, success in achieving our company's targets for revenue generation and expense control. In February 2011, the Compensation Committee implemented a 2011 bonus plan under which certain of our executive officers, including our Chief Executive Officer, are eligible to earn cash payouts upon the achievement of specified performance targets.

Key elements of the 2011 Bonus Plan were as follows:

Non-Sales Executive Officers. For our executive officers, including our Chief Executive Officer but excluding our two Senior Vice Presidents of Sales and Market Development and our Executive Chairman, the 2011 bonus plan was tied to our company's revenue and expense control.

50% of the bonus amount was tied to performance targets based on our company's actual revenue and 50% of the bonus amount was tied to performance targets based on our company's non-GAAP operating income or loss, or NGOI. NGOI was calculated as our company's actual net operating income or loss for full year 2011, adjusted to remove stock-based compensation charges, payments under the 2011 bonus plan itself and certain other charges.

- For the revenue portion of the 2011 bonus plan (i.e., 50% of the total targeted bonus for each participant), the 2011 bonus plan had three tiers, as follows:

    (i) The first tier had a "cliff" below 85% of targeted revenue, in which case no revenue-based bonus would have been paid. If 85% of targeted revenue were achieved, then 70% of the revenue-based bonus would be paid;

    (ii) The second tier had a "primary" bonus rate on revenue from 85% up to and including 100% of targeted revenue, which primary rate was calculated such that the remaining 30% of the revenue-based bonus would be paid over the remaining 15% of targeted revenue; and

    (iii) The third tier had an "accelerated" bonus rate on revenue over 100% of targeted revenue, which accelerated rate is calculated at 50% more than the primary bonus rate.

- For the NGOI portion of the 2011 bonus plan (i.e., 50% of the total targeted bonus for each participant), the 2011 bonus plan also had three tiers, as follows:

    (i) At the first tier, the NGOI-based bonus would be paid if the primary NGOI target was achieved. No NGOI-based bonus would have been paid if this target is not achieved;

    (ii) At the second tier, the 2011 bonus plan had milestones from 0% to 100% measured against a second, more stringent NGOI target (with each milestone increasing by ten percentage points), each of which was a cliff. For example, no second tier NGOI-based bonus would have been paid if the first milestone had not been met, and the full second tier NGOI-based bonus would be paid if all milestones are met. If NGOI fell between two milestones, then the NGOI-based bonus associated with the lesser milestone would be paid. The full amount of the second tier NGOI-based bonus would be equal to the amount of the first tier NGOI-based bonus; and

(iii) At the third tier, an additional NGOI-based bonus would be paid if a third, even more stringent, NGOI target was achieved. The amount of the third tier NGOI-based bonus would be equal to 50% of the first tier NGOI-based bonus. The NGOI-based bonus was capped at two and one half times the target bonus amount.

Sales Executive Officers. For our Senior Vice President of Utilities Sales and Market Development (who is now our Senior Vice President of Sales for Worldwide Markets) and Senior Vice President of Commercial Sales and Market Development (who is now our Senior Vice President of Strategic Accounts and Business Development), the bonus plan is tied to revenue and successful revenue generating activities, such as bookings and design wins.

- The 2011 bonus plan for our company's Senior Vice President of Commercial Sales and Market Development was tied 100% to performance targets based on our company's revenue for commercial markets products, and with a payment for each "design win" during 2011.

- The 2011 bonus plan for our company's Senior Vice President of Utilities Sales and Market Development was tied 50% to performance targets based on our company's revenue for utilities markets products and 50% to new orders (bookings) for utilities markets products during 2011.

- The 2011 bonus for these sales executives also had three tiers:

  (i) The first tier had a "cliff" below 85% of targeted revenue or orders, as applicable, in which case no bonus would be paid. If 85% of targeted revenue or orders, as applicable, were achieved, then 70% of the applicable bonus would be paid;

  (ii) The second tier had a primary bonus rate on targeted revenue or orders, as applicable, from 85% up to and including 100% of targeted revenue or orders, as applicable, which primary rate is calculated such that the remaining 30% of the applicable bonus would be paid over the remaining 15% of targeted revenue or orders, as applicable; and

  (iii) The third tier had an "accelerated" bonus rate on revenue or orders, as applicable, over 100% of targeted revenue or orders, as applicable. The accelerated rate was calculated at 50% or 100% more than the primary bonus rate, depending on the products sold.

Target Bonus Amounts. The target amount of the bonus for our Chief Executive Officer for 2011 was set in his employment agreement with our company. For our other Named Executive Officers, the target bonus amount for 2011 was set relative to the officer's total compensation, the allocated dollar amount of the officer's bonus for the prior year, and internal equity. The Compensation Committee did not set the dollar amount of the bonus amount as a percentage of salary, although the Compensation Committee determined that in the future it would be appropriate to have a greater percentage of the total on-target compensation for each executive officer to be tied to a bonus with performance criteria.

If the performance criteria were met, the target bonus amounts to be paid to the Named Executive Officers under the 2011 bonus plan would be as set forth in the chart below. If the performance criteria were exceeded, the amount of the bonus paid to each Named Executive Officer could exceed such target bonus amount. No cap was imposed on the revenue-based portion of the bonus since, to the extent our revenue increases, our company would have benefited to a greater extent than the amount of the additional bonus that would be payable.

In March 2012 the Compensation Committee determined that, due to our company's strong revenue performance in the systems business in 2011, the 2011 revenue target had been achieved and exceeded for the non-sales executives and the Senior Vice President of Worldwide Markets, and all three tiers of the NGOI targets had been met. Overall, the 2011 bonus was calculated to pay out at approximately 192% of target. However, our executives reflected that in connection with an employee performance bonus plan that had been established in 2011 for non-officer employees and non-sales employees, such employee bonus plan, which was also tied to our company's revenue and NGOI performance, was to be paid out in shares of our company's common stock, and the price of our common stock was lower at the time of the March 2012 employee bonus plan payout than when the employee bonus grants were made in August 2011. To compensate for a portion of the difference in the value of the employee bonuses, the non-sales executive officers decided to request of the Compensation Committee that the cash bonus payout to the non-sales executive officers under the Management Bonus Plan be reduced and allow the additional cash to be paid to the non-executive officer employees who participated in the employee bonus plan. The Compensation Committee agreed to this request, and this resulted in the payout under the 2011 Management Bonus Plan being limited to 150% of target, and was also consistent with the 150% cash bonus cap applicable under Mr. Sege's employment agreement.

Named Executive Officer	Title	Threshold 2011 Revenue Bonus Amount – 85%	2011 Total Bonus Amount at 100%	Actual 2011 Bonus Amount Paid
Ronald A. Sege	Chairman of the Board, President and Chief Executive Officer	$140,000 (1)	$400,000	$600,000
Oliver R. Stanfield	Executive Vice President and Chief Financial Officer (served as Chief Financial Officer until November 7, 2011)	$30,100 (1)	$86,000	$129,000
Michael T. Anderson	Senior Vice President of Worldwide Markets	$70,000	$100,000	$194,342
William R. Slakey	Executive Vice President and Chief Financial Officer (commencing November 7, 2011)	$6,720	$19,200	$28,800
Robert Hon	Senior Vice President, Engineering (commencing March 31, 2011)	$17,605	$50,240	$75,360
Varun Nagaraj	Senior Vice President, Product Management and Product Marketing (commencing May 3, 2011)	$17,668	$50,480	$75,720

(1) The threshold for the 2011 bonus payable based on NGOI was 100% of the NGOI target.

Executive Chairman. In addition, for 2011, the Compensation Committee approved compensation for our company's Executive Chairman, M. Kenneth Oshman. Such compensation consisted of an annual salary of $150,000 and participation in the management bonus plan.

Under the bonus plan, while he remained an employee of our company, Mr. Oshman was entitled to receive a total of 40,651 performance shares over a two year period under our 1997 Stock Plan, calculated as a $400,000 bonus amount divided by the per share closing price of our company's common stock on February 10, 2011, which was $9.84. The issuance to Mr. Oshman of the shares of our company's common stock underlying the performance shares was subject to monthly vesting, so that one-twenty-fourth of the performance shares issuable vested as of the first of each month, commencing March 1, 2011, as long as Mr. Oshman continued to be employed by our company as of the applicable monthly vesting date. A total of 10,162 shares were released to Mr. Oshman in connection with this plan. No cash bonus was issued under the bonus plan for Mr. Oshman.

Q: What is the basis for equity compensation grants?

A: Equity compensation grants are made under our 1997 Stock Plan, which was approved by our stockholders at our 2004 annual meeting. Our 1997 Stock Plan provides for the grant of the following types of incentive awards:

- Stock options,
- Stock purchase rights,
- Stock appreciation rights,
- Performance units and performance shares, and
- Restricted stock.

As of March 27, 2012, a total of 20,101,482 shares of our common stock were reserved for issuance under our 1997 Stock Plan, with 5,143,357 of such shares subject to outstanding awards granted under our 1997 Stock Plan and 14,958,125 of such shares remaining available for new awards to be granted in the future.

Q. What forms of equity compensation awards may our company issue each year?

A. Our Compensation Committee regularly monitors equity compensation practices based upon data from Compensia and compensation surveys and makes changes to our equity compensation program to help us meet our goals, including achieving long-term stockholder value and employee and executive retention. We use various forms of equity compensation to motivate, retain and reward long-term performance. We have typically granted performance shares, stock appreciation rights, or SARs, stock options, and restricted stock, each of which carries a vesting requirement.

Our Compensation Committee annually approves an equity compensation award to our executive officers under our 1997 Stock Plan. The Compensation Committee intends that equity awards granted under our 1997 Stock Plan will offer long-term incentives to our executives to remain with our company and continue to perform well. We regard our equity award program as an important tool for retaining and motivating our executives.

The Compensation Committee believes that the use of performance shares provides a more predictable value to executives than stock options, and therefore that they are an efficient tool to retain and motivate executives, while also serving as an incentive to increase the value of our common stock. Performance shares also help conserve our 1997 Stock Plan share reserves because fewer performance shares are needed to provide a retention and incentive value similar to stock options. As explained below, in 2011, our Compensation Committee elected to grant only performance shares in our annual long-term equity compensation grant to executives, rather than a combination of SARs and performance shares.

Our Compensation Committee is authorized by our Board of Directors to grant awards under our 1997 Stock Plan. In addition, our Board of Directors has delegated to a "stock option committee," comprised solely of our Chief Executive Officer, a limited power to make equity compensation awards. In his "stock option committee" capacity, our Chief Executive Officer is empowered to grant stock options, performance shares and/or SARs under our 1997 Stock Plan, only to non-executive officer employees of our company, up to a maximum of 25,000 shares per employee per year and an aggregate limit of 250,000 shares per year. Any equity compensation awards to any executive officer or to any employee in excess of 25,000 shares in any year or in excess of the 250,000 share aggregate limit must be approved by the Compensation Committee or our Board of Directors.

Q: What determinations did the Compensation Committee make with respect to long-term equity incentive compensation in 2011?

A: In determining the amount and terms of the 2011 equity compensation awards for each of our Named Executive Officers and our Chief Executive Officer, the Compensation Committee received equity input from Steve Umphreys of EastWest Consulting, a performance and compensation consultant for the Company. The Compensation Committee reviewed the individual performance of each Named Executive Officer (other than our Chief Executive Officer) after receiving input from our Chief Executive Officer. The Compensation Committee reviewed the individual performance of our Chief Executive Officer, following input on his performance from the full Board (other than our Chief Executive Officer). In establishing 2011 award amounts for the Named Executive Officers, the Compensation Committee considered that the purpose of the awards is to retain and reward the most valuable contributors and reinforce a pay-for-performance culture, and the awards were determined based on performance, current non-vested shareholding value and target multiplier of annual on-target cash compensation.

The following grants were made to the Named Executive Officers in 2011:

Named Executive Officer	Title	Number of Performance Shares Granted
Ronald A. Sege	Chairman of the Board, President and Chief Executive Officer	100,000
Oliver R. Stanfield	Executive Vice President and Chief Financial Officer (served as Chief Financial Officer until November 7, 2011)	20,000
Michael T. Anderson	Senior Vice President of Worldwide Markets	40,000
William R. Slakey	Executive Vice President and Chief Financial Officer (commencing November 7, 2011)	0 (1)
Varun Nagaraj	Senior Vice President, Product Management and Product Marketing (commencing May 3, 2011)	0 (1)
Robert Hon	Senior Vice President, Engineering (commencing March 31, 2011)	0 (1)

(1) These Named Executive Officers did not participate because they had either recently or had not yet joined our company.

Q: How does our company determine grant dates for equity awards?

A: In August 2007, our Board of Directors and Compensation Committee adopted equity compensation grant guidelines regarding the timing of granting equity compensation awards to company employees, including executive officers. The guidelines provide that while we intend to follow the timing guidelines to the extent possible, our Board of Directors, the Compensation Committee or the stock option committee may issue equity compensation grants at a different time if doing so would be in the best interests of our company, our stockholders and our employees.

The equity compensation grant guidelines provide that awards will generally be granted on the 10^{th} day of the calendar month (or the next business day, if the 10^{th} day is not a business day). The grant date of the award will be the date that the exercise price (determined as the closing price for our company's common stock on the Nasdaq Stock Market) and vesting date are set. Awards may be approved in advance of the grant date for that month. Award approvals by the Compensation Committee generally will be made at an in-person or telephonic committee meeting. If an award is approved by unanimous written consent, the effective date of such written consent will be the date the last signature is obtained.

The guidelines apply to awards for both new and existing employees, including executive officers. The grant date for new employees will generally be the 10^{th} day of the month following the date the award is approved, provided that the grant date cannot be prior to the employee's first day of employment. The guidelines provide that, in the case of the annual equity compensation award to all or any subset of existing employees, the grant date will be the date of our company's annual meeting of stockholders for such year. In the case of awards to executive officers (including the annual award), if our company's "insider trading window" is not then open, then the grant date shall be the day the insider trading window next opens. However, in 2011, the annual equity compensation grant was not made on our company's annual meeting date, in order to allow performance evaluations to be completed. The annual grant was made on August 10, 2011, and our company's "insider trading window" was open on that date.

The Compensation Committee has not granted, nor does it intend to grant in the future, equity compensation awards in anticipation of the release of material nonpublic information that is likely to result in changes to the price of our common stock, such as a significant positive or negative earnings announcement. Similarly, the Compensation Committee has not timed, nor does it intend to time in the future, the release of material nonpublic information based on equity award grant dates.

Q: How was the compensation for our company's Chief Executive Officer and other Named Executive Officers determined?

A: In February 2011, the Compensation Committee reviewed Mr. Sege's compensation, which was initially set by the employment agreement between Mr. Sege and our company entered into in August 2010. The employment agreement provided for Mr. Sege's compensation for 2011 to be $400,000 in salary and $400,000 in bonus, with the bonus to be tied to performance criteria to be established by the Compensation Committee. The Compensation Committee did not make any changes to the level of compensation, and determined that the performance criteria applicable to Mr. Sege's 2011 bonus should be identical to the performance criteria applicable to our Chief Financial Officer and the other executive officers who do not head up our company's sales organizations. So doing assured that all executives (other than our sales executives, whose goals are focused on revenue generation) strive for the same goals. The performance criteria, which are described in more detail above, were intended to drive revenue and control spending. Mr. Sege's 2011 bonus was capped at 150% as stipulated in Mr. Sege's employment agreement.

In 2011, for Michael Anderson, who was then our Senior Vice President of Utilities Sales and Market Development and is now our Senior Vice President Worldwide Markets, after a review of salary levels at the peer companies referenced above and among our company's executive officers, the Compensation Committee approved an increase in annual salary from $300,000 to $325,000. There was no change to his 2011 on-target bonus of $100,000.

William Slakey, Executive Vice President and Chief Financial Officer, was hired by our company in November 2011. His $312,000 salary and a $124,800 on-target bonus were approved by the Compensation Committee based on the market data of peer companies provided by the Compensia, a management compensation consulting firm. Mr. Slakey's base salary and bonus were prorated for the remainder of 2011.

Robert Hon, Senior Vice President Engineering, was hired by our company in March 2011. His $255,000 salary and $63,800 on-target bonus were approved by the Compensation Committee based on market data of peer companies provided by Compensia. Mr. Hon's base salary and bonus were prorated for the remainder of 2011.

Varun Nagaraj, Senior Vice President of Product Management and Product Marketing, was hired by our company in May 2011. His $300,000 base salary and $75,000 on-target bonus were approved by the Compensation Committee based on market data of peer companies provided by Compensia. Mr. Nagaraj's base salary and bonus were prorated for the remainder of 2011.

Q: Does our company maintain stock ownership guidelines for its directors and executive officers?

A: In 2007, our Board of Directors determined that our directors and executive officers should own and hold common stock of our company to further align their interests and actions with the interests of our stockholders. Accordingly, our Board of Directors adopted stock ownership guidelines applicable to our directors and executive officers. The guidelines provide that directors who are not also officers of our company are expected to own and hold common stock of our company with a minimum of value of $100,000. In addition, the following guidelines apply to our executive officers:

Position	Minimum Ownership Guideline
Chief Executive Officer:	Shares with a value equal to five times base salary
President, Chief Operating Officer, Chief Financial Officer:	Shares with a value equal to three times base salary
Senior Vice President:	Lesser of 20,000 shares or shares with a value equal to one times base salary

Company common stock that will count towards satisfying the guidelines includes:

- Shares owned outright by the director or executive officer and his or her immediate family members who share the same household, whether held individually or jointly, and shares held in trust where the director or executive officer is the beneficial owner;
- Shares owned outright and resulting from the exercise of stock options or SARs and the release of performance shares; and
- Shares purchased in the open market.

Directors and executive officers are expected to achieve the specified stock ownership level within five years after the August 2007 adoption date of the guidelines, in the case of persons who were directors or officers as of that date, or five years after the date of their appointment as a director or executive officer, in the case of new appointments. Currently, four of seven non-employee directors, five of ten executive officers and one of six Named Executive Officers exceed these ownership guidelines. We note that three of the six Named Executive Officers joined our company in 2011 and one of the six Named Executive Officers joined our company in 2010.

Q: Does our company offer other benefits and programs to our executive officers?

A: We also offer a number of other benefits to our employees, including our executive officers, including medical, dental and vision insurance, long-term and short-term disability insurance, life and accidental death and dismemberment insurance, health and dependent care flexible spending accounts, wellness programs, educational assistance, and employee assistance programs. We also maintain a tax-qualified 401(k) Plan, which provides for broad-based employee participation. Our company does not offer matching for 401(k) Plan contributions, nor does our company offer a pension program, except as mandated by local laws.

We believe that the availability of these benefits programs generally enhances employee productivity and loyalty to our company. The main objectives of our benefits programs are to give our employees access to quality healthcare, financial protection from unforeseen events, assistance in achieving retirement financial goals, and enhanced health and productivity. These generally available benefits typically do not specifically factor into decisions regarding an individual executive's total compensation or equity award package.

Q: Does our company maintain any employment arrangements?

A: ***Chief Executive Officer.*** Effective as of August 19, 2010, Mr. Sege entered into an employment agreement with our company. The compensation payable to Mr. Sege under the employment agreement is described above, and the change-in-control benefit is described in the following section. Other material terms of that employment agreement are summarized below:

- Our Board of Directors appointed Mr. Sege to serve as a member of our Board and agreed to nominate Mr. Sege to serve as a member of our Board of Directors during the term of his employment term.

- If Echelon either terminates Mr. Sege for any reason other than "cause" or Mr. Sege resigns for "good reason" (either event being an "Involuntary Termination"), then subject to a release of claims in favor of Echelon becoming effective, Mr. Sege will be entitled to receive: (a) a lump sum payment equal to the sum of the following, paid within thirty days of departure: twelve months of his then-current base salary, plus an amount equal to the pro-rata portion of his then-current target bonus; (b) up to eighteen months of COBRA reimbursement; (c) twelve months vesting acceleration of his then unvested equity awards other than the performance-based restricted stock award. This severance program will be in effect for the entire term of service as Chief Executive Officer, except in the case of a change-in-control (as described below).

Chief Financial Officer. We entered into a letter agreement with Mr. Slakey with respect to his appointment as Executive Vice President and Chief Financial Officer, which became effective on November 7, 2011. The compensation payable to Mr. Slakey under the employment letter is described above. Mr. Slakey is also subject to the change-in-control benefit described in the following section.

Other Named Executive Officers. None of our other Named Executive Officers is subject to an employment or comparable agreement.

Q: Does our company provide any of its executive officers with change-in-control benefits?

A: ***Chief Executive Officer.*** Under Mr. Sege's employment agreement, in the event our company experiences a change-in-control and Mr. Sege is subject to an Involuntary Termination (not for cause) during the three month period prior to the change-in-control or following the change-in-control, then subject to a release of claims in favor of our company becoming effective, Mr. Sege would be entitled to receive:

- A lump sum payment equal to eighteen months of his base salary and target annual bonus (based on the average annual bonus paid over the last two years or the current target annual bonus, whichever is higher);

- Up to eighteen months of COBRA reimbursement; and

- 100% vesting acceleration of equity compensation (at target levels for performance-based awards).

Other Executive Officers. In June 2008, our Board of Directors approved modifications to the forms of equity award agreements under our 1997 Stock Plan. Under these modifications, if within twelve months following a change-in-control of our company, an employee of our company or our subsidiaries at the level of Vice President and above is subject to an involuntary (not for cause) termination within the meaning of our 1997 Stock Plan, then certain equity compensation awards of that employee would become fully vested. Our Board of Directors made this decision to reflect common practice among comparable situated companies in the Silicon Valley, following a review of such practices and input from our company's outside counsel.

Q: Did the Compensation Committee consider the risk inherent in our company's compensation plans and policies?

A: Yes, management conducted an analysis of the risk profile of our company's significant compensation plans and policies. This analysis was reviewed with the Board of Directors and Compensation Committee in 2011.

Compensation Committee Report

The information contained in this report shall not be deemed to be "soliciting material" or "filed" with the SEC or subject to the liabilities of Section 18 of the Securities Exchange Act of 1934, as amended, except to the extent that Echelon specifically incorporates it by reference into a document filed under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended.

The Compensation Committee has reviewed and discussed with management the Compensation Discussion and Analysis for fiscal 2011. Based on the review and discussions, the Compensation Committee recommended to our Board of Directors that the Compensation Discussion and Analysis be included in Echelon's Proxy Statement for its 2012 Annual Meeting of Stockholders.

This report is submitted by the Compensation Committee of the Board of Directors of Echelon.

Richard M. Moley, Chairman
Armas Clifford Markkula, Jr.
Betsy Rafael

Summary Compensation Table

The following table shows compensation information for the fiscal years ended December 31, 2011, December 31, 2010 and December 31, 2009 for the Named Executive Officers.

Name and Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($) (1)	Option Grants ($) (1)	Non-Equity Incentive Plan Compensation ($)	All Other Compen-sation ($)	Total ($)
Ronald A. Sege (2)	2011	400,000	—	905,000	—	600,000	—	1,905,000
Chairman of the Board,	2010	145,833	145,833	1,865,000	996,869	—	—	3,153,535
President and Chief Executive Officer	2009	—	—	—	—	—	—	—
Varun Nagaraj (3)	2011	198,750	—	796,500	395,863	75,720	—	1,466,833
Senior Vice President,	2010	—	—	—	—	—	—	—
Product Management and Product Marketing	2009	—	—	—	—	—	—	—
Robert W. Hon (4)	2011	195,781	—	577,850	320,215	75,360	—	1,169,206
Senior Vice President,	2010	—	—	—	—	—	—	—
Engineering	2009	—	—	—	—	—	—	—
William R. Slakey (5)	2011	47,273	—	553,000	279,990	28,800	—	909,063
Executive Vice President and	2010	—	—	—	—	—	—	—
Chief Financial Officer	2009	—	—	—	—	—	—	—
Michael T. Anderson	2011	322,917	—	362,000	—	194,342	6,986 (6)	886,245
Senior Vice President of	2010	300,000	—	719,998	—	—	—	1,019,998
Worldwide Markets	2009	43,750	—	320,500	530,886	—	—	895,136
Oliver R. Stanfield (7)	2011	360,000	—	181,000	—	129,000	—	670,000
Former Executive Vice	2010	342,000	—	705,998	—	—	6,317	1,054,315
President and Chief Financial Officer	2009	324,000	—	197,036	140,268	—	—	661,304

(1) Amounts shown do not reflect compensation actually received by the Named Executive Officers. Instead, the amounts shown are the grant date fair value of the stock awards (disregarding an estimate of forfeitures) as determined in accordance with FASB ASC Topic 718, which were recognized for financial statement purposes. The assumptions used in the valuation of these awards are set forth in the notes to our consolidated financial statements, which are included in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on March 15, 2012. These amounts do not correspond to the actual values that will be recognized by the Named Executive Officers.
(2) Mr. Sege has served as President and Chief Executive Officer of Echelon (the "Principal Executive Officer" or "PEO") since August 19, 2010. See "*Executive Compensation and Related Matters—Compensation Discussion and Analysis*" and "*—Potential Payments Upon Termination or Change in Control—Employment Agreement with Ronald A. Sege*" for a description of the material terms of Mr. Sege's employment agreement.
(3) Mr. Nagaraj has served as Senior Vice President, Product Management and Marketing of Echelon since May 3, 2011.
(4) Mr. Hon has served as Senior Vice President, Engineering of Echelon since March 31, 2011.
(5) Mr. Slakey has served as Executive Vice President and Chief Financial Officer of Echelon since November 7, 2011.
(6) Represents grossed-up reimbursement in 2011 for California income taxes paid by Mr. Anderson in 2010.
(7) Mr. Stanfield served as Chief Financial Officer of Echelon until November 7, 2011 and continued to serve as Executive Vice President until April 4, 2012.

Grants of Plan-Based Awards in 2011

The following table presents information concerning each grant of an award made to a Named Executive Officer in fiscal 2011 under any plan. All awards were granted under our 1997 Stock Plan. Except as set forth in the footnotes to the below table, see *"Outstanding Equity Awards at 2011 Fiscal Year-End"* regarding the vesting of each award grant.

			Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards							
Name	Grant Date	Approval Date	Threshold ($)	Threshold ($)	Threshold ($)	Threshold (#)	Threshold (#)	Threshold (#)	All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Under lying Options (#)	Exercise or Base Price of Option Awards ($/Sh)	Closing Price on Grant Date ($/Sh)	Grant Date Fair Value of Stock and Option Awards ($)(11)
Ronald A. Sege	02/04/2011	02/04/2011	—	400,000	600,000 (1)	—	—	—	—	—	—	—	—
	08/10/2011	07/27/2011	—	—	—	—	—	—	100,000 (2)	—	—	9.05	905,000
Varun Nagaraj	05/10/2011	04/22/2011	—	50,480	75,720 (1)	—	—	—	—	—	—	—	—
	05/10/2011	04/22/2011	—	—	—	—	—	—	—	73,000 (3)	10.62	10.62	395,863
	05/10/2011	04/22/2011	—	—	—	—	—	—	35,000 (4)	—	—	10.62	371,700
	05/10/2011	04/22/2011	—	—	—	—	40,000 (5)	—	—	—	—	10.62	424,800
Robert W. Hon	04/11/2011	02/28/2011	—	50,240	75,360 (1)	—	—	—	—	—	—	—	—
	04/11/2011	02/28/2011	—	—	—	—	—	—	—	70,000 (6)	8.89	8.89	320,215
	04/11/2011	02/28/2011	—	—	—	—	—	—	30,000 (7)	—	—	8.89	266,700
	04/11/2011	02/28/2011	—	—	—	—	35,000 (5)	—	—	—	—	8.89	311,150
William R. Slakey	11/10/2011	09/28/2011	—	19,200	28,800 (1)	—	—	—	—	—	—	—	—
	11/10/2011	09/28/2011	—	—	—	—	—	—	—	100,000 (8)	5.53	5.53	279,990
	11/10/2011	09/28/2011	—	—	—	—	—	—	50,000 (9)	—	—	5.53	276,500
	11/10/2011	09/28/2011	—	—	—	—	50,000 (10)	—	—	—	—	5.53	276,500
Oliver R. Stanfield	02/04/2011	02/04/2011	—	86,000	129,000 (1)	—	—	—	—	—	—	—	—
	08/10/2011	07/27/2011	—	—	—	—	—	—	20,000 (2)	—	—	9.05	181,000
Michael T. Anderson	02/04/2011	02/04/2011	—	100,000	194,342 (1)	—	—	—	—	—	—	—	—
	08/10/2011	07/27/2011	—	—	—	—	—	—	40,000 (2)	—	—	9.05	362,000

(1) Reflects amount actually paid.

(2) The amount shown reflects a performance share grant, which vests as to 1/4th of the shares on August 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(3) The amount shown reflects a grant of a SAR, which vests as to one-fourth of the shares on May 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(4) The amount shown reflects a performance share grant, which vests as to 1/4th of the shares on May 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(5) The target amount shown reflects the estimated payout pursuant to a performance share grant, the vesting of which is subject to specific performance requirements of our company. See *"Outstanding Equity Awards at 2011 Fiscal Year-End,"* footnote (7).

(6) The amount shown reflects a grant of a SAR, which vests as to one-fourth of the shares on April 11, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(7) The amount shown reflects a performance share grant, which vests as to 1/4th of the shares on April 11, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(8) The amount shown reflects a grant of a SAR, which vests as to one-fourth of the shares on November 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(9) The amount shown reflects a performance share grant, which vests as to 1/4th of the shares on November 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(10) The target amount shown reflects the estimated payout pursuant to a performance share grant, the vesting of which is subject to specific performance requirements of our company. See *"Outstanding Equity Awards at 2011 Fiscal Year-End,"* footnote (12).

(11) The amount shown reflects the grant date fair value of each equity award computed in accordance with SFAS 123R (disregarding an estimate of forfeitures). The assumptions used in the valuation of these awards are set forth in the notes to our consolidated financial statements, which are included in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on March 15, 2012. These amounts do not correspond to the actual value that will be recognized by the Named Executive Officers upon exercise or sale of such award.

Outstanding Equity Awards at 2011 Fiscal Year-End

The table below shows all outstanding equity awards held by the Named Executive Officers at the end of our fiscal year ended December 31, 2011. All awards were granted under our 1997 Stock Plan.

		Option Awards					Stock Awards			
Name	Grant Date	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Option Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($) (23)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($) (23)
Ronald A. Sege	08/19/2010	62,500 (1)	187,500 (1)	—	7.46	08/19/2017	—	—	—	—
	08/19/2010	—	—	—	—	—	93,750 (2)	456,563	—	—
	08/10/2011	—	—	—	—	—	100,000 (3)	487,000	—	—
	08/19/2010	—	—	—	—	—	—	—	125,000 (4)	608,750
Varun Nagaraj	05/10/2011	—	73,000 (5)	—	10.62	05/10/2016	—	—	—	—
	05/10/2011	—	—	—	—	—	35,000 (6)	170,450	—	—
	05/10/2011	—	—	—	—	—	—	—	40,000 (7)	194,800
Robert W. Hon................	04/11/2011	—	70,000 (8)	—	8.89	04/11/2016	—	—	—	—
	04/11/2011	—	—	—	—	—	30,000 (9)	146,100	—	—
	04/11/2011	—	—	—	—	—	—	—	35,000 (7)	170,450

		Option Awards					Stock Awards			
Name	Grant Date	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Option Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($) (23)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($) (23)
William R. Slakey............	11/10/2011	—	100,000 (10)	—	5.53	11/10/2016	—	—	—	—
	11/10/2011	—	—	—	—	—	50,000 (11)	243,500	—	—
	11/10/2011	—	—	—	—	—	—	—	50,000 (12)	243,500
Oliver R. Stanfield...........	12/17/2008	18,750 (13)	6,250 (13)	—	7.69	12/17/2013	—	—	—	—
	12/17/2008	9,375 (14)	3,125 (14)	—	7.69	12/17/2013	—	—	—	—
	05/14/2009	16,876 (15)	16,874 (15)	—	7.47	05/14/2014	—	—	—	—
	05/27/2008	—	—	—	—	—	3,125 (16)	15,219	—	—
	10/23/2008	—	—	—	—	—	3,750 (17)	18,263	—	—
	05/26/2010	—	—	—	—	—	26,250 (18)	127,838	—	—
	08/10/2011	—	—	—	—	—	20,000 (3)	97,400	—	—
	05/14/2009	—	—	—	—	—	—	—	11,250 (19)	54,788
	08/24/2010	—	—	—	—	—	—	—	45,000 (7)	219,150
Michael T. Anderson	11/10/2009	37,500 (20)	37,500 (20)	—	12.82	11/10/2014	—	—	—	—
	11/10/2009	—	—	—	—	—	12,500 (21)	60,875	—	—
	05/26/2010	—	—	—	—	—	26,250 (22)	127,838	—	—
	08/10/2011	—	—	—	—	—	40,000 (3)	194,800	—	—
	08/24/2010	—	—	—	—	—	—	—	45,000 (7)	219,150

(1) This SAR is subject to vesting at the rate of one-fourth of the shares on August 19, 2011 and each one-year anniversary thereafter, subject to continued employment with our company.

(2) This restricted stock award was originally for 125,000 shares and subject to vesting at the rate of one-fourth of the shares on August 19, 2011 and each one-year anniversary thereafter, subject to continued employment with our company. As of December 31, 2011, 31,250 of such shares of restricted stock have vested.

(3) This performance share grant is subject to vesting at the rate of one-fourth of the shares on August 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(4) This performance-based restricted stock award vests as to 50% of the shares only if Mr. Sege remains employed with our company through August 19, 2011 and only if our company reports four consecutive quarters of cumulative non-GAAP operating profit following the date of grant and on or prior to April 1, 2015. The remaining 50% of the shares will vest only if Mr. Sege remains employed with our company through August 19, 2012 and only if our company reports a completed fiscal year with a specified non-GAAP operating profit following the date of grant and on or prior to April 1, 2015.

(5) This SAR is subject to vesting at the rate of one-fourth of the shares on May 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(6) This performance share grant is subject to vesting at the rate of one-fourth of the shares on May 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(7) This performance share grant vests as to 50% of the shares only if the officer remains employed with our company through the first anniversary of the grant date and only if our company reports four consecutive quarters of cumulative non-GAAP operating profit following the date of grant and on or prior to April 1, 2015. The remaining 50% of the shares will vest only if the officer remains employed with our company through the second anniversary of the grant date and only if our company reports a completed fiscal year with a specified non-GAAP operating profit following the date of grant and on or prior to April 1, 2015.

(8) This SAR is subject to vesting at the rate of one-fourth of the shares on April 11, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(9) This performance share grant is subject to vesting at the rate of one-fourth of the shares on April 11, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(10) This SAR is subject to vesting at the rate of one-fourth of the shares on November 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(11) This performance share grant is subject to vesting at the rate of one-fourth of the shares on November 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company.

(12) This performance share grant is subject to vesting at the rate of one-fourth of the shares on November 10, 2012 and each one-year anniversary thereafter, subject to continued employment with our company; provided, however, that vesting is subject to the following additional performance criteria: 50% of the shares will vest only if our company reports four consecutive quarters of cumulative non-GAAP operating profit following the date of grant and on or prior to April 1, 2015. The remaining 50% of the shares will vest only if our company reports a completed fiscal year with a specified non-GAAP operating profit following the date of grant and on or prior to April 1, 2015.

(13) In December 2008, our company completed an equity compensation "Exchange Program" under which eligible employees were given an opportunity to exchange some or all of their outstanding stock options and SARs for a predetermined number of new SARs, if the existing awards were "underwater" on the December 17, 2008 exchange grant date for the Exchange Program. An option or SAR was "underwater" if its exercise price was more than the market value of our common stock on the exchange grant date. This SAR was issued pursuant to the Exchange Program in exchange for a 37,500 share SAR granted on May 27, 2008, and re-priced from $13.32 per share to $7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to continued employment with our company.

(14) This SAR was issued pursuant to the Exchange Program in exchange for a 37,500 share SAR granted on September 10, 2007, and re-priced from $27.80 per share to $7.69 per share. The shares vest at the rate of one-fourth of the shares on December 17, 2009 and each one-year anniversary thereafter, subject to continued employment with our company.

(15) This SAR is subject to vesting at the rate of one-fourth of the shares on May 14, 2010 and each one-year anniversary thereafter, subject to continued employment with our company.

(16) This performance share grant was originally for 12,500 shares and subject to vesting at the rate of one-fourth of the shares on May 27, 2009 and each one-year anniversary thereafter, subject to continued employment with our company. As of December 31, 2011, 9,375 of such performance shares have been released.

(17) This performance share grant was originally for 15,000 shares and subject to vesting at the rate of one-fourth of the shares on October 23, 2009 and each one-year anniversary thereafter, subject to continued employment with our company. As of December 31, 2011, 11,250 of such performance shares have been released.

(18) This performance share grant was originally for 35,000 shares and subject to vesting at the rate of one-fourth of the shares on May 26, 2011 and each one-year anniversary thereafter, subject to continued employment with our company. As of December 31, 2011, 8,750 of such performance shares have been released.

(19) Subject to continued employment with our company, this performance share grant vests as to 25% on each one-year anniversary of the May 14, 2009 date of grant, in each case subject to the satisfaction of the following performance criteria: In the event we achieve four consecutive quarters of cumulative non-GAAP operating income (as defined below) on or before May 14, 2014, such shares of common stock will be issued to the employee upon settlement of the performance shares, subject to the employee continuing to be a Service Provider (as defined in our 1997 Stock Plan) as of date of determination that the performance criterion has been achieved. "Non-GAAP operating income" means operating income under generally accepted accounting principles, excluding the following: (i) stock-based compensation expense; (ii) one-time charges associated with business combinations; (iii) amortization of intangibles associated with business combinations; (iv) impairment charges; and (v) the affect of any extraordinary event that our Compensation Committee, in the exercise of its reasonable discretion, determines should be excluded.

(20) This SAR is subject to vesting at the rate of one-fourth of the shares on November 10, 2010 and each one-year anniversary thereafter, subject to continued employment with our company.

(21) This performance share grant was originally for 25,000 shares and subject to vesting at the rate of one-fourth of the shares on November 10, 2010 and each one-year anniversary thereafter, subject to continued employment with our company. As of December 31, 2011, 12,500 of such performance shares have been released.

(22) This performance share grant was originally for 35,000 shares and subject to vesting at the rate of one-fourth of the shares on May 26, 2011 and each one-year anniversary thereafter, subject to continued employment with our company. As of December 31, 2011, 8,750 of such performance shares have been released.

(23) The market value is based on the $4.87 per share closing price of our common stock on December 30, 2011, the last market trading day in 2011.

Option Exercises and Stock Vested for Fiscal 2011

The table below shows all stock options and SARs exercised and value realized upon exercise, and all stock awards vested and value realized upon vesting, by the Named Executive Officers during the fiscal year ended December 31, 2011.

	Option Awards		Stock Awards	
Name	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise ($) (1)	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting ($) (2)
Ronald A. Sege	—	—	31,250 (3)	250,625 (3)
Varun Nagaraj	—	—	—	—
Robert W. Hon	—	—	—	—
William R. Slakey	—	—	—	—
Oliver R. Stanfield	37,500	80,375	28,118	241,262
Michael T. Anderson	—	—	25,893	210,189

(1) The value realized equals the difference between the option exercise price or the SAR grant price, as applicable, and the fair market value of our common stock on the date of exercise, multiplied by the number of shares for which the option was exercised.

(2) The value realized equals the fair market value of our common stock on the date of vesting, multiplied by the number of shares vested.

(3) Pertains to a restricted stock award issued to Mr. Sege on August 19, 2010.

Potential Payments Upon Termination or Change in Control

1997 Stock Plan

The following table sets forth the estimated benefit to the Named Executive Officers in the event a successor corporation had refused to assume or substitute for the Named Executive Officers' outstanding equity awards, assuming the date of the triggering event was December 31, 2011.

Name	Estimated Benefits ($) (1)
Ronald A. Sege	1,552,313
Varun Nagaraj	365,250
Robert W. Hon	316,550
William R. Slakey	487,000
Oliver R. Stanfield	532,656
Michael T. Anderson	602,663

(1) Based on the aggregate market value of unvested SARs, shares of restricted stock and performance shares and assuming that the triggering event took place on the last business day of fiscal 2011 (December 30, 2011), and the price per share of Echelon's common stock is the closing price on the NASDAQ Global Select Market as of that date ($4.87). Aggregate market value for SARs is computed by multiplying (i) the difference between $4.87 and the stated exercise price of the SAR, by (ii) the number of shares underlying unvested SARs at December 31, 2011. Aggregate market value for shares of restricted stock and performance shares is computed by multiplying (i) $4.87 by (ii) unvested shares of restricted stock and the number of shares underlying unvested performance shares at December 31, 2011. There can be no assurance that a triggering event would produce the same or similar results as those estimated if such event occurs on any other date or at any other price, or if any other assumption used to estimate potential payments and benefits is not correct. Due to the number of factors that affect the nature and amount of any potential payments or benefits, any actual payments and benefits may be different.

Employment Agreement with Ronald A. Sege

The following table provides information concerning the estimated payments and benefits that would have been provided to Mr. Sege in the event of termination in the regular course of business or termination in connection with a change-in-control, assuming a termination date of December 31, 2011.

	Estimated Payments and Benefits (1)	
	Involuntary Termination Other Than for Cause or Voluntary Termination for Good Reason	
	Not in Connection with a Change-in-Control ($)	**In Connection with a Change-in-Control ($)**
Salary	400,000	600,000
Annual Incentive Bonus	400,000	600,000
Vesting Acceleration on Equity Awards (2)	426,125	1,552,313
Reimbursement for Premiums Paid for Continued Health Benefits (3)	55,855	55,855
Total Termination Benefits	1,281,980	2,808,168

(1) Payments and benefits are estimated assuming that the triggering event took place on the last business day of fiscal 2011 (December 30, 2011), and the price per share of our company's common stock is the closing price on the NASDAQ Global Select Market as of that date ($4.87). The payments and benefits shown in connection with a change of control are estimated assuming that the executive does not use transitional outplacement benefits; amounts for any such benefits actually paid are not expected to be significant. There can be no assurance that a triggering event would produce the same or similar results as those estimated if such an event occurs on any other date or at any other price, or if any other assumption used to estimate potential payments and benefits is not correct. Due to the number of factors that affect the nature and amount of any potential payments or benefits, any actual payments and benefits may be different.

(2) Reflects the aggregate market value of unvested SARs, shares of restricted stock and performance shares that would become vested under the circumstances. Aggregate market value for such shares of restricted stock and performance shares is computed by multiplying $4.87 by the number of unvested shares at December 31, 2011. Aggregate market value for such SARs is computed by multiplying (i) the difference between $4.87 and the stated exercise price of the SAR, by (ii) the number of shares underlying unvested SARs at December 31, 2011.

(3) Assumes continued coverage of health benefits for eighteen months for Mr. Sege, his spouse and dependents at the same level of coverage provided at December 31, 2011.

Compensation Committee Interlocks and Insider Participation

During fiscal 2011, the following directors were members of Echelon's Compensation Committee: Armas Clifford Markkula, Jr., Richard M. Moley and Betsy Rafael. None of these directors has at any time been an officer or employee of Echelon. None of Echelon's executive officers serves, or in the past fiscal year has served, as a member of the board of directors or compensation committee of any entity that has one or more of its executive officers serving on Echelon's Board of Directors or Compensation Committee.

Equity Compensation Plan Information

The following table provides information as of December 31, 2011 about our equity compensation plans under which shares of our common stock may be issued to employees, consultants or members of our Board of Directors:

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column(a))
Equity compensation plans approved by security holders (1) (2)	5,625,064	$4.81 (3)	13,047,736
Equity compensation plans not approved by security holders	—	—	—
Total	5,625,064	$4.81 (3)	13,047,736

(1) These plans include our 1997 Stock Plan and our 1998 Director Option Plan. Our 1998 Director Option Plan expired in July 2008.
(2) The number of shares reserved for issuance under our 1997 Stock Plan is subject to an automatic annual increase equal to the lesser of (i) 5,000,000 shares, (ii) 4% of our outstanding common stock on the first day of our fiscal year or (iii) a lesser number of shares determined by our Board of Directors.
(3) The weighted average exercise price reflects the issuance of 2,521,593 performance shares, for which no consideration will be paid upon exercise. The weighted average exercise price for the remaining securities to be issued upon exercise of outstanding options, warrants and rights (3,103,471 shares) is $8.71.

Policies and Procedures with Respect to Related Party Transactions

Our Corporate Governance Guidelines require our directors to take a proactive, focused approach to their position and to set standards that ensure our company is committed to business success through the maintenance of the highest standards of responsibility and ethics. Thus, our Board of Directors is committed to upholding the highest legal and ethical conduct in fulfilling its responsibilities and recognizes that related party transactions can present heightened risk of potential or actual conflicts of interest. Accordingly, as a general matter, it is Echelon's preference to avoid related party transactions.

The charter of our Audit Committee requires that the members of the Audit Committee, all of whom are independent directors, review and approve in advance all related party transactions for which approval is required under applicable law. Current SEC rules define a related party transaction to include any transaction, arrangement or relationship in which our company is a participant and in which any of the following persons has or will have a direct or indirect interest:

- an executive officer, director or director nominee of Echelon;
- any person who is known to be the beneficial owner of more than 5% of our common stock;
- any person who is an immediate family member (as defined in Item 404 of Regulation S-K) of an executive officer, director or director nominee or beneficial owner of more than 5% of our common stock; and
- any firm, corporation or other entity in which any of the foregoing persons is employed or is a partner or principal or in a similar position or in which such person, together with any other of the foregoing persons, has a 5% or greater beneficial ownership interest in our common stock.

Certain Relationships

Agreements with ENEL

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for $130.7 million. 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 our 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 our Board of Directors. A representative of Enel is not presently serving on our Board of Directors; however, Livio Gallo, a representative of Enel, served on our Board of Directors from June 30, 2011 until his resignation from our Board of Directors on March 14, 2012.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the "R&D Agreement"). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we 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 us. Under the software enhancement agreement, we provide 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.

Legal Services

During fiscal year 2011, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C. We incur bills for legal services that vary from year to year depending upon our legal needs. In determining the independence of Mr. Sonsini, our Board of Directors reviews our relationship with Wilson Sonsini Goodrich & Rosati, P.C. in conjunction with the applicable independence guidelines under the applicable listing standards of Nasdaq and SEC rules.

OTHER INFORMATION

Section 16(a) Beneficial Ownership Reporting Information

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our executive officers, directors and persons who own more than 10% of a registered class of our equity securities to file certain reports with the SEC regarding ownership of, and transactions in, our securities. Such officers, directors and 10% stockholders are also required by the SEC to furnish us with copies of all Section 16(a) forms that they file.

Based solely on our review of such forms furnished to us and written representations from certain reporting persons, we believe that all filing requirements applicable to our executive officers, directors and more than 10% stockholders were complied with during the fiscal year ended December 31, 2011.

No Incorporation by Reference

In Echelon's filings with the SEC, information is sometimes "incorporated by reference." This means that we are referring you to information that has previously been filed with the SEC and the information should be considered as part of the particular filing. As provided under SEC regulations, the "Report of the Audit Committee of our Board of Directors" and the "Compensation Committee Report" contained in this Proxy Statement specifically are not incorporated into any other filings with the SEC. In addition, this Proxy Statement includes several website addresses. These website addresses are intended to provide inactive, textual references only. The information on these websites is not part of this Proxy Statement.

Stockholder Proposals—2013 Annual Meeting

Stockholders may present proposals for action at a future meeting if they comply with SEC rules and Echelon's Bylaws. For additional details and deadlines for submitting proposals, see "*Deadline for Receipt of Stockholder Proposals*" in this Proxy Statement above. If you would like a copy of the requirements contained in our Bylaws, please contact: Kathleen B. Bloch, Senior Vice President, General Counsel and Secretary, Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126.

Available Information

You may obtain a copy of our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 without charge by sending a written request to Echelon Corporation, 550 Meridian Avenue, San Jose, California 95126, Attention: Investor Relations. The annual report is also available online at www.echelon.com or the SEC's website at www.sec.gov.

REPORT OF THE AUDIT COMMITTEE OF OUR BOARD OF DIRECTORS

Notwithstanding any statement to the contrary in any of our previous or future filings with the SEC, this report of the Audit Committee of our Board of Directors shall not be deemed "filed" with the SEC or "soliciting material" under the Securities Exchange Act of 1934, as amended, and shall not be incorporated by reference into any such filings.

The Audit Committee of our Board of Directors serves as the representative of our Board of Directors for general oversight of our financial accounting and reporting process, system of internal control, audit process, and process for monitoring compliance with laws and regulations. Our management has primary responsibility for preparing our financial statements and our financial reporting process. Our independent registered public accounting firm, KPMG LLP, is responsible for expressing an opinion on the conformity of our fiscal year 2011 audited financial statements to generally accepted accounting principles. In this context, the Audit Committee hereby reports as follows:

1. The Audit Committee has reviewed and discussed the audited financial statements with our management, including a discussion of the quality and acceptability of the financial reporting, the reasonableness of significant accounting judgments and estimates and the clarity of disclosures in the financial statements. In connection with this review and discussion, the Audit Committee asked a number of follow-up questions of management and KPMG LLP to help give the Audit Committee comfort in connection with its review.

2. The Audit Committee has discussed with KPMG LLP the matters required to be discussed by the Statement on Auditing Standards No. 61, as amended, as adopted by the Public Company Accounting Oversight Board in Rule 3200T.

3. The Audit Committee has received the written disclosures and the letter from KPMG LLP required by applicable requirements of the Public Company Accounting Oversight Board regarding KPMG LLP's communications with the Audit Committee concerning independence, and has discussed with KPMG LLP the independence of KPMG LLP.

4. Based on the review and discussions referred to in paragraphs (1) through (3) above, the Audit Committee recommended to our Board of Directors that the audited financial statements be included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, for filing with the SEC.

Our Board of Directors has adopted a written charter for the Audit Committee, a copy of which can be viewed at the investor relations section of our website at www.echelon.com. Each of the members of the Audit Committee is independent as defined under the Nasdaq listing standards.

Audit Committee

Robert J. Finocchio, Jr., Chairman
Robyn M. Denholm
Betsy Rafael

OTHER MATTERS

As of the date hereof, our Board of Directors is not aware of any other matters to be submitted at the annual meeting. If any other matters properly come before the meeting, it is the intention of the persons named in the enclosed Proxy to vote the shares they represent as our Board of Directors recommends or as they otherwise deem advisable.

THE BOARD OF DIRECTORS

San Jose, California
April 12, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

☑ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 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 _________.

Commission file number: 000-29748

ECHELON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**77-0203595**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

550 Meridian Avenue
San Jose, California 95126
(Address of principal executive office and zip code)
(408) 938-5200
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01	The NASDAQ Stock Market LLC (The Nasdaq Global Market)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ☐ No ☒

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

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 ☒ Non-accelerated filer ☐ Smaller reporting company ☐
(do not check if a 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 ☒

As of June 30, 2011, the last business day of the registrant's most recently completed second fiscal quarter, there were 42,437,605 shares of the registrant's common stock outstanding, and the aggregate market value of such shares held by non-affiliates of the registrant (based on the per share closing sale price of $9.09 of such shares on the Nasdaq Global Market on June 30, 2011) was approximately $293.6 million. Shares of the registrant's common stock held by each executive officer and director and by each entity that owns 5% or more of the registrant's outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 29, 2012, 42,529,936 shares of the registrant's common stock, $.01 par value per share, were issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Document	Parts Into Which Incorporated
Proxy Statement for the Annual Meeting of Stockholders to be held May 22, 2012 (Proxy Statement)	Part III

ECHELON CORPORATION
FORM 10-K
FOR THE YEAR ENDED DECEMBER 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 or strategies regarding the future that are forward-looking. These statements include those discussed in Item 1, Business, including "General," "Markets," "Products and Services," "Product Development," "Marketing," "Competition," and "Government Regulation" in Item 1A, Risk Factors, in Item 2, "Properties" in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, including "Critical Accounting Policies," "Results of Operations," "Off-Balance-Sheet Arrangements and Other Contractual Obligations," "Liquidity and Capital Resources," "Related Party Transactions," "Recently Issued Accounting Standards," and elsewhere in this report. In this report, the words "anticipate," "believe," "expect," "intend," "future," "moving toward" and 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 factors including, but not limited to, those set forth in the section entitled "Risk Factors" and elsewhere in this report. All forward-looking statements and reasons why results may differ included in this report are made as of the date of this report, and we assume no obligation to update any such forward-looking statement or reason why such results might differ.

PART I

ITEM 1. BUSINESS

General

Echelon Corporation develops, markets and supports an open standard, multi-application energy control networking platform. Echelon's vision from its inception more than 20 years ago is one of low-cost embedded monitoring and control technology in every electrically controlled device in the world. Today Echelon's technology platform is embedded in more than 100 million devices, 35 million homes, and 300,000 buildings.

Our platform powers energy-savings applications for the smart grid, smart cities and smart buildings that can help customers save on their energy usage, reduce outage duration or prevent outages from happening, reduce carbon footprint and more. Echelon offers, directly and through its partners worldwide, a wide range of products and services. We classify these products and services into two primary categories:

- <u>Systems,</u> such as our smart metering solutions, which are targeted for use by utilities. We previously referred to revenues from our Systems products and services as Utility revenues; and
- <u>Sub-systems, which</u> include our components, control nodes and development software, and which are sold typically to Original Equipment Manufacturers (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.

This model allows Echelon to address a broad range of geographies and regulatory environments and allows our customers to balance time-to-market and cost requirements. As was the case with Enel in Italy, we believe that customers in Brazil, China, and elsewhere will use our Sub-systems for their smart grid applications.

In addition to the energy savings, efficiency and environmental benefits, our energy control networking platform will be important as the electric grid transitions from a centralized and predictable system to de-centralized and dynamic one. In the past, the grid has had predictable usage patterns, using centralized generation and scheduled meter reading with a limited need for information and control at the edge of the grid. Going forward, the grid must accommodate new distributed generation sources that often connect into the distribution part of the grid (such as solar and wind) and new sources of electricity consumption and supply (such as electric vehicles and distributed storage), while effectively managing demand peaks. This requires a greater amount of visibility, control, and automation at the edge of the grid, and therefore requires electric meters and other devices to serve as power quality sensors and controllers, not just as billing devices.

Energy consumers also benefit from Echelon's energy control networking platform. Commercial buildings can consume over 30% of the energy used on today's grid. Making buildings "smart" and more energy efficient presents several important opportunities for building owners by helping them reduce the amount of money they spend monthly on energy bills, improving occupant comfort, and reducing the building's carbon footprint. Another significant consumer of electricity is street lighting. Streetlights are among a city's most important assets, providing safer streets, parks, and city centers. They also consume a significant part of a city's budget — as much as 40% in electricity bills plus significant resources for maintenance and operations. Cities today can benefit from smarter street lighting systems that reduce electricity use, costs, and carbon emissions while enhancing safety and environmental comfort. Smart outdoor lighting is an initial application for cities moving to a "smart cities" infrastructure.

Energy control networking is distinct from data networking. Data networking focuses on getting data from one point to the other, and generally does not concern itself with the content of the data or with the decisions that need to be made based on the data. In contrast, energy control networking is built around knowledge of the data elements, with distributed intelligence and decisions made as close to the point of data collection as possible. Relative to pure data networks, energy control networks are more reliable, survivable, and real-time.

Our energy control networking platform consists of three tiers, or categories, of products: a device tier, a control node tier, and an enterprise tier. Echelon's Control Operating System (COS) software unifies and works across the device, control node and enterprise tiers. At the device tier, devices such as load controllers, lighting ballasts, meters and thermostats, embed our Free Topology (FT) Power line (PL) smart transceivers enabling them to act as peers working together to collect data and take action. For example, our headquarters buildings in San Jose have lighting and heating ventilation and air conditioning devices that communicate together over a twisted pair network using Echelon's FT transceivers. These devices are managed by control nodes, in this case Echelon's Smart Servers. When these control nodes receive information that our local utility needs in order to shed electrical load, this information is published across the twisted pair network. Echelon's COS software enables these devices to work together to reduce Echelon's energy consumption while preserving a safe and comfortable work environment.

At the control node tier, different control technologies and protocols are unified and supervised so that local decisions can be made at or near the devices. Examples of control nodes include our Edge Control Node (ECN), SmartServer and Data Concentrator. In general, devices and control nodes communicate using control protocols such as LonWorks® technology (ISO/EN 14908), BACnet®, and Open Smart Grid Protocol (OSGP). OSGP is a family of standards published by the European Telecommunications Standards Institute (ETSI) optimized for smart grid applications used in conjunction with LonWorks technology. Often, at the physical layer, our devices and control nodes communicate using our power line communications (PLC) products, which are designed to provide enhanced capabilities such as the ability to measure power quality "on the line" and to dynamically map grid topologies. At the enterprise tier we tie the controls to enterprise information technology (IT) systems, so business rules can be provided to the control system and operational data can be archived for later analysis. Our Networked Energy System (NES) system software and LonWorks Control Networks Software (LNS) are examples of enterprise layer products. Control nodes communicate with system software using the Internet protocols such as TCP/IP and web services. Thus, Echelon's technology sits at the intersection of two vast and critical worlds – control systems and Internet systems.

With a broad range of energy applications and geographies to choose from, we apply our product and sales efforts to the highest growth opportunities. We target changing and fast growing geographies that require the smart grid monitoring and control that our energy control networking platform offers. Business drivers that compel the need for an energy control networking platform include energy supply constraints, the condition of existing distribution grids, theft levels, the use of renewable energy, electric vehicle (EV) integration into the grid, and the desire for air quality improvements and greenhouse emission reduction. In some geographies, strong government energy policies and resulting regulations that support and drive a timeline and budget for specific deployments also provide a good fit for our platform.

Echelon was incorporated in California in 1988 and reincorporated in Delaware in 1989. We have 106 patents related to our energy control networking solutions and there are more than 100 million smart devices enabled by our products deployed around the world. With our global headquarters in Silicon Valley in San Jose, California, engineering locations in the United States and Germany, and regional sales offices throughout North America, Europe and Asia, our products are available throughout the world.

Market Overview

Echelon targets the smart energy market, and specifically within that market, offers solutions for smart buildings, smart cities and smart grid with our energy control networking platform.

Smart Buildings – Echelon's Sub-system products enable OEMs to build building automation, lighting control, elevator control, and access control systems for the smart building. We also sell some of our Sub-system products to integrators who use them alongside our OEM customers' products to architect energy-efficient grid-aware buildings that can respond to real-time grid events such as the need to quickly lower demand. Over 300,000 buildings around the world use our technology to provide a comfortable, safe, and productive environment, all while reducing energy consumption. Our technology enables interoperability between products and between the various building systems and allows a building owner or integrator to maintain an open procurement and vendor independent environment, thereby reducing life cycle costs.

Our product portfolio includes:

- Smart Transceivers - Free-topology twisted pair smart transceivers that can be embedded into building automation devices such as sensors, thermostats, motion detectors, air handlers, and chillers.
- SmartServer Controller - A system manager and field controller that provides functionality for high-performance building networks and smart-energy applications and can serve as a standalone controller for smaller networks. The Echelon SmartServer connects control networks to IP-based applications using web services and other open protocols such as LONWORKS, BACnet (BACnet/IP) and Modbus (Modbus/IP) and provides important functions to facility management, enterprise resource planning, or service provider software.
- LNS and OpenLNS Operating System - These development and integration tools allow building owners to change service providers as needed and leverage competitive bidding because all the necessary information about the network is maintained in the building owner's LNS database. With a community of software developers at leading building automation system (BAS) manufacturers, hundreds of plug-ins have been developed to help installers more easily commission, configure, monitor, control, diagnose or repair LONWORKS devices.
- Third Party Software - Third party energy management or grid analytics software and apps are available for the SmartServer in hosted or server-based configurations.

Smart Cities - Cities are responsible for approximately two thirds of the energy used and 70 percent of all greenhouse gases produced worldwide. As a result, sustainable cities are looking for ways to improve their infrastructures to become more environmentally friendly, increase the quality of life for their residents, and reduce costs. Since street lighting is a large energy consumer and is a highly visible service provided by the city, smart street lighting is often the starting point for a smart city. Echelon's sub-system products transform streetlights into intelligent, energy-efficient, remotely managed networks that deliver dependable lighting at lower cost than low-energy luminaires alone. Cities can schedule lights on or off and set dimming levels for individual or groups of lights and intelligently provide the right level of lighting needed by time of day, season, or weather conditions while reducing energy usage. Smart street lighting is often just the first step to a smarter city, with applications such as a bus lane control system or pollution monitoring subsequently added on top of the street lighting network.

Our product portfolio includes:

- Smart Transceivers - Street light manufacturers can embed our Power line smart transceivers into their streetlight ballasts, drivers, generators, and/or outdoor lighting controllers. These components enable command, control, and monitoring of each light. They communicate with our SmartServer segment controller over existing power lines.
- SmartServer Segment Controller - Our SmartServer Segment Controller is a controller and gateway for connecting streetlight segments to a city's service center. The SmartServer provides rules for operation, invoking on/off time and sequencing, dimming time and percentage, and other functions.
- PL/RF Bridge - Our PL/RF Bridge can be used to connect segments (groups) of streetlights to a SmartServer. The PL/RF Bridge uses a plug-and-play RF connection for simple, low-cost installation. Each virtual segment communicates with the SmartServer over existing power lines.
- Third Party Software - Third-party system software integrates with a city's enterprise applications and manages the street lighting network using the SmartServer for control and communication. System software is available in hosted or server-based configurations.

Smart Grid – As energy demand and supply variability grows, utilities are either modernizing their electric grids, or building new smart grids. Our smart grid Systems and Sub-systems products connect more than 35 million homes to the grid and allow utilities such as Enel (Italy), Vattenfall (Sweden and Finland), SEAS NVE (Denmark), E.ON (Sweden), and Duke Energy (US) to accurately collect billing data and vital health statistics with a high degree of field proven reliability. In addition to usage data required for billing the consumer, our products collect a large number of power quality metrics at the smart meter and from other devices such as distribution transformers. This data can be used in applications such as transformer monitoring, theft detection, and fault detection to guide preventive maintenance and to reduce energy loss.

Echelon's smart grid products consist of:

- Smart Meters - Our smart meters are part of our NES Smart Metering Solution and provide revenue-grade payment capabilities such as load profiling, time-of-use, display of energy consumption and prepaid metering as well as advanced features such as an integrated remote connect/disconnect switch, the ability to provide remote upgrades and over 50 power quality measurements (PQMs). Once deployed, software embedded in the solutions enables changes that once required a truck roll (customer visit), such as a firmware upgrade or connect/disconnect, to be completed with the click of a mouse. Reducing the number of truck rolls enables utilities to achieve a return on their investment more quickly.
- Edge Control Nodes (ECNs) or Data Concentrators - Located at the medium voltage/low voltage transformer, the ECNs or Data Concentrators connect smart meters and OSGP-based grid devices, such as load controllers or water and gas meter

gateways to the wide area network (WAN). ECNs can accommodate hardware expansion and run multiple software applications, allowing utilities to add new functionalities efficiently.

- NES System Software – NES System Software allows a utility to deploy, configure, audit, diagnose, and retrieve data from smart meters and other OSGP-based devices connected to the low voltage grid. The NES System Software communicates with a utility's middleware using a scalable, standards-based interface. Using standard Web services interfaces, the NES System Software integrates with the software and servers deployed at the data center as well as with leading meter data management (MDM) solutions. The NES System Software makes the operation of the integrated network transparent to a utility's application developers, allowing them to focus their expertise on issues important to the utility, such as outage avoidance, power quality management, and load shedding, among other things.
- Element Manager - Our Element Manager is browser-based software employed at the data center that simplifies installation and commissioning of smart meters, other OSGP-based grid devices and Echelon Control Nodes and provides network analysis, graphed statistics, and automated network management.
- Control Point Modules - Our Control Point Modules are Sub-system devices that enable OEMs to build OSGP compliant smart grid devices, such as smart meters, load controllers, and electric vehicle (EV) chargers. Devices that incorporate our Control Point Modules are completely and securely interoperable, end to end, with our NES Smart Metering System, creating the opportunity for the OEMs to sell their products and services to our global installed base of utility customers.

Go-To-Market (Sales) Strategy

Smart Buildings & Smart Cities - We sell our Sub-systems for the smart buildings and smart street lighting markets to OEMs directly and through distribution. These efforts are supported with worldwide sales, application engineering, technical, and industry experts working in the U.S. as well as China, France, Germany, Hong Kong, Italy, Japan, the Netherlands, South Korea, and the United Kingdom.

Echelon focuses our sales resources covering these markets in two areas. We have a global sales team dedicated to working with large OEM customers such as Honeywell, Siemens, Philips, Trane and others to ensure a coordinated effort and maximize "design in" wins. The remainder of the sales force targets large "sell with" opportunities with our distribution, Value Added Reseller (VAR) and Systems Integrator (SI) partners for buildings, street lighting and other controls projects. This joint selling effort helps pull through sales from distributors so we can best serve current customers and efficiently target new growth opportunities. We encourage our customers to work together. For instance, many smart outdoor lighting systems currently being planned for and installed in China will be managed by third party enterprise software that was initially developed for the European market.

Smart Grid - We market and sell our smart grid Systems to utilities, both directly and through VARs who offer additional products and services. In Europe and North America, we sell our complete flagship NES Smart Metering solution, which is used for metering and low voltage distribution automation applications.

Primary customers of our NES Smart Metering System are VARs such as Eltel Networks, One Nordic, EVB, Görlitz, ENERGOAUDITCONTROL, and Telvent Energia. Representative end-use customers served through our VARs include SEAS-NVE, Energi Midt, and NRGi in Denmark, Vattenfall and E.ON in Sweden, Linz in Austria, and Fortum in Finland. In the United States, we market to VARs and also directly to utilities. Duke Energy is our direct customer in the United States.

Strategic partnering for Sub-systems used in smart grid applications allows Echelon to reach markets otherwise unavailable to us. In markets such as Brazil and China, we partner with local suppliers to leverage their manufacturing and in-region expertise so they can build and market solutions based on Echelon Sub-systems. For example, Brazil meter manufacturer ELO Sistemas Eletronicos (ELO) has developed and is marketing electricity meters in Brazil and elsewhere in Latin America, becoming the first alternate source for Echelon smart meters on the market. In markets where alternative standards and approaches have been established, our sales teams go to market with components such as our PLC products and our PLC meshing modules. We have such an arrangement with our Chinese partner, Holley, a leading meter maker in China, to address the large and fast growing Chinese market. We are targeting other regional markets with our subsystems strategy as well. The sub-system strategy was initially implemented for the Enel project in Italy.

Product Development

Our future success depends in large part on our ability to enhance existing products, reduce product cost, and develop new products that maintain technological competitiveness. We have made and intend to continue to make substantial investments in product development.

Our strategy is to focus our product innovation efforts on unique areas where we can add value, and to partner aggressively in other areas. We focus on areas where we have leading technical expertise, including power-line communications, system architecture for supporting smart energy, multi-protocol processing for control and enterprise networks, and interoperating with a range of other vendors' products. We partner with other companies that have specific skills outside our core expertise, such as low-cost technology or RF technologies. Our product investments also focus on designing, building and delivering software as a means of realizing value in smart energy systems.

Our total expenses for product development were $34.8 million for 2011, $34.8 million for 2010, and $35.4 million for 2009. Included in these totals were stock-based compensation expenses of $3.9 million, $4.2 million, and $5.7 million, for the years ended December 31, 2011, 2010, and 2009, respectively. In addition, during 2011 and 2010, we received payments of $1.5 million and $4.5 million, respectively, from a third party that were used to offset our product development expenses. Without those offsetting payments, our product development expenses would have been $36.3 million and $39.3 million in 2011 and 2010, respectively.

We anticipate that we will continue to commit substantial resources to product development in the future and, as a result, product development expenses may continue to increase over historical levels. To date, we have not capitalized any software development costs from our development efforts.

Marketing

Our marketing efforts focus on two key elements: awareness and demand generation/sales enablement. From an awareness perspective, we seek to generate visibility and credibility of our brand, the products and solutions that we offer, and the capabilities and benefits that they bring. Our marketing program comprises press releases, advertising, collateral such as brochures, published technical and thought-leadership papers, newsletters, and customer case studies describing the benefits our customers are seeing from implementing our solutions. We also participate in industry trade shows, speak at industry conferences and are continually enhancing our global websites. Marketing also focuses on making it easier for our sales teams and our partners to sell our solutions. We do this through a variety of demand generation and sales enablement activities such as webinars/seminars, direct mail, lead-generation from our participation at industry exhibitions and conferences, and the production of focused selling tools such as sales playbooks, competitive analyses, and sales presentations and training. We have also formed and actively participate in two associations directly focused on the adoption of our products, LONMARK® International and the Energy Services Network Association (ESNA), and participate in other relevant industry organizations.

We focus our sales team using a systematic pipeline management process, whereby prospects are identified, qualified, and tracked, with the expectation that a portion of these opportunities are ultimately closed. In 2012, we restructured our sales force to take advantage of what we see as the converging market opportunity in energy control networking applications. Under this new structure we have a single, integrated sales force responsible for all the products in our portfolio. We believe this approach increases our sales efficiency and enables us to better match the solutions we offer to the customer's requirements.

Training and Support

We offer a variety of technical training courses covering our products and technology. These courses are designed to provide hands-on, in-depth and practical experience that can be used immediately by our customers to build products and systems based on our offerings. In some instances these classes are licensed to third parties in foreign markets who present them in the local language. Additionally, we offer a variety of computer-based training courses that can be taken over the Internet. We also offer telephone, e-mail, and on-site technical support to our customers on a term contract or per-incident basis. The goal of these support services is to resolve customers' technical problems on a timely basis, ensure that our products will be used properly, and shorten the time required for our customers to develop products that use our technology. Lastly, we offer a variety of post-contract support (PCS) packages for our NES System Software and Element Manager products, which we market as Software Investment Protection (SIP). These SIP packages range from providing simple bug fixes to providing software upgrades and enhancements.

Principal Customers

During the three years ended December 31, 2011, we had four customers that accounted a for significant portion of our revenues: EBV Electronik and Avnet Europe Comm VA ("EBV/Avnet"), the primary distributors of our Sub-systems products in Europe; Duke Energy ("Duke"), a U.S. utility company; and Telvent Energia ("Telvent") and Eltel Networks ("Eltel"), value added resellers of our Systems products. For the years ended December 31, 2011, 2010, and 2009, the percentages of our revenues attributable to sales made to these customers were as follows:

	Year Ended December 31,		
	2011	2010	2009
Duke	27.2%	6.3%	10.7%
Telvent	15.7%	2.8%	1.2%
Eltel	11.5%	28.5%	25.3%
EBV/Avnet	9.5%	12.8%	13.6%
Total	63.9%	50.4%	50.8%

Our international sales include both export sales and sales by international subsidiaries and accounted for 62.8% of our total revenues for 2011, 78.1% of our total revenues for 2010, and 74.9% of our total revenues for 2009.

Geographic Information

We operate 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 our customers located in the respective region. Our long-lived assets include property and equipment, goodwill, purchased technology, and deposits on our leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of December 31, 2011 and 2010, long-lived assets of approximately $33.2 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.

Revenues are attributed to geographic areas based on the country where the customer is domiciled. Summary revenue information by geography for the years ended December 31, 2011, 2010, and 2009 is as follows (in thousands):

	Year Ended December 31,		
	2011	2010	2009
Americas	$ 60,706	$ 26,769	$ 27,746
EMEA	80,248	73,543	65,656
APJ	15,533	10,725	9,936
Total	$ 156,487	$ 111,037	$ 103,338

Manufacturing

Our manufacturing strategy is to outsource production to third parties where it reduces our costs and to limit our internal manufacturing to such tasks as quality inspection, system integration, custom configuration, testing, and order fulfillment. We maintain manufacturing agreements with Cypress and Toshiba related to the Neuron® Chip. Toshiba declined to renew its Neuron Chip agreement with Echelon, which expired in January 2010, and ceased manufacturing Neuron Chips in 2011. We also maintain manufacturing agreements with STMicroelectronics for production of our power line transceiver, with Cypress for production of our free topology transceiver, with Open-Silicon for production of our Neuron 5000 microprocessor, and with Cypress, On Semiconductor, and AMI Semiconductor for the production of certain other components we sell.

For most of our products requiring assembly, we use third party contract electronic manufacturers (CEMs), including Jabil and TYCO. These CEMs procure material and assemble, test, and inspect the final products to our specifications.

Working Capital

As of December 31, 2011, we had working capital, defined as current assets less current liabilities, of $74.9 million, which was a decrease of approximately $2.3 million compared to working capital of $77.3 million as of December 31, 2010.

As of December 31, 2011, we had cash, cash equivalents, and short-term investments of $58.7 million, which was a decrease of approximately $6.0 million compared to a balance of $64.6 million as of December 31, 2010. Cash used in operating activities in 2011 of $225,000 was primarily the result of our net loss of $13.0 million and a net change in our operating assets and liabilities of $3.0 million, which was partially offset by non-cash charges for stock-based compensation expenses of $9.6 million and depreciation and amortization expenses of $5.9 million.

Competition

We believe the markets for our products are becoming more competitive and price competition is becoming more intense. We believe this is happening since sales opportunities are being adversely affected by macro economic conditions. In addition, competition in our markets involves rapidly changing technologies, evolving industry standards, frequent new product introductions, and changes in customer requirements. To maintain and improve our competitive position, we must keep pace with the evolving needs of our customers and continue to develop and introduce new products, features and services in a timely and efficient manner. The principal competitive factors that affect the markets for our products include:

- the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;
- our ability to anticipate changes in customer requirements and to develop new or improved products that meet these requirements in a timely manner;
- our product reputation, quality, performance, and conformance with established industry standards;
- our customer service and support;
- warranties, indemnities, and other contractual terms; and
- customer relationships and market awareness.

In each of our markets, our competitors include both small companies as well as some of the largest companies in the electronics industry operating either alone or together with trade associations and partners. Our key competitors in the Smart Buildings and Smart Cities markets include companies such as Digi, STMicroelectronics, Maxim, Texas Instruments, and Siemens. Key competitors in the Smart Grid market include ESCO, Elster, Enel, GE, IBM, Iskraemeco, Itron, Kamstrup, Landis+Gyr (a subsidiary of Toshiba), Siemens, and Silver Spring Networks. Key industry standard and trade group competitors include BACnet, Konnex, DALI, DeviceNet, HART, Profibus, ZigBee and the ZWave Alliance in Smart Buildings and Smart Cities markets and DLMS in the Smart Grid market.

Additionally, while our product implementations are proprietary to Echelon and are often protected by unique, patented implementations, key technologies such as LonWorks and OSGP are open, meaning that many of our basic control networking patents are broadly licensed without royalties or license fees. For instance, all of the network management commands required to develop software that competes with our LNS software are published as are the messages used by NES field devices. As a result, our customers are capable of developing hardware and software solutions that compete with many of our products.

Government Regulation

Many of our products and the industries in which they are used are subject to U.S. and foreign regulation as well as local, industry-specific codes and requirements. For example, the power line medium, which is the communications medium used by some of our products, is subject to special regulations in North America, Europe and Japan. In general, these regulations limit the ability of companies to use power lines as a communication medium. In addition, some of our competitors have attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their own products. We have resisted these efforts and will continue to oppose competitors' efforts to use regulation to impede competition in the markets for our products. Our business may also be affected by other regulatory factors, including public utility commission or similar approvals, the outcome and timing of which may be affected by matters unrelated to smart grid deployment. This could lead to an extension of the sales cycle or even cancellation of a customer's order.

In addition, the market for our products may experience a movement towards standards-based protocols driven by governmental action, such as smart grid standards being considered in the U.S. by the National Institute of Standards and Technology (NIST), and the EU 441 mandate, which directs European standards organizations to create standards for smart metering interoperability. To the extent that we do not adopt such protocols or do not succeed in achieving adoption of OSGP and other protocols we use as standards or de facto standards, sales of our products may be adversely affected. The adoption of voluntary standards or the passage of governmental regulations that are incompatible with our products or technology could limit the market opportunity for our products, which could harm our revenues, results of operations, and financial condition. For example, we believe that the market for smart meters in Germany has been delayed and may be negatively impacted due to uncertainty related to regulations of the German Federal Office for Information Security (BSI).

Proprietary Rights

We own numerous patents, trademarks, and logos. As of February 29, 2012, we had received 106 United States patents, and had 6 patent applications pending. Some of these patents have also been granted in selected foreign countries. Many of the specific patents that are fundamental to LonWorks technology have been licensed to our customers with no license fee or royalties. At present, the principal value of the remaining patents relates to our specific implementation of our products and designs.

We hold several trademarks in the United States, many of which are registered, including Echelon, LonBuilder®, LonMark, LonTalk®, LonWorks, Neuron, LON, LonPoint®, LonUsers®, LonMaker, 3120®, 3150®, LNS, LonManager®, Digital Home®, and NodeBuilder®. We have also registered some of our trademarks and logos in foreign countries.

Employees

As of February 29, 2012, we had 302 employees worldwide, of which 127 were in product development, 75 were in sales and marketing, 45 were in general and administrative, 43 were in operations, and 12 were in customer support and training. About 185 employees are located at our headquarters in California and 40 employees are located in other offices throughout the United States. Our remaining employees are located in thirteen countries worldwide, with the largest concentrations in Germany, China, Hong Kong, the Netherlands, and the United Kingdom. None of our employees is represented by a labor union. We have not experienced any work stoppages and we believe relations with our employees are good.

Where to Find More Information

We make our public filings with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all exhibits and amendments to these reports, available free of charge at our website, www.echelon.com, as soon as reasonably practicable after we file such material with the SEC. These materials are located in the "Investor Relations" portion of our Web site under the link "SEC Filings." The inclusion of our Web site address in this report does not include or incorporate by reference into this report any information on our Web site. Copies of our public filings may also be obtained from the SEC Web site at www.sec.gov.

Executive Officers of the Registrant

Ronald Sege, age 54, has been our President and Chief Executive Officer and a member of our board of directors since August 2010. He has been Chairman of the Board of Directors since October 2011. Prior to joining Echelon, he was President and Chief Operating Officer of 3COM Corporation from 2008 to 2010. He held the position of President and CEO of Tropos Networks from 2004 to 2008, and was the President and CEO of Ellacoya Networks from 2001 to 2004. Earlier in Mr. Sege's career, he was Executive Vice President at Lycos from 1998 to 2001 and he spent 10 years at 3COM holding various Executive Vice President and Vice President positions. Mr. Sege received his BA in Economics from Pomona College and earned an M.B.A. from the Harvard Business School.

William R. Slakey, age 53, has been our Executive Vice President & Chief Financial Officer since November 2011. Mr. Slakey joined our company from LiveOps Inc., where he served as Chief Financial Officer. He has also held the position of Chief Financial Officer at Extreme Networks and Handspring, Inc., as well as at several private companies including SnapTrack and Tropos Networks. Previously, Mr. Slakey held senior finance and investor relations positions at 3Com and Apple. Mr. Slakey holds a B.A. in Economics from the University of California and an M.B.A. from the Harvard Business School.

Oliver R. Stanfield, age 62, has been our Executive Vice President since November 2011. He served as our Executive Vice President and Chief Financial Officer from September 2001 to November 2011, and as our Vice President and Chief Financial Officer from March 1989 to August 2001. He retired as Chief Financial Officer in November 2011 and has remained at our company during a transition period. Mr. Stanfield joined our company from ROLM, where he served in several positions since 1980, including: Director of Pricing; Vice President, Plans and Controls; Vice President, Business Planning; Vice President, Financial Planning and Analysis; Treasurer; and Controller, Mil Spec Division. Prior to joining ROLM, Mr. Stanfield worked for ITEL Corporation, Computer Automation and Rockwell International. Mr. Stanfield began his business career with Ford Motor Company in 1969 in various accounting positions while completing a B.S. degree in Business Administration and an M.B.A. degree from the University of Southern California.

Michael T. Anderson, age 42, has been our Senior Vice President, Worldwide Markets since January 2012. He served as our Senior Vice President of Utilities Sales & Market Development from November 2009 to December 2011. Mr. Anderson joined our company from Telcordia Technologies, where he was President of the Next Generation software division, focused on telecommunications companies globally. From 2001 to 2004, he was Vice President of Marketing & Business Development for ADC Software division. Prior to joining ADC, Mr. Anderson served as President & CEO of two startup technology companies, Big Planet and Telismart, which were both sold under his leadership. Prior to these assignments, he was Vice President of Product Development for GST Telecom, a company that was acquired by Time Warner. Mr. Anderson started his career with AT&T in 1992. He holds a B.A. from the University of Washington.

Anders B. Axelsson, age 52, has been our Senior Vice President, Strategic Accounts and Business Development since January 2012. He served as our Senior Vice President of Commercial Sales & Market Development from June 2003 to December 2011. Prior to joining our company, he was Chief Executive Officer of PowerFile, Inc. From 1999 to 2001, he was President/General Manager of Snap Appliances, Inc. Between 1992 and 1999, he worked for Measurex, which was later acquired by Honeywell, and served in several positions, including Vice President of Engineering and Marketing and President/Managing Director for Europe. Mr. Axelsson started his career with ABB in 1981 where he worked for 11 years in various sales, marketing, and engineering management positions. He holds a B.S. in Electrical Engineering from ED Technical Institute in Jonkpoing, Sweden and is a graduate of the Executive Program at the University of Michigan.

Kathleen Bloch, age 55, has been our Senior Vice President and General Counsel since February 2003. Prior to joining our company, Ms. Bloch was a partner in the law firm of Wilson Sonsini Goodrich & Rosati, P.C., where she practiced from 1996 to 2003. Prior to joining Wilson Sonsini Goodrich & Rosati, she was a partner with the San Francisco and Los Angeles offices of Sheppard Mullin Richter & Hampton. Ms. Bloch received a B.S. degree in Business Administration from the University of Southern California and her law degree from Stanford Law School.

Russell Harris, age 50, joined us in September 2001 as our Senior Vice President of Operations. Prior to joining our company, he served as the Vice President of Operations for NetDynamics from 1996 until its acquisition by Sun Microsystems in 1998. From 1998 to 1999, Mr. Harris served in a management transition role for Sun Microsystems. From 1991 to 1996, Mr. Harris was the Director of Operations at Silicon Graphics, Inc. From 1985 through 1991, he held various positions at Convergent Technologies and Unisys Corporation. His last position at Unisys was as Director of IT for Worldwide Operations. Mr. Harris earned B.S. and M.S. degrees in Industrial Engineering from Stanford University.

Robert Hon, age 57, has been our Senior Vice President of Engineering since April 2011. Prior to joining our company, he served as Executive Vice President of Engineering at ConSentry Networks. Prior to ConSentry Networks, he was the Vice President of Engineering at Network Physics. Prior to Network Physics, Mr. Hon was the Vice President of Engineering at Packeteer. He has also held senior management positions at Cadence Design Systems and Apple, and he was on the faculty of Columbia University. Mr. Hon received a B.S. in Engineering and Applied Science from Yale University and earned both an M.S. and Ph.D in Computer Science from Carnegie-Mellon University.

Varun Nagaraj, age 46, has been our Senior Vice President, Product Management and Marketing since January 2011. He served as our Senior Vice President of Product Management and Product Marketing from May 2011 to December 2011. Prior to joining our company, Mr. Nagaraj was the CEO of NetContinuum. Prior to NetContinuum, he served as Executive Vice President of Marketing and Customer Operations for Ellacoya. Prior to Ellacoya, he was Vice President of Product Management and Marketing at Extreme Networks. Mr. Nagaraj was previously a Partner at PRTM, a leading management consulting company focused on product and operations strategy. He started his career at HP. He received a B.S.E.E. from IIT Bombay, an M.S. in Computer Engineering from North Carolina State University, and an M.B.A. from Boston University.

ITEM 1A. RISK FACTORS

Interested persons should carefully consider the risks described below in evaluating our company. Additional risks and uncertainties not presently known to us, or that we currently consider immaterial, may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock would likely decline. Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described in this section. This section should be read in conjunction with the consolidated financial statements and accompanying notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Annual Report on Form 10-K.

Our Systems revenues may not meet expectations, which could cause volatility in the price of our stock.

We and our partners sell our smart metering and distribution automation products to utilities. For several reasons, sales cycles with utility companies can be extended and unpredictable. Utilities generally have complex budgeting, purchasing, and regulatory processes that govern their capital spending. In addition, in many instances, a utility may require one or more field trials of a smart grid system (such as one based on our NES Smart Grid System) before moving to a volume deployment. There is also generally an extended development and integration effort required in order to incorporate a new technology into a utility's existing infrastructure. A number of other factors may also need to be addressed before the utility decides to engage in a full-scale deployment of our NES Smart Grid System, including:

- regulatory factors, including public utility commission or similar approvals, the outcome and timing of which may be affected by matters unrelated to smart grid deployment; standards compliance; or internal utility requirements that may affect the smart metering system or the timing of its deployment;

- the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments;
- the deployment schedule for projects undertaken by our utility or systems integrator customers; and
- delays in installing, operating, and evaluating the results of a smart grid field trial that is based on our NES Smart Grid System.

As a result, we can often spend up to two years working either directly or through a reseller to make a sale to a utility. At the end of that lengthy sales process, particularly in view of increasing competition in the Smart Grid market and continuing economic challenges, there is no guarantee that we will be selected by the utility.

In addition, shipment of Systems products to a particular jurisdiction or customer is generally dependent on either obtaining regulatory approval for the NES meter or other products, including modifications to those products, from a third party for the relevant jurisdiction, or satisfying the customer's internal testing requirements, or both. This certification approval process is often referred to as homologation. Further, shipment of Systems products into some jurisdictions requires our contract manufacturers to pass certain tests and meet various standards related to the production of our NES meters. Failure to receive any such approval on a timely basis or at all, or failure to maintain any such approval, would have a material adverse impact on our ability to ship our Systems products, and would therefore have an adverse affect on our results of operations and our financial condition.

Once a utility decides to move forward with a large-scale deployment of a smart grid project that is based on our NES Smart Grid System, the timing of and our ability to recognize revenue on our Systems product shipments will depend on several factors. These factors, some of which may not be under our control, include shipment schedules that may be delayed or subject to modification, other contractual provisions, such as customer acceptance of all or any part of the NES Smart Grid System, our ability to manufacture and deliver quality products according to expected schedules, and customer cancellation rights. For example, in October 2011, Duke Energy cancelled certain orders for our products that we anticipated we would have delivered in late 2012 and beyond.

In addition, the revenue recognition rules relating to products such as our NES Smart Grid System may also require us to defer some of our Systems revenues until certain conditions are met in a future period. For example, beginning in the third quarter of 2011, we began shipping hardware products to a customer for which we had not yet delivered a final version of the related firmware. As a result, we cannot recognize the revenue associated with this hardware until such time as the firmware is delivered because payment for the hardware is contingent upon delivery of the firmware.

As a consequence of these long sales cycles, unpredictable delay factors, and revenue recognition policies, our ability to predict the amount of Systems revenues that we may expect to recognize in any given fiscal quarter is likely to be limited. As Systems revenues account for an increasing percentage of our overall revenues, we are likely to have increasing difficulty in projecting our overall financial results. Our inability to accurately forecast future revenues is likely to cause our stock price to be volatile.

Sales of our products, particularly our Systems products, may fail to meet our financial targets, which would harm our results of operations.

If we are unable to receive orders for, ship, and recognize revenue for our products in a timely manner and in line with our targets (and often in the same year), our financial results will be harmed. We have invested and intend to continue to invest significant resources in the development and sales of our products, particularly our Systems products, such as our Smart Grid portfolio of products, the Echelon Control Operating System, or COS, and the ECN. Our long-term financial goals include expectations for a reasonable return on these investments, particularly for our Systems products. To date the revenues generated from sales of these Systems products have not yielded gross margins in line with our long term goals for this product line, although our operating expenses have increased significantly. Our Systems products are also experiencing continuing downward pricing pressures due to intense competition.

In order to achieve our financial targets, we must meet the following objectives:

- Increase market acceptance of our products worldwide in order to increase our revenues;
- Increase gross margin from our Systems revenues by continuing to reduce the cost of manufacturing our Systems products, while at the same time managing manufacturing cost pressures associated with commodity prices and foreign exchange fluctuations;
- Manage our operating expenses to a reasonable percentage of revenues; and
- Manage the manufacturing transition to reduced-cost Systems products.

Because a significant portion of our operating expenses are fixed, if we cannot achieve our revenue targets, our use of cash balances would increase, our losses would increase, and/or we would be required to take additional actions necessary to reduce expenses. We cannot assure you that we will meet any or all of these objectives to the extent necessary to achieve our financial goals and, if we fail to achieve our goals, our results of operations are likely to be harmed.

The loss of or significant curtailment of purchases by any of our key customers could adversely affect our results of operations and financial condition.

While we generate revenue from numerous customers worldwide, our sales are currently concentrated within a relatively small group of customers. During the fiscal year ended December 31, 2011, a large percentage of our revenue, approximately 64%, came from sales to our top four customers. These customers have a variety of suppliers to choose from and therefore can make substantial demands on us, including demands on product pricing and on contractual terms, which often results in the allocation of risk to us as the supplier. In addition, if a large customer contract is not replaced upon its expiration with new business of similar magnitude, our revenue and gross product would be adversely affected. Our ability to maintain strong, long-term relationships with our key customers is essential to our future performance.

Customers in any of our target market sectors could also experience unexpected reductions in demand for their products and consequently reduce their purchases of our product, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. If any of our key customers are unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to us. The loss of or significant curtailment of purchases by any one or more of our key customers may adversely affect our results of operations and financial condition.

Adverse changes in general economic or political conditions in any of the major countries in which we do business could adversely affect our business or operating results.

Our business can be affected by a number of factors that are beyond our control, such as general geopolitical, economic, and business conditions. The ongoing economic slowdown, particularly in Europe, where we have sold many NES Smart Grid products, and the uncertainty over its breadth, depth and duration continue to put pressure on the global economy, which has a negative effect on our business. Further, the recent worldwide financial and credit crisis has hampered the availability of liquidity and credit to fund the continuation and expansion of business operations worldwide. The shortage of liquidity and credit, combined with losses in worldwide equity markets, has continued to contribute to the recent world-wide economic recession.

In addition, there could be a number of follow-on effects from the credit crisis on our business, such as the insolvency of certain of our key customers, which could impair our distribution channels or result in the inability of our customers to obtain credit to finance purchases of our products.

This uncertainty about future economic and political conditions makes it difficult for us to forecast operating results and to make decisions about future investments. We continue to see the effects of the economic slowdown on both our Systems and Sub-systems revenues, particularly in locations where government support for energy-related projects has ended or will end in the near future. If economic activity in the U.S. and other countries' economies remains weak, many customers may continue to delay, reduce, or even eliminate their purchases of networking technology products. This could result in reductions in sales of our products, longer sales cycles, slower adoption of our technologies, increased price competition, and increased exposure to excess and obsolete inventory. For example, distributors could decide to reduce inventories of our products. Also, the inability to obtain credit could cause a utility to postpone its decision to move forward with a large scale deployment of our Systems products. If conditions in the global economy, U.S. economy or other key vertical or geographic markets we serve remain uncertain or continue to be weak, we would experience material negative impacts on our business, financial condition, results of operations, cash flow, capital resources, and liquidity.

Because the markets for our products are highly competitive, we may lose sales to our competitors, which would harm our revenues and results of operations.

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, rapid changes in customer or regulatory requirements, and localized market requirements. Competition in the Systems business has increased as the smart metering industry faces slow growth and ongoing consolidation, particularly in Europe where the financial crisis has continued. In each of our existing and new target markets, we compete with a wide array of manufacturers, vendors, strategic alliances, systems developers and other businesses.

The principal competitive factors that affect the markets for our products include the following:

- our ability to anticipate changes in customer or regulatory requirements and to develop, have developed, or improve our products to meet these requirements in a timely manner;

- the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;
- our product reputation, quality, performance, and conformance with established industry standards;
- our ability to expand our product line to address our customers' requirements, such as adding additional electricity meter form factors;
- our ability to meet a customer's required delivery schedules;
- our customer service and support;
- warranties, indemnities, and other contractual terms; and
- customer relationships and market awareness.

Competitors for our Systems products include ESCO, Elster, Enel, GE, IBM, Iskraemeco, Itron, Kamstrup, Landis+Gyr (a subsidiary of Toshiba), Siemens, and Silver Spring Networks, which directly or through IT integrators such as IBM or telecommunications companies such as Telenor, offer metering systems that compete with our Systems offerings.

For our Sub-systems products, our competitors include some of the largest companies in the electronics industry, operating either alone or together with trade associations and partners. Key company competitors include companies such as Digi, STMicroelectronics, Maxim, Texas Instruments, and Siemens. Key industry standard and trade group competitors include BACnet, DALI, and Konnex in the buildings industry; DeviceNet, HART, and Profibus in the industrial control market; DLMS in the utility industry; Echonet, ZigBee and the Z-Wave alliance in the home control market; and the Train Control Network (TCN) in the rail transportation market. Each of these standards and/or alliances is backed by one or more competitors. For example, the ZigBee alliance includes over 300 member companies with promoter members such as Ember, Emerson, Freescale, Itron, Kroger, Landis+Gyr (a subsidiary of Toshiba), Philips, Reliant Energy, Schneider Electric, STMicroelectronics, Tendril, and Texas Instruments.

Many of our competitors, alone or together with their trade associations and partners, have significantly greater financial, technical, marketing, service and other resources, significantly greater name recognition, and broader product offerings. In addition, the utility metering market is experiencing a trend towards consolidation. As a result, these competitors may be able to devote greater resources to the development, marketing, and sale of their products, and may be able to respond more quickly to changes in customer requirements or product technology. Some of our competitors may also be eligible for stimulus money, which could give them an additional financial advantage. If we are unable to compete effectively in any of the markets we serve, our revenues, results of operations, and financial position would be harmed.

A limited number of utilities are currently responsible for a significant portion of our revenues.

A significant portion of our sales were made to a limited number of customers in 2011. As a particular utility's smart grid project nears completion, or if the utility experiences changes in business requirements or implements changes in purchase plans, our revenues could decrease significantly. We expect that a limited number of customers will continue to account for a substantial portion of our revenue in future periods.

We face operational and other risks associated with our international operations.

Risks inherent in our international business activities include the following:

- the imposition of tariffs or other trade barriers on the importation of our products;
- timing of and costs associated with localizing products for foreign countries and lack of acceptance of non-local products in foreign countries;
- inherent challenges in managing international operations;
- the burdens of complying with a wide variety of foreign laws; the applicability of foreign laws that could affect our business or revenues, such as laws that purport to require that we return payments that we received from insolvent customers in certain circumstances; and unexpected changes in regulatory requirements, tariffs, and other trade barriers;
- potentially adverse tax consequences, including restrictions on repatriation of earnings;
- economic and political conditions in the countries where we do business;

- differing vacation and holiday patterns in other countries, particularly in Europe;
- labor actions generally affecting individual countries, regions, or any of our customers, which could result in reduced demand for, or could delay delivery or acceptance of, our products; and
- international terrorism.

Any of these factors could have a material adverse effect on our revenues, results of operations, and our financial condition.

If we are not able to develop or enhance our products in a timely manner, our revenues will suffer.

Due to the nature of development efforts in general, we often experience delays in the introduction of new or improved products beyond our original projected shipping date for such products. Historically, when these delays have occurred, we experienced an increase in our development costs and a delay in our ability to generate revenues from these new products. In addition, such delays could impair our relationship with any of our customers that were relying on the timely delivery of our products in order to complete their own products or projects, or could cause them to cancel orders or to seek alternate sources of supply or other remedies. We believe that similar new product introduction delays in the future could also increase our costs and delay our revenues.

For System products we are sometimes required to modify products to meet local rules and regulations. We may not be able to increase the price of such products to reflect the costs of such modifications, given competive markets. In addition, given the long term nature of development activities, we may be required to undertake such modifications prior to receiving firm commitments or orders from our customers.

We are collaborating with a Chinese partner to develop smart metering products for the Chinese market. To the extent we expand our development activities to third parties in China or elsewhere, our development activities will be exposed to risks inherent in such activities, such as protection of intellectual property, investment risk, economic and political stability, and labor matters. We could also be adversely affected by delays or cost increases experienced by third parties that are developing products on our behalf.

Because we depend on a limited number of key suppliers and in certain cases, a sole supplier, the failure of any key supplier to produce timely and compliant products could result in a failure to ship products, or could subject us to higher prices, which would harm our results of operations and financial position.

Our future success will depend significantly on our ability to timely manufacture our products cost effectively, in sufficient volumes, and in accordance with quality standards. For most of our products requiring assembly, we rely on a limited number of contract electronic manufacturers (CEMs), principally Jabil and TYCO. These CEMs procure material and assemble, test, and inspect the final products to our specifications. This strategy involves certain risks, including reduced control over quality, costs, delivery schedules, availability of materials, components, finished products, and manufacturing yields. As a result of these and other risks, our CEMs could demand price increases for manufacturing our products. The Jabil and TYCO factories where our products are manufactured are located in China. Recently, the Chinese government announced a program whereby labor rates for the manufacture of our products will increase over time. As an example of this, in June 2011, Jabil 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. In addition, our agreements with our CEMs make us responsible for components and subassemblies purchased by the CEMs when based on our forecasts or purchase orders. Accordingly, we will be at risk for any excess and obsolete inventory purchased by our CEMs. Lastly, CEMs can experience turnover, instability, and lapses in manufacturing or component quality, exposing us to additional risks as well as missed commitments to our customers.

We also maintain manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products. The Neuron Chip is an important component that we and our customers use in control network devices. In addition to those sold by Echelon, the Neuron Chip is currently manufactured and distributed only by Cypress Semiconductor. The other former producer of the Neuron Chip, Toshiba, ceased production due to earthquake damage at its factory in Japan in March 2011. As a result, we or our customers may experience longer lead times and higher pricing for these parts, which could result in reduced orders for our products from these same customers.

We also have sole source relationships with third party foundries for the production of certain other key products, including STMicroelectronics, who produces our power line smart transceivers, and Open-Silicon, which is the foundry for our new Neuron 5000 processor. In addition, we currently purchase several key products and components from sole or limited source suppliers with which we do not maintain signed agreements that would obligate them to supply to us on negotiated terms. Any sole source relationship could make us vulnerable to price increases, particularly where we do not maintain long-term supply agreements with the supplier.

We are continuing to review the impact that the ongoing worldwide financial crisis is having on our suppliers. Some of these suppliers are large, well capitalized companies, while others are smaller and more highly leveraged. In order to mitigate these risks, we may take actions such as increasing our inventory levels and/or adding additional sources of supply. Such actions may increase our costs and increase the risk of excess and obsolete inventories. Even if we undertake such actions, there can be no assurance that we will be able to prevent any disruption in the supply of goods and services we receive from these suppliers.

We may also elect to change any of these key suppliers. For example, in 2009 we completed the process of ending our relationship with a former CEM partner, Flextronics. As part of this transition, we moved the production of products Flextronics built for us to alternative CEMs. We were also required to purchase certain raw material and in-process inventory from Flextronics that Flextronics procured in anticipation of our production requirements. In addition, if any of our key suppliers were to stop manufacturing our products or supplying us with our key components, it could be expensive and time consuming to find a replacement. Also, as our Systems business grows, we will be required to expand our business with our key suppliers or find additional sources of supply. There is no guarantee that we would be able to find acceptable alternative or additional sources. Additional risks that we face if we must transition between CEMs include:

- moving raw material, in-process inventory, and capital equipment between locations, some of which may be in different parts of the world;
- reestablishing acceptable manufacturing processes with a new work force; and
- exposure to excess or obsolete inventory held by contract manufacturers for use in our products.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with our product, assembly and test specifications could result in our failure to ship products, which would adversely affect our revenues and gross profit, and could result in claims against us by our customers, which could harm our results of operations and financial position.

Because our products use components or materials that may be subject to price fluctuations, shortages, interruptions of supply, or discontinuation, we may be unable to ship our products in a timely fashion, which would adversely affect our revenues, harm our reputation and negatively impact our results of operations.

We may be vulnerable to price increases for products, components, or materials, such as silver, copper, and cobalt. We generally do not enter into forward contracts or other methods of hedging against supply risk for these items. In addition, we have in the past and may in the future occasionally experience shortages or interruptions in supply for certain of these items, including products or components that have been or will be discontinued, which can cause us to delay shipments beyond targeted or announced dates. Such shortages or interruptions could result from events outside our control, as was the case with the earthquake and tsunami in Japan in March 2011. To help address these issues, we may decide from time to time to purchase quantities of these items that are in excess of our estimated requirements. As a result, we could be forced to increase our excess and obsolete inventory reserves to provide for these excess quantities, which could harm our operating results. In addition, if a component or other product goes out of production, we may be required to requalify substitute components or products, or even redesign our products to incorporate an alternative component or product.

If we experience any shortage of products or components of acceptable quality, or any interruption in the supply of these products or components, or if we are not able to procure them from alternate sources at acceptable prices and within a reasonable period of time, our revenues, gross profits or both could decrease. In addition, under the terms of some of our contracts with our customers, we may also be subject to penalties if we fail to deliver our products on time.

We are subject to numerous governmental regulations concerning the manufacturing and use of our products. We must stay in compliance with all such regulations and any future regulations. Any failure to comply with such regulations, and the unanticipated costs of complying with future regulations, may adversely affect our business, financial condition, and results of operations.

We manufacture and sell products that contain electronic components that may contain materials that are subject to government regulation in the locations in which our products are manufactured and assembled, as well as the locations where we sell our products. Since we operate on a global basis, maintaining compliance with regulations concerning the materials used in our products is a complex process that requires continual monitoring of regulations and ongoing compliance procedures. While we do not currently know of any proposed regulations regarding components in our products that would have a material impact on our business, the adoption of any unanticipated new regulations that significantly impact the various components we use or require that we use more expensive components would have a material adverse impact on our business, financial condition and results of operations.

Our manufacturing processes, including the processes used by our suppliers, are also subject to numerous governmental regulations that cover both the use of various materials as well as environmental concerns. Since we and our suppliers operate on a global basis, maintaining compliance with regulations concerning our production processes is also a complex process that requires continual monitoring of regulations and ongoing compliance procedures. For example, environmental issues such as pollution and climate change have seen significant legislative and regulatory interest on a global basis. Changes in these areas could directly increase the cost of energy, which may have an impact on the way we or our suppliers manufacture products or use energy to produce our products. In addition, any new regulations or laws in the environmental area might increase the cost of raw materials we use in our products. We are currently unable to predict how any such changes will impact us and if any such impact could be material to our business. Any new law or regulation that significantly increases our costs of manufacturing or causes us or our suppliers to significantly alter the way that our products are manufactured would have a material adverse effect on our business, financial condition and results of operations.

Liabilities resulting from defects in or misuse of our products, whether or not covered by insurance, may delay our revenues and increase our liabilities and expenses.

Our products may contain or may be alleged to contain undetected errors or failures, including relating to actual or potential security breaches. In addition, our customers or their installation partners may improperly install or implement our products, which could delay completion of a deployment or hinder our ability to win a subsequent award. Furthermore, because of the low cost and interoperable nature of our Sub-systems products, LONWORKS technology could be used in a manner for which it was not intended.

Even if we determine that an alleged error or failure in our products does not exist, we may incur significant expense and shipments and revenue may be delayed while we analyze the alleged error or failure. If errors or failures are found in our products, we may not be able to successfully correct them in a timely manner, or at all, and our reputation may suffer. Such errors or failures could delay our product shipments and divert our engineering resources while we attempt to correct them. In addition, we could decide to extend the warranty period, or incur other costs outside of our normal warranty coverage, to help address any known errors or failures in our products and mitigate the impact on our customers. This could delay our revenues and increase our expenses.

To address these issues, the agreements we maintain with our customers may contain provisions intended to limit our exposure to potential errors and omissions claims as well as any liabilities arising from them. However, our customer contracts may not effectively protect us against the liabilities and expenses associated with errors or failures attributable to our products.

Defects in our products may also cause us to be liable for losses in the event of property damage, harm or death to persons, claims against our directors or officers, and the like. Such liabilities could harm our reputation, expose our company to liability, and adversely affect our operating results and financial position.

To help reduce our exposure to these types of liabilities, we currently maintain property, general commercial liability, errors and omissions, directors and officers, and other lines of insurance. However, it is possible that such insurance may not be available in the future or, if available, may be insufficient in amount to cover any particular claim, or we might not carry insurance that covers a specific claim. In addition, we believe that the premiums for the types of insurance we carry will continue to fluctuate from period to period. Significant cost increases could also result in increased premiums or reduced coverage limits. Consequently, if we elect to reduce our coverage, or if we do not carry insurance for a particular type of claim, we will face increased exposure to these types of claims.

If we are unable to obtain additional funds when needed, our business could suffer.

We currently expect that our combined cash, cash equivalent, and short-term investment balance will decline during 2012. We expect that cash requirements for our payroll and other operating costs will continue at near existing levels. We also expect that we will continue to acquire capital assets such as computer systems and related software, office and manufacturing equipment, furniture and fixtures, and leasehold improvements, as the need for these items arises.

In the future, to the extent that our revenues grow, we may experience higher levels of inventory and accounts receivable, which will also use our cash balances. In addition, our cash reserves may be used to strategically acquire or invest in other companies, products, or technologies that are complementary to our business. Lastly, our combined cash, cash equivalents, and short-term investment balances could be negatively affected by the various risks and uncertainties that we face. For example, any continued weakening of economic conditions or changes in our planned cash outlay could negatively affect our existing cash reserves.

While we do not currently depend on access to the credit markets to finance our operations, there can be no assurance that the current state of the financial markets would not impair our ability to obtain financing in the future, including, but not limited to, our ability to draw on funds under our existing credit facilities or our ability to incur indebtedness or sell equity if that became necessary or desirable. In addition, if we do not meet our revenue targets, our use of our cash balances would increase due to the fact that a significant portion of our operating expenses are fixed. If we were not able to obtain additional financing when needed, or on acceptable terms, our ability to invest in additional research and development resources and sales and marketing resources could be adversely affected, which could hinder our ability to sell competitive products into our markets on a timely basis and harm our business.

We have limited ability to protect our intellectual property rights.

Our success depends significantly upon our intellectual property rights, which can vary significantly from jurisdiction to jurisdiction. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements and other contractual provisions to establish, maintain and protect these intellectual property rights, all of which afford only limited protection, particularly in those countries that lack robust or accessible enforcement mechanisms. For example, we are partnering with a third party to develop certain products in China, and the intellectual property mechanisms available in China are generally less stringent than those found in the U.S. If any of our patents fail to protect our technology, or if we do not obtain patents in certain countries, our competitors may find it easier to offer equivalent or superior technology. In addition, our trade secrets or other intellectual property that we license to third parties could be used improperly or otherwise in violation of the license terms.

We have also registered or applied for registration for certain trademarks, and will continue to evaluate the registration of additional trademarks as appropriate. If we fail to properly register or maintain our trademarks, or to otherwise take all necessary steps to protect our trademarks, the value associated with the trademarks may diminish. In addition, if we fail to protect our trade secrets or other intellectual property rights, we may not be able to compete as effectively in our markets.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services or use information that we regard as proprietary, or it may not be economically feasible to enforce them. Any of our patents, trademarks, copyrights, trade secrets, or intellectual property rights could be challenged, invalidated or circumvented. In addition, we cannot assure you that we have taken or will take all necessary steps to protect our intellectual property rights. Third parties may also independently develop similar technology without breach of our trade secrets or other proprietary rights. In addition, the laws of some foreign countries, including several in which we operate or sell our products, do not protect proprietary rights to as great an extent as do the laws of the United States, and it may take longer to receive a remedy from a court outside of the United States. Also, some of our products are licensed under shrink-wrap license agreements that are not signed by licensees and therefore may not be binding under the laws of certain jurisdictions.

From time to time, litigation may be necessary to defend and enforce our proprietary rights. As a result, we could incur substantial costs and divert management resources, which could harm our business, regardless of the final outcome. Despite our efforts to safeguard and maintain our proprietary rights both in the United States and abroad, we may be unsuccessful in doing so. Also, the steps that we take to safeguard and maintain our proprietary rights may be inadequate to deter third parties from infringing, misusing, misappropriating, or independently developing our technology or intellectual property rights, or to prevent an unauthorized third party from misappropriating our products or technology.

We are exposed to credit risk and payment delinquencies on our accounts receivable, and this risk has been heightened during the ongoing decline in economic conditions.

We only recognize revenue when we believe collectability is reasonably assured. However, only a relatively small percentage of our outstanding accounts receivables are covered by collateral, credit insurance, or acceptable third-party guarantees. In addition, our standard terms and conditions require payment within a specified number of days following shipment of product, or in some cases, after the customer's acceptance of our products. While we have procedures to monitor and limit exposure to credit risk on our receivables, there can be no assurance such procedures will effectively limit our credit risk and avoid losses. Additionally, when one of our resellers makes a sale to a utility, we face further credit risk, and we may defer revenue, due to the fact that the reseller may not be able to pay us until it receives payment from the utility. This risk could become more magnified during a particular fiscal period if the resellers facing credit issues represent a significant portion of our accounts receivable during that period. As economic conditions change and worsen, certain of our direct or indirect customers may face liquidity concerns and may be unable to satisfy their payment obligations to us or our resellers on a timely basis or at all, which would have a material adverse effect on our financial condition and results of operations. Our revenues are highly concentrated with 63.9% of our 2011 revenues being attributable to four customers and 71.9% of our December 31, 2011 accounts receivable balance being attributable to these same customers. This concentration risk further increases our credit exposure.

Our executive officers and technical personnel are critical to our business.

Our success depends substantially on the performance of our executive officers and key employees. Due to the specialized technical nature of our business, we are particularly dependent on our Chief Executive Officer and other executive officers, as well as our technical personnel. Our future success will depend on our ability to attract, integrate, motivate and retain qualified executive, managerial, technical, sales, and operations personnel.

Competition for qualified personnel in our business areas is intense, and we may not be able to continue to retain qualified executive officers and key personnel and attract new officers and personnel when necessary. Our product development and marketing functions are largely based in Silicon Valley, which is a highly competitive marketplace. It may be particularly difficult to recruit, relocate and retain qualified personnel in this geographic area. Moreover, the cost of living, including the cost of housing, in Silicon Valley is known to be high. Because we are legally prohibited from making loans to executive officers, we will not be able to assist potential key personnel as they acquire housing or incur other costs that might be associated with joining our company. In addition, if we lose the services of any of our key personnel and are not able to find suitable replacements in a timely manner, our business could be disrupted, other key personnel may decide to leave, and we may incur increased operating expenses in finding and compensating their replacements.

If we do not maintain adequate distribution channels, our revenues will be harmed.

We market our Systems products directly, as well as through selected VARs and integration partners. We believe that a significant portion of our Systems sales will be made through our VARs and integration partners, rather than directly by us. To date, our VARs and integration partners have greater experience in overseeing projects for utilities. As a result, if our relationships with our VARs and integration partners are not successful, or if we are not able to create similar distribution channels for our Systems products with other companies in other geographic areas, revenues from sales of our Systems products may not meet our financial targets, which will harm our operating results and financial condition.

Historically, significant portions of our Sub-systems revenues have been derived from sales to distributors, including EBV, the primary independent distributor of our products to OEMs in Europe. In April 2011, our distributor agreement with EBV was assigned from EBV to Avnet Europe Comm VA, a limited partnership organized under the laws of Belgium ("Avnet"). Both 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 our distributor agreement with Avnet was extended and will now expire in June 2014. If our distributor relationship with Avnet is not successful, our business, revenues, and financial results will suffer.

Agreements with our other distributor partners are generally renewed on an annual basis. If any of these agreements are not renewed, we would be required to locate another distributor or add our own distribution capability to meet the needs of our end-use customers. Any replacement distribution channel could prove less effective than our current arrangements. In addition, if any of our distributor partners fail to dedicate sufficient resources to market and sell our products, our revenues would suffer. Furthermore, if our distributor partners were to significantly reduce their inventory levels for our products, we could expect a decrease in service levels to our end-use customers.

Voluntary and/or industry standards and governmental regulatory actions in our markets could limit our ability to sell our products.

Standards bodies, which are formal and informal associations that attempt to set voluntary, non-governmental product standards, are influential in many of our target markets. We participate in many voluntary and/or industry standards organizations around the world in order to help prevent the adoption of exclusionary standards as well as to promote standards for our products. However, we do not have the resources to participate in all standards processes that may affect our markets and our efforts to influence the direction of those standards bodies in which we do participate may not be successful. Many of our competitors have significantly more resources focused on standards activities and may influence those standards in a way that would be disadvantageous to our products.

Many of our products and the industries in which they are used are subject to U.S. and foreign regulation. For example, the power line medium, which is the communications medium used by some of our products, is subject to special regulations in North America, Europe and Japan. In general, these regulations limit the ability of companies to use power lines as a communication medium. In addition, some of our competitors have attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their own products.

In addition, the markets for our Systems and Sub-systems products may experience a movement towards standards based protocols driven by governmental action, such as those being considered in the U.S. by NIST and in Europe by those related to the EU 441 mandate. We are also attempting to gain widespread adoption for our Open Smart Grid Protocol, which is used by smart meters and other devices within our NES Smart Grid System. To the extent that we do not adopt such protocols or do not succeed in achieving adoption of our own protocols as standards or de facto standards, sales of our Systems and Sub-systems products may be adversely affected. Moreover, if our own protocols are adopted as standards, we run the risk that we could lose business to competing implementations.

The adoption of voluntary and/or industry standards or the passage of governmental regulations, for example by state utility commissions or national regulatory bodies such as FERC in the United States and PTB or BSI in Germany, that are incompatible with our products or technology could limit the market opportunity for our products, which could harm our revenues, results of operations, and financial condition.

We may be unable to promote and expand acceptance of our open, interoperable control systems over competing protocols, standards, or technologies.

LONWORKS technology is open, meaning that many of our technology patents are broadly licensed without royalties or license fees. As a result, our Sub-systems customers are able to develop hardware and software solutions that compete with some of our products. Because some of our customers are OEMs that develop and market their own control systems, these customers in particular could develop competing products based on our open technology. For instance, we have published all of the network management commands required to develop software that competes with our LNS software.

In addition, many of our Sub-systems competitors are dedicated to promoting closed or proprietary systems, technologies, software and network protocols or product standards that differ from or are incompatible with ours. We also face strong competition from large trade associations that promote alternative technologies and standards for particular vertical applications or for use in specific countries. These include BACnet, DALI, and KNX in the buildings market; DeviceNet, HART, and ProfiBus in the industrial controls market; TCN in the rail transportation market; DLMS in the electric metering market; and Echonet, ZigBee, and Z-Wave in the home control market.

Our technologies, protocols, or standards may not be successful or we may not be able to compete with new or enhanced products or standards introduced by our Sub-systems product line competitors, which would have a material adverse effect on our revenues, results of operations, and financial condition.

Because we may incur penalties, be liable for damages, or otherwise subject to adverse contractual provisions with respect to sales of our Systems products, we could incur unanticipated liabilities or suffer other negative impacts to our business or operating results.

The agreements governing the sales of our NES Smart Grid System products may expose us to penalties, damages, order cancellations, and other liabilities in the event of, among other things, late deliveries, late or improper installations or operations, failure to meet product specifications or other product failures, failure to achieve performance specifications, indemnities, or other compliance issues. Even in the absence of such contractual provisions, we may agree, or may be required by law, to assume certain liabilities for the benefit of our customers. In addition, the contractual provisions governing sales of our Systems or other products could give our customers cancellation rights, even in the absence of a material failure by our company, such as upon the failure of conditions that are outside of our control. Such liabilities or rights could have an adverse effect on our financial condition and operating results.

We face currency risks associated with our international operations.

We have operations located in eleven countries and our products are sold in many more countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 62.8%, 78.1%, and 74.9% of our total revenues for the years ended December 31, 2011, 2010, and 2009, respectively. We expect that international sales will continue to constitute a significant portion of our total net revenues. Given our high dependency on sales of our products into Europe, the recent escalation in the financial crisis in that region could adversely affect our financial results significantly.

Changes in the value of currencies in which we conduct our business relative to the U.S. dollar have caused and could continue to cause fluctuations in our reported financial results. The three primary areas where we are exposed to foreign currency fluctuations are revenues, cost of goods sold, and operating expenses.

In general, we sell our products to foreign customers primarily in U.S. dollars. As such, fluctuations in exchange rates have had, and could continue to have, an impact on revenues. If the value of the dollar rises, our products will become more expensive to our foreign customers, which could result in their decision to postpone or cancel a planned purchase.

With respect to the relatively minimal amount of our revenues generated in foreign currencies, our historical foreign currency exposure has been related primarily to the Japanese Yen and has not been material to our consolidated results of operations. However, in the future, we expect that some foreign utilities may require us to price our Systems products in the utility's local currency, which will increase our exposure to foreign currency risk.

In addition, for our cost of goods sold, our products are generally assembled by CEMs in China. Although our transactions with these companies are presently denominated in U.S. dollars, in the future they may require us to pay in their local currency, or demand a U.S. dollar price adjustment or other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases. In addition, increases in labor costs in the markets where our products are manufactured could also result in higher costs to procure our products. For example, China has recently experienced overall wage increases, which our CEMs have generally passed along to us.

We use the local currency to pay for our operating expenses in the various countries where we have operations. If the value of the U.S. dollar declines as compared to the local currency where the expenses are incurred, our expenses, when translated back into U.S. dollars, will increase.

To date, we have not hedged any of our foreign currency exposures and currently do not maintain any hedges to mitigate our foreign currency risks. Consequently, any resulting adverse foreign currency fluctuations could significantly harm our revenues, cost of goods sold, or operating expenses.

The sales cycle for our Sub-systems products is lengthy and unpredictable.

The sales cycle between initial Sub-systems customer contact and execution of a contract or license agreement with a customer or purchaser of our products, can vary widely. Initially, we must educate our customers about the potential applications of and cost savings associated with our products. If we are successful in this effort, OEMs typically conduct extensive and lengthy product evaluations before making a decision to design our products into their offerings. Once the OEM decides to incorporate our products, volume purchases of our products are generally delayed until the OEM's product development, system integration, and product introduction periods have been completed. In addition, changes in our customer's budgets, or the priority they assign to control network development, could also affect the sales cycle.

We generally have little or no control over these factors, any of which could prevent or substantially delay our ability to complete a transaction and could adversely affect the timing of our revenues and results of operations.

Our business may suffer if it is alleged or found that our products infringe the intellectual property rights of others, or if we are unable to secure rights to use the intellectual property rights of others on reasonable terms.

We may be contractually obligated to indemnify our customers or other third parties that use our products in the event our products are alleged to infringe a third party's intellectual property rights. From time to time, we may also receive notice that a third party believes that our products may be infringing patents or other intellectual property rights of that third party. Responding to those claims, regardless of their merit, can be time consuming, result in costly litigation, divert management's attention and resources, and cause us to incur significant expenses. We do not insure against infringement of a third party's intellectual property rights.

As the result of such a claim, we may elect or be required to redesign our products that are alleged to infringe the third party's patents or other intellectual property rights, which could cause those product offerings to be delayed. Or we could be required to cease distributing those products altogether. In the alternative, we could seek a license to the third party's intellectual property. Even if our products do not infringe, we may elect to take a license or settle to avoid incurring litigation costs. However, it is possible that we would not be able to obtain such a license or settle on reasonable terms, or at all.

In some cases, even though no infringement has been alleged, we may attempt to secure rights to use the intellectual property rights of others that would be useful to us. We cannot guarantee that we would be able to secure such rights on reasonable terms, or at all.

Lastly, our customers may not purchase our products if they are concerned our products may infringe third party intellectual property rights. This could reduce the market opportunity for the sale of our products and services.

Any of the foregoing risks could have a material adverse effect on our revenues, results of operations, and financial condition.

If we sell our NES Smart Grid System products directly to a utility, we may face additional risks.

When we sell our NES Smart Grid System products to a utility directly, we may be required to assume responsibility for installing the NES Smart Grid System in the utility's territory, integrating the NES Smart Grid System into the utility's operating and billing system, overseeing management of the combined system, working with other of the utility's contractors, and undertaking other activities. To date, we do not have any significant experience with providing these types of services. As a result, when we sell directly to a utility, it may be necessary for us to contract with third parties to satisfy these obligations. We cannot assure you that we would find appropriate third parties to provide these services on reasonable terms, or at all. Assuming responsibility for these or other services would add to the costs and risks associated with NES Smart Grid System installations, and could also negatively affect the timing of our revenues and cash flows related to these transactions.

Fluctuations in our operating results may cause our stock price to decline.

Our quarterly and annual results have varied significantly from period to period, and we have sometimes failed to meet securities analysts' expectations. Moreover, we have a history of losses and cannot assure you that we will achieve sustained profitability in the future. Our future operating results will depend on many factors, many of which are outside of our control, including the following:

- orders may be cancelled;
- the mix of products and services that we sell may change to a less profitable mix;
- shipment, payment schedules, and product acceptance may be delayed;
- our products may not be purchased by utilities, OEMs, systems integrators, service providers and end-users at the levels we project;
- we may be required to modify or add to our Systems product offerings to meet a utility's requirements, which could delay delivery and/or acceptance of our products or increase our costs;
- the revenue recognition rules relating to products such as our NES Smart Grid System could require us to defer some or all of the revenue associated with Systems product shipments until certain conditions, such as delivery and acceptance criteria for our software and/or hardware products, are met in a future period;
- our CEMs may not be able to provide quality products on a timely basis, especially during periods where capacity in the CEM market is limited;
- our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;
- downturns in any customer's or potential customer's business, or declines in general economic conditions, could cause significant reductions in capital spending, thereby reducing the levels of orders from our customers;
- we may incur costs associated with any future business acquisitions; and
- any future impairment charges related to goodwill, other intangible assets, and other long-lived assets required under generally accepted accounting principles in the United States may negatively affect our earnings and financial condition.

Any of the above factors could, individually or in the aggregate, have a material adverse effect on our results of operations and our financial condition, which could cause our stock price to decline.

If our Systems solutions become subject to cyber-attacks, or if public perception is that they are vulnerable to cyber-attacks, our reputation and business would suffer.

We have integrated security technologies into our Systems solutions that are designed to prevent and monitor unauthorized access, misuse, modification or other activity. However, we could be subject to liability or our reputation could be harmed if those technologies fail to prevent cyber-attacks, or if our partners or utility customers fail to safeguard the systems with security policies that conform to industry best practices. In addition, because some of the information collected by our Systems solutions is or could be considered confidential consumer information in some jurisdictions, a cyber-attack could cause a violation of applicable privacy, consumer or security laws, which could cause our company to face financial or legal liability. In addition, any cyber-attack or security breach that affects a competitor's products could lead to the negative perception that our solutions are or could be subject to similar attacks or breaches.

Natural disasters, power outages, and other factors outside of our control such as widespread pandemics could disrupt our business.

We must protect our business and our network infrastructure against damage from earthquake, flood, hurricane and similar events, as well as from power outages. A natural disaster, power outage, or other unanticipated problem could also adversely affect our business by, among other things, harming our primary data center or other internal operations, limiting our ability to communicate with our customers, limiting our ability or our partners' or customers' ability to sell or use our products, affecting our third party developer's ability to complete developments on schedule or at all, or affecting our suppliers' ability to provide us with components or products. For example, the recent earthquake and tsunami in Japan may adversely impact our revenues from customers located in Japan and/or our ability to source parts from companies located in Japan. Shortly after the earthquake, we received notice from Toshiba (one of two manufacturers of the Neuron Chip - an important component that we and our customers use in control network devices), that they would no longer be able to manufacture Neuron Chips due to earthquake damage suffered at the semiconductor manufacturing facility that produced the Neuron Chips. However, the abrupt termination of Toshiba's Neuron Chip manufacturing capability caused a disruption in supply and an increase in prices from the remaining supplier, Cypress Semiconductor. Consequently, there is a risk that the events in Japan could ultimately reduce demand for certain of our transceiver products, which are used in conjunction with Neuron Chips in developing control network devices by our customers. Such a reduction in demand could negatively impact our results of operations and financial condition. We do not insure against several natural disasters, including earthquakes.

Any outbreak of a widespread communicable disease pandemic, such as the outbreak of the H1N1 influenza virus in 2009, could similarly impact our operations. Such impact could include, among other things, the inability for our sales and operations personnel located in affected regions to travel and conduct business freely, the impact any such disease may have on one or more of the distributors for our products in those regions, and increased supply chain costs. Additionally, any future health-related disruptions at our third-party contract manufacturers or other key suppliers could affect our ability to supply our customers with products in a timely manner, which would harm our results of operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

At our corporate headquarters in San Jose, California, we lease two buildings, each of which contains approximately 75,000 square feet of useable space. We moved to this location in October 2001. The leases for the two buildings were scheduled to expire in 2011 and 2013, respectively.

In June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately $48.9 million. For accounting purposes only, we are the "deemed owner" of these buildings. See Note 3 of Notes to Consolidated Financial Statements in Part II, Item 8 of this report for further explanation of the accounting treatment for these leases.

We also lease office space for some of our sales and marketing employees in China, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Sweden, South Korea, Thailand, and the United Kingdom and for some of our research and development employees in Fargo, North Dakota, and Germany. The leases for these offices expire at various dates through 2018. As of December 31, 2011, the future minimum rental payments for all of our leased office space, including those for our corporate headquarters facilities, totaled approximately $35.9 million. For the year ended December 31, 2011, the aggregate rental expense for all leased office space (which does not include the rent expense for our corporate headquarters facility) was approximately $1.7 million.

We believe that our facilities will be adequate for at least the next 12 months. For additional information regarding our obligations under property leases, please see Note 8 of Notes to Consolidated Financial Statements included in Part II, Item 8 of this Report.

ITEM 3. LEGAL PROCEEDINGS

For a discussion regarding our legal proceedings and matters, please refer to the "Legal Actions" section of Note 8, Commitments and Contingencies, in Notes to the Consolidated Financial Statements in Item 15 of Part IV of this Annual Report on Form 10-K, which is incorporated herein by reference.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the Nasdaq Global Market under the symbol "ELON." We began trading on NASDAQ on July 28, 1998, the date of our initial public offering. The following table sets forth, for the quarter indicated, the high and low sales price per share of our common stock as reported on the Nasdaq Global Market.

	Price Range	
Year Ended December 31, 2011	**High**	**Low**
Fourth quarter	$ 7.44	$ 4.39
Third quarter	10.05	6.99
Second quarter	10.72	8.26
First quarter	10.58	7.67
Year Ended December 31, 2010	**High**	**Low**
Fourth quarter	$ 10.67	$ 7.71
Third quarter	8.96	6.90
Second quarter	10.75	7.02
First quarter	12.09	6.85

As of February 29, 2012, there were approximately 373 stockholders of record. Because brokers and other institutions hold many shares on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders.

Dividend Policy

We have never paid dividends on our capital stock and do not currently expect to pay any dividends in the foreseeable future. We intend to retain future earnings, if any, for use in our business.

Equity Compensation Plan Summary Information

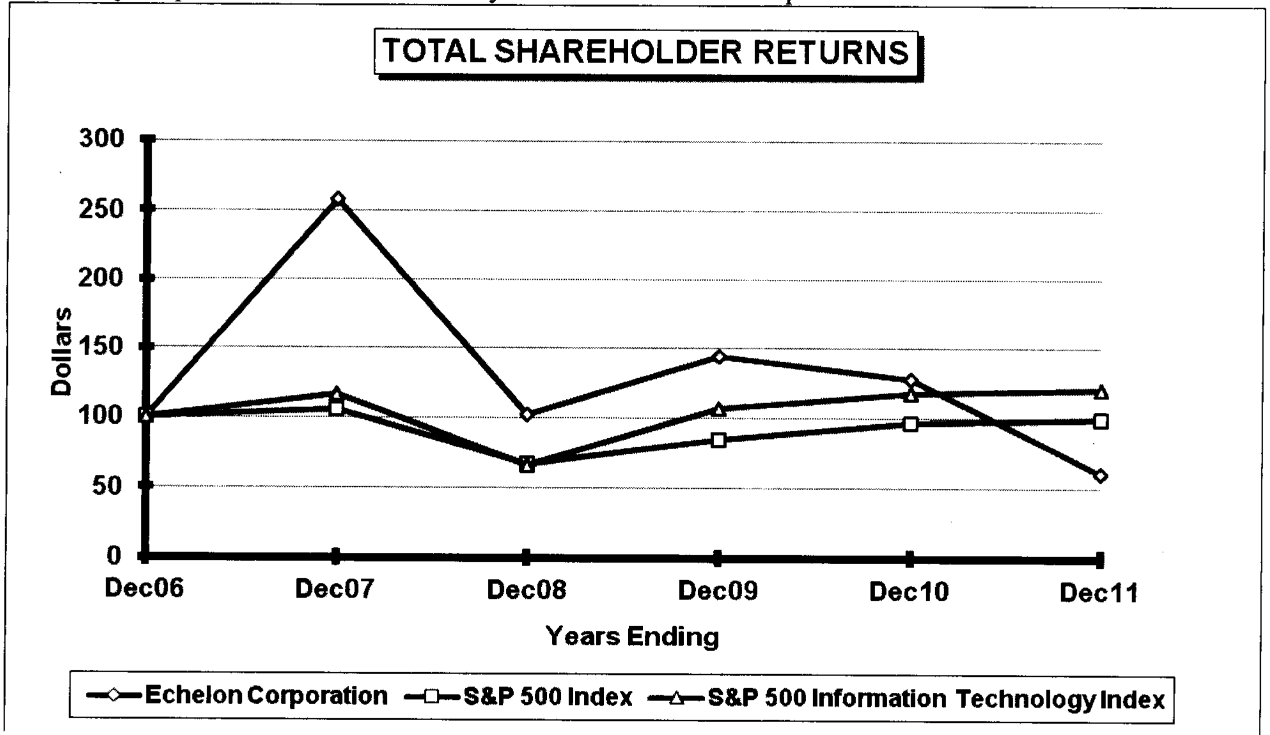
For information on our equity compensation plans, please refer to Note 4 to our accompanying Consolidated Financial Statements.

Recent Sales of Unregistered Securities

There were no sales of unregistered securities during the fourth quarter of our fiscal year ended December 31, 2011.

Stock Price Performance Graph

The following graph compares the cumulative total stockholder return on our common stock (assuming reinvestment of dividends) with the cumulative total return on the S&P 500 Index and the S&P 500 Information Technology Index (which is comprised of those companies in the information technology sector of the S&P 500 Index). The graph assumes that $100 was invested in our common stock on December 31, 2006 and in the S&P 500 Index and the S&P 500 Information Technology Index. Historic stock price performance is not necessarily indicative of future stock performance.



	December 2006	December 2007	December 2008	December 2009	December 2010	December 2011
Echelon Corporation	$100.00	$258.00	$101.87	$144.50	$127.37	$60.87
S&P 500 Composite Index	$100.00	$105.49	$66.46	$84.05	$96.71	$98.76
S&P 500 Information Technology Index	$100.00	$116.31	$66.13	$106.95	$117.85	$120.69

Repurchase of Equity Securities by the Company

In April 2008, our board of directors approved a stock repurchase program, which authorized us to repurchase up to 3.0 million shares of the Company's common stock. In 2008, we repurchased a total of 750,000 shares under the program at a cost of $8.9 million. During the years ended December 31, 2009, 2010, and 2011, no shares were repurchased under the repurchase program. The stock repurchase program expired in April 2011. The following table provides information about the repurchase of our common stock during the quarter ended December 31, 2011:

	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
October 1- October 31	17,130	$6.77	--	--
November 1- November 30	6,060	$5.59	--	--
December 1- December 31	1,178	$4.86	--	--
Total	24,368	$6.38	--	--

(1) Shares purchased that were not part of our publicly announced repurchase program represent those shares surrendered to us by employees in order to satisfy stock-for-stock option exercises and/or withholding tax obligations related to stock-based compensation. These purchases do not reduce the number of shares that may yet be purchased under our publicly announced repurchase program.

ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data is derived from our consolidated financial statements. The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and Notes in Item 8 of this Form 10-K in order to fully understand factors that may affect the comparability of the information presented below.

	Year Ended December 31,				
	2011	2010	2009	2008	2007
	(in thousands, except per share data)				
Consolidated Statement of Operations Data:					
Net revenues:					
Product	$ 152,699	$ 107,441	$ 100,187	$ 131,073	$ 135,405
Service	3,788	3,596	3,151	2,974	2,172
Total revenues	156,487	111,037	103,338	134,047	137,577
Cost of revenues:					
Cost of product	87,063	59,722	56,813	79,984	85,035
Cost of service	2,262	2,464	2,418	2,587	2,360
Total cost of revenues	89,325	62,186	59,231	82,571	87,395
Gross profit	67,162	48,851	44,107	51,476	50,182
Operating expenses:					
Product development	34,755	34,762	35,435	37,753	32,644
Sales and marketing	25,719	25,062	23,525	23,635	21,181
General and administrative	17,897	17,647	15,742	17,143	16,083
Restructuring charges	--	1,212	--	--	--
Total operating expenses	78,371	78,683	74,702	78,531	69,908
Operating loss	(11,209)	(29,832)	(30,595)	(27,055)	(19,726)
Interest and other income (expense), net	6	393	(28)	2,925	5,717
Interest expense on lease financing obligations	(1,468)	(1,572)	(1,668)	(1,404)	(1,211)
Loss before provision for income taxes	(12,671)	(31,011)	(32,291)	(25,534)	(15,220)
Income tax expense (benefit)	329	301	(257)	297	452
Net loss	$ (13,000)	$ (31,312)	$ (32,034)	$ (25,831)	$ (15,672)
Loss per share [1]:					
Basic	$ (0.31)	$ (0.76)	$ (0.79)	$ (0.64)	$ (0.39)
Diluted	$ (0.31)	$ (0.76)	$ (0.79)	$ (0.64)	$ (0.39)
Shares used in per share calculation [1]:					
Basic	42,083	41,365	40,724	40,636	39,891
Diluted	42,083	41,365	40,724	40,636	39,891
Cash dividends declared per common share	$ --	$ --	$ --	$ --	$ --
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$ 58,656	$ 64,632	$ 80,116	$ 87,316	$ 107,190
Working capital	74,922	77,259	96,357	108,811	126,711
Total assets	151,705	145,570	164,437	185,517	204,707
Total liabilities	62,597	51,581	48,539	52,946	51,496
Total stockholders' equity	89,108	93,989	115,898	132,571	153,211

[1] See Note 1 of Notes to Consolidated Financial Statements for an explanation of shares used in computing basic net loss per share, and diluted net loss per share.

ITEM 7. 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 Annual 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 "Business" and "Risk Factors" sections. 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 financial performance during 2011 reflects significant improvement in revenues from sales of our Systems products and services, and modest improvement in sales of our Sub-systems products and services. Overall, our net revenues increased by 40.9% over amounts generated in 2010. This led to a significant reduction in our net loss for the year. The following table provides an overview of key financial metrics for the years ended December 31, 2011 and 2010 that our management team focuses on in evaluating our financial condition and operating performance (in thousands, except percentages).

	2011	2010	$ Change	% Change
Net revenues	$ 156,487	$ 111,037	$ 45,450	40.9%
Gross margin	42.9%	44.0%	---	(1.1 ppt)
Operating expenses	$ 78,371	$ 78,683	$ (312)	(0.4%)
Net loss	$ (13,000)	$ (31,312)	$ (18,312)	(58.5%)
Cash, cash equivalents, and short-term investments	$ 58,656	$ 64,632	$ (5,976)	(9.2%)

- *Net revenues:* As noted above, our net revenues increased in both our Systems and Sub-systems product lines during 2011. As compared to 2010, net revenues from our Systems and Sub-systems product lines increased by 73.7% and 6.1%, respectively. The increase in our Systems revenues was primarily due to 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 2011 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 Critical Accounting Policies and Estimates. With respect to our Sub-systems product line, virtually all of the 6.1% growth in 2011 was due to increased sales to Enel. Excluding sales of products and services to Enel, our Sub-systems revenues increased by $805,000, or 1.6% in 2011 as compared to 2010. 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.

- *Gross margin:* Our gross margin declined by 1.1 percentage points in 2011 as compared to 2010. Excluding the impact of non-cash stock-based compensation charges, gross margins declined by 1.7%, from 45.2% in 2010 to 43.5% in 2011. The year-over-year decrease in gross margin was primarily due to the significant increase in percentage of our revenues attributable to sales of our Systems products, which generally carry lower gross margins than our Sub-systems products. In addition, increases in the cost to manufacture our products, as well as the recognition of costs associated with certain product sales for which revenue was not yet recognized as of December 31, 2011, also contributed to the year-over-year gross margin decline. Partially offsetting these negative gross margin trends in 2011 was the impact of higher overall revenue levels, as indirect costs as a percentage of revenues decreased.

- *Operating expenses:* Our operating expenses decreased by 0.4% in 2011 as compared to 2010. Excluding the impact of restructuring costs and non-cash stock-compensation charges, operating expenses increased by $3.3 million, or 4.9%, from $66.4 million in 2010 to $69.7 million in 2011. Changes in payments received from a third party accounted for $3.0 million of this $3.3 million increase. During 2010, we received third party payments of $4.5 million that were used to reduce our product development expenses. While this arrangement continued in 2011, the amount we received and used to offset product development expenses declined to $1.5 million.

- *Net loss:* Our net loss decreased by $18.3 million in 2011 as compared to 2010. This reduction was directly attributable to the $45.5 million year-over-year increase in net revenues and slightly reduced operating expenses, and was partially offset by a 1.1 percentage point reduction in gross margins. Excluding the impact of restructuring costs of $1.2 million in 2010 and non-cash stock-compensation charges, our net loss decreased by approximately $14.4 million in 2011.

- *Cash, cash equivalents, and short-term investments:* During 2011, our cash, cash equivalent, and short-term investment balance decreased by 9.2%, from $64.6 million at December 31, 2010 to $58.7 million at December 31, 2011. This $6.0 million reduction was primarily the result of $2.3 million worth of capital expenditures, $2.3 million used to pay taxes on behalf of our employees associated with equity compensation awards, and $1.7 million in principal payments on our lease financing obligations.

As we look forward to 2012, we acknowledge that 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 tenders for smart–metering are fewer and farther between 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.

Japan Earthquake and Tsunami. The Neuron Chip is an important component that we and our customers use in control network devices. The Japanese earthquake of March 2011 accelerated a previously announced exit of Toshiba from the Neuron business. Shortly after the earthquake, Toshiba informed us that they would no longer manufacture the Neuron Chip due to earthquake damage suffered at the semiconductor manufacturing facility that produced the Neuron Chip. In light of this development, we have been working with Toshiba's customers to provide them with a smooth migration path to our new Neuron 5000 processor. Alternatively our customers can purchase Neuron Chips from a second manufacturer, Cypress Semiconductor, the sole remaining supplier of 5 volt Neuron Chips. However, the abrupt termination of Toshiba's Neuron Chip manufacturing capability may cause some short-term disruption in these plans, and in the meantime could negatively affect our customer's ability to manufacture control network devices until such time as they complete their transition work. Consequently, there is a risk that the events in Japan could ultimately reduce demand for certain of our transceiver products that are used in conjunction with Neuron Chips in developing control network devices by our customers, for at least the short term. Such a reduction in demand could negatively impact our results of operations and financial condition. In addition, due to Toshiba's inability to manufacture parts and satisfy demand, Cypress recently informed us that it has experienced a sharp increase in Neuron Chip demand. To address this, Cypress told us that they intend to add additional manufacturing capacity. However, in the near term, we or our customers may experience longer lead times and higher pricing for these parts, which could result in reduced orders for our products from these same customers.

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 this Annual Report on Form 10-K 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 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.

We believe the following critical accounting policies and estimates relate to those policies that are most important to the presentation of our consolidated financial statements and require the most difficult, subjective, and complex judgments.

Revenue Recognition. Our revenues are derived from the sale and license of our products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to our 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.

We recognize 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 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. Determining whether sufficient data exists to support recognition of revenue prior to customer acceptance or lapse of acceptance provisions involves significant judgment and changes in those judgments could have a material impact on the timing of revenue recognition. For example, in 2011 we began recognizing revenue on sales of data concentrators at the time of delivery to the customer's carrier (and once all other revenue recognition criteria had been met) irrespective of the contractual acceptance rights stated in our agreements. This decision was based on the acceptance history for this product. We continue to measure acceptance history for other Systems products and intend to transition to revenue recognition at point of delivery to the customer's carrier for these products if and when the acceptance history supports this decision. For sales made to our 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.

We account for the rights of return, price protection, rebates, and other sales incentives offered to distributors of our 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 our products to the end customer.

Our multiple deliverable revenue arrangements are primarily related to sales of 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.

We allocate revenue to each element in a multiple-element arrangement based upon the element's relative selling price. We determine 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, we use our best estimated selling price ("BESP") for that deliverable. Since the use of the residual method is eliminated under the new accounting standards, any discounts we offer 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 so long as such revenue is not contingent upon the delivery of other undelivered elements.

Consistent with our methodology under previous accounting guidance, if available, we determine 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. We currently estimate the selling prices for our PCS and extended warranties based on VSOE of fair value.

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

When we are 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 our NES software, we use our BESP in determining the allocation of arrangement consideration. The objective of BESP is to determine the price at which we 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.

We establish pricing for our 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 our management, taking into consideration our go-to-market strategy. These pricing practices apply to both our Hardware and software products.

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

When establishing BESP for our specified software enhancements or upgrades, we consider 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 our pricing practices for NES system PCS packages, which may include rights to the specified enhancements or upgrades.

We regularly review VSOE and have established a review process for TPE and BESP. We maintain internal controls over the establishment and updates of these estimates. There were no material impacts during the year ended December 31, 2011 resulting from changes in VSOE, TPE, or BESP, nor do we 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, we defer the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, we recognize 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 software, as well as for extended warranties on Systems Hardware products, are recognized ratably over the associated service period, which generally commences upon the latter of the delivery of all software, or the customer's acceptance of any given Hardware shipment.

As of December 31, 2011 and December 31, 2010, approximately $9.4 million and $3.7 million, respectively, of our Systems revenue was deferred. Of the $3.7 million of deferred revenue at December 31, 2010, approximately $1.5 million related to arrangements entered into prior to January 1, 2010. All of the $9.4 million of deferred revenue at December 31, 2011 relates to arrangements that were entered into subsequent to December 31, 2009.

Performance-Based Equity Compensation. Certain of the stock-based compensation awards we issue vest upon the achievement of specific financial-based performance requirements. We are required to estimate whether or not it is probable that these financial-based performance requirements will be met, and, in some cases, when they will be met. These estimates of future financial performance require significant management judgement and are based on the best information available at the time of grant, and each quarterly period thereafter until the awards are either earned or forfeited. Any changes we make to our estimates of future financial performance could have a material impact on the amount and timing of compensation expense associated with these awards. For example, during the year ended December 31, 2009, our management concluded that it was unlikely that the financial performance requirements for certain of these awards would be met, and accordingly, we reversed previously recognized compensation expense of $731,000 associated with these awards. See Note 5 of Notes to Consolidated Financial Statements in Part II, Item 8 of this report for further discussion of these awards with financial-based performance requirements.

Inventory Valuation. At each balance sheet date, we evaluate our ending inventories for excess quantities and obsolescence. In general, the evaluation for excess quantities includes analyses of historical sales levels by product and projections of future demand. In general, inventories on hand in excess of one year's forecasted demand are deemed to be excess. However, in certain instances when the facts and circumstances for a particular item warrant an extended view, periods of longer than one year are used to determine excess supplies. In performing this analysis, management must make significant judgments in determining the appropriate time horizon over which to analyze for excess inventories.

In performing the excess inventory analysis, management considers factors that are unique to each of our Systems and Sub-systems product lines. For our Systems products, the analysis requires us to consider that Systems customers procure specific meter types that meet their requirements. In other words, any given customer may require a meter that is "custom" to their specifications.

Accordingly, management must make significant judgments not only as to which customers will buy how many meters (and associated data concentrators), but also which meter type(s) each customer will buy. In making these judgments, management uses the best sales forecast information available at the time. However, because future sales volumes for any given customer opportunity have the potential to vary significantly, actual results could be materially different from original estimates. This could increase our exposure to excess inventory for which we would need to record a reserve, thereby resulting in a potentially material negative impact to our operating results.

For most of our Sub-systems products, our customers generally buy from a portfolio of "off-the-shelf" or standard products. In addition, whereas for our Systems customers our revenues are attributable to a relatively few customers buying substantial quantities of any given product, our Sub-systems revenues are composed of a larger volume of smaller dollar transactions. Accordingly, while any single Sub-systems customer's demand for a given product may fluctuate from quarter to quarter, the fact that there are so many Sub-systems customers buying a standard product tends to average out increases or decreases in any individual customer's demand. This has historically resulted in a relatively stable future demand forecast for our Sub-systems products, which, absent outside forces such as worsening general economic conditions, management evaluates in determining its requirement for an excess inventory reserve.

In addition to providing a reserve for excess inventories, we do not value inventories that we consider obsolete. We consider a product to be obsolete when one of several factors exists. These factors include, but are not limited to, our decision to discontinue selling an existing product, the product has been re-designed and we are unable to rework our existing inventory to update it to the new version, or our competitors introduce new products that make our products obsolete.

We adjust remaining inventory balances to approximate the lower of our cost or market value. If future demand or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales in the period the revision is made.

Warranty Reserves. We evaluate our reserve for warranty costs based on a combination of factors. In circumstances where we are aware of a specific warranty related problem, for example a product recall, we reserve an estimate of the total out-of-pocket costs we expect to incur to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. When evaluating the need for any additional reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical warranty-related return rates, historical costs of repair, and knowledge of new products introduced. If any of these factors were to change materially in the future, we may be required to increase our warranty reserve, which could have a material negative impact on our results of operations and our financial condition. Our reserve for warranty costs was $875,000 as of December 31, 2011, and $904,000 as of December 31, 2010.

RESULTS OF OPERATIONS

The following table reflects the percentage of total revenues represented by each item in our Consolidated Statements of Operations for the years ended December 31, 2011, 2010, and 2009:

	Year Ended December 31,		
	2011	**2010**	**2009**
Revenues:			
Product	97.6%	96.8%	97.0%
Service	2.4	3.2	3.0
Total revenues	100.0	100.0	100.0
Cost of revenues:			
Cost of product	55.6	53.8	55.0
Cost of service	1.5	2.2	2.3
Total cost of revenues	57.1	56.0	57.3
Gross profit	42.9	44.0	42.7
Operating expenses:			
Product development	22.2	31.3	34.3
Sales and marketing	16.4	22.6	22.8
General and administrative	11.5	15.9	15.2
Restructuring charges	---	1.1	---
Total operating expenses	50.1	70.9	72.3
Loss from operations	(7.2)	(26.9)	(29.6)
Interest and other income, net	---	0.4	---
Interest expense on lease financing obligations	(0.9)	(1.4)	(1.6)
Loss before provision for income taxes	(8.1)	(27.9)	(31.2)
Income tax expense (benefit)	0.2	0.3	(0.2)
Net loss	(8.3)%	(28.2)%	(31.0)%

Revenues

Total revenues

(Dollars in thousands)	Year Ended December 31, 2011	2010	2009	2011 over 2010 $ Change	2010 over 2009 $ Change	2011 over 2010 % Change	2010 over 2009 % Change
Total revenues	$156,487	$111,037	$103,338	$45,450	$7,699	40.9%	7.5%

The $45.5 million increase in total revenues in 2011 as compared to 2010 was primarily attributable to a $42.2 million increase in Systems revenues and a $3.3 million increase in Sub-systems revenues. The $7.7 million increase in total revenues in 2010 as compared to 2009 was primarily attributable to a $9.0 million increase in Systems, partially offset by a $1.3 million decrease in Sub-systems revenues.

Systems revenues

(Dollars in thousands)	Year Ended December 31, 2011	2010	2009	2011 over 2010 $ Change	2010 over 2009 $ Change	2011 over 2010 % Change	2010 over 2009 % Change
Systems Revenues	$99,428	$57,257	$48,271	$42,171	$8,986	73.7%	18.6%

Our Systems revenues are primarily comprised of sales of our NES system products and associated services. During 2011, 2010, and 2009, 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.

The $42.2 million, or 73.7% increase in Systems revenues during 2011 as compared to 2010 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 was also attributable to the fact that, during 2011 we began recognizing revenue upon delivery to the customer's carrier for our data concentrator products (once all other revenue recognition criteria had been met). Previously, these revenues would have been deferred until the customer acceptance provisions contained in our arrangements had been satisfied. However, based on our review of historical acceptance rates for this product, we were able to objectively demonstrate that the contractual acceptance criteria had been met at the time of delivery to the customer's carrier. For 2011, this increased Systems revenues by approximately $1.2 million.

During 2010, our Systems revenues increased by $9.0 million, or 18.6% as compared to 2009. This increase was primarily due to increased shipments of our NES products for projects in Russia and Denmark. In addition, due to our January 1, 2010 adoption of new accounting guidance for multiple element arrangements, our Systems revenues during 2010 were approximately $3.1 million higher than they would have been if we had applied the revenue recognition standards in effect during the prior year.

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

	Year Ended December 31,			2011 over 2010	2010 over 2009	2011 over 2010	2010 over 2009
(Dollars in thousands)	2011	2010	2009	$ Change	$ Change	% Change	% Change
Sub-systems Revenues	$57,059	$53,780	$55,067	$3,279	($1,287)	6.1%	(2.3%)

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 increased by $805,000, or 1.6% in 2011 as compared to 2010. This increase was primarily due to an 18% increase in revenues in the APJ region and a 5% increase in revenues in the EMEA region, partially offset by a 10% reduction in revenues in the Americas region. During the first quarter of 2010, Sub-systems revenues from the Americas were unusually high due to a concentration with one customer. That unusually high level of revenue was not repeated during the remainder of 2010, or during 2011. Within the Sub-systems family of products, the year-over-year increase was driven primarily from increased sales of our control and connectivity products, partially offset by a decrease in sales of our Network Services products.

Excluding sales of products and services sold to Enel, our Sub-systems revenues increased by $4.6 million, or 10.3% in 2010 as compated to 2009. This increase was primarily due to an 18% increase in revenues in the Americas region, and to a lesser extent, from more modest increases in revenues from both the APJ and EMEA regions of 9% and 4%, respectively. We believe these increases were due in large part to improving macro-economic conditions in the Americas and EMEA regions, both of which were severely impacted by the economic slowdown that began in late 2008 and continued through 2009. Within the Sub-systems family of products, the year-over-year increase was driven primarily from increases in our control and connectivity as well as SmartServer products.

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 7.4% in 2011, 7.3% in 2010, and 6.9% in 2009. 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)

	Year Ended December 31,			2011 over 2010	2010 over 2009	2011 over 2010	2010 over 2009
(Dollars in thousands)	2011	2010	2009	$ Change	$ Change	% Change	% Change
Enel Project Revenues	$7,119	$4,645	$10,518	$2,474	($5,873)	53.3%	(55.8%)

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 $7.1 million, $4.6 million, and $10.5 million of Enel project revenue recognized during 2011, 2010, and 2009, respectively, related primarily to shipments under the 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 United States dollars. Therefore, the associated revenues are not subject to foreign currency risks.

Gross Profit and Gross Margin

	Year Ended December 31,			2011 over 2010	2010 over 2009	2011 over 2010	2010 over 2009
(Dollars in thousands)	2011	2010	2009	$ Change	$ Change	% Change	% Change
Gross Profit	$67,162	$48,851	$44,107	$18,311	$4,744	37.5%	10.8%
Gross Margin	42.9%	44.0%	42.7%	—	—	(1.1)	1.3

Gross profit is equal to revenues less cost of goods sold. Cost of goods sold for product revenues includes direct costs associated with the purchase of components, subassemblies, and finished goods, as well as indirect costs such as allocated labor and overhead; costs associated with the packaging, preparation, and shipment of products; and charges related to warranty and excess and obsolete inventory reserves. Cost of goods sold for service revenues consists of employee-related costs such as salaries and fringe benefits as well as other direct and indirect costs incurred in providing training, customer support, and custom software development services. Gross margin is equal to gross profit divided by revenues.

Gross margin during 2011 was approximately 1.1 percentage points lower than in 2010. This reduction was primarily due to the mix of revenues reported. During 2011, approximately 64% of our revenues were attributable to sales of our Systems products and services, while the remaining 36% came from sales of our Sub-systems products and services. In 2010, 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.

Also contributing to the reduction in gross margins during 2011 was the accounting treatment effect for a software deliverable we have committed to a customer but that was not yet delivered as of December 31, 2011. In this case, we have committed to provide a particular customer with firmware for certain hardware that we began delivering to them during the third quarter of 2011 and continued for the remainder of the year. This firmware will enable the hardware, which is included in some of the meters we've shipped to this customer, to become fully functional. Because this incremental hardware is not separable from the meters, we are expensing its cost once the customer accepts the corresponding meter. However, we are deferring the associated revenue for this additional hardware functionality until such time as we deliver the promised firmware, which we currently expect will be in the first quarter of 2012. At the time the firmware is delivered, we will recognize the deferred revenue for which the cost has already been recognized, which we currently estimate will result in improved gross margins of approximately 3 to 4 percentage points in that period.

Partially offsetting the negative 2011 gross margin trends described above was the impact of higher overall revenues. While our indirect costs increased modestly during 2011 as compared to 2010, when expressed as a percentage of revenues, these costs decreased, which improved gross margins.

2010 gross margins of 44.0% improved by 1.3 percentage points as compared to those generated in 2009. This improvement was primarily due to improved gross margins in our Systems product line, which resulted from a higher percentage of our Systems revenues being generated from sales of the more recent and cost reduced versions of our Systems products. In addition, as a percentage of 2010 revenues, indirect costs were down 0.9 percentage points as compared to 2009, which was due in part to higher overall revenues. Partially offsetting these improvements was the impact on gross margins resulting from the mix of revenues reported. During 2010, approximately 52% of our revenues were attributable to sales of our Systems products and services, while the remaining 48% of our revenues were attributable to sales of our Sub-systems products and services. During 2009, approximately 47% of our revenues were attributable to sales of our Systems products and services, while the remaining 53% of our revenues were attributable to sales of our Sub-systems products and services.

In addition to the impact of the Jabil cost increases, our future gross margins will continue to be affected by several factors, including, but not limited to: overall revenue levels, changes in the mix of products sold, periodic charges related to excess and obsolete inventories, warranty expenses, introductions of cost reduced versions of our Systems and Sub-systems products, changes in the average selling prices of the products we sell, purchase price variances, and fluctuations in the level of indirect overhead spending that is capitalized in inventory. In addition, the impact of foreign exchange rate fluctuations and labor rates may affect our gross margins in the future. We currently outsource the manufacturing of most of our products requiring assembly to CEMs located primarily in China. To the extent labor rates were to rise further, or to the extent the U.S. dollar were to weaken against the Chinese currency, or other currencies used by our CEMs, our costs for the products they manufacture could rise, which would negatively affect our gross margins. Lastly, many of our products, particularly our Systems products, contain significant amounts of certain commodities, such as silver, copper, and cobalt. Prices for these commodities have been volatile, which in turn have caused fluctuations in the prices we pay for the products in which they are incorporated.

Operating Expenses

Product development

	Year Ended December 31,			2011 over 2010	2010 over 2009	2011 over 2010	2010 over 2009
(Dollars in thousands)	2011	2010	2009	\$ Change	\$ Change	% Change	% Change
Product Development	\$34,755	\$34,762	\$35,435	(\$7)	(\$673)	(0.0%)	(1.9%)

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

During 2010 and 2011, our product development expenses were impacted by a contractual arrangement whereby a third party made payments to us in connection with certain design and development activities we performed. During 2010, we completed efforts worth \$4.5 million, for which payments from the third party were used to offset our product development expenses. During 2011, we completed additional milestones worth \$1.5 million. These amounts were also used to offset our product development expenses. Excluding the impact of these offsetting payments, our product development expenses decreased \$3.0 million in 2011 as compared to 2010.

The \$3.0 million reduction in product development expenses during 2011 as compared to the same period in 2010 was primarily due to a \$1.2 million reduction in compensation related expenses, which was primarily attributable to the restructuring program that reduced our product development headcount by approximately 10% in early 2011; a \$611,000 reduction in expensed materials used in our product development activities; a \$608,000 reduction in fees paid to third party service providers who assist in our product development activities; and a \$187,000 reduction in out-of-pocket costs we incurred in connection with the design and development project discussed above. The remaining reduction came from miscellaneous other spending categories.

As discussed above, the \$673,000 decrease in product development expenses during 2010 as compared to 2009 was primarily due to the \$4.5 million of offsetting payments we received from a third party in 2010. Excluding the impact of this \$4.5 million, our product development expenses increased by \$3.8 million during 2010. This increase was primarily due to the incremental expenses we incurred associated with this project. Another factor contributing to the 2010 decrease in product development expenses as compared to 2009 was a reduction in non-cash equity compensation charges, which decreased by $1.5 million between the two periods. This reduction was due primarily to the equity awards issued in conjunction with our 2008 employee stock option exchange program. Many of these awards, which were granted in December 2008, vested in full during 2009. As such, the grant date fair value associated with these awards was fully expensed during 2009.

We currently expect that our product development expenses will increase modestly in 2012 as compared to 2011 due primarily to the fact that we do not anticipate receiving any further offsetting payments in 2012.

Sales and marketing

	Year Ended December 31,			2011 over 2010	2010 over 2009	2011 over 2010	2010 over 2009
(Dollars in thousands)	2011	2010	2009	$ Change	$ Change	% Change	% Change
Sales and Marketing	$25,719	$25,062	$23,525	$657	$1,537	2.6%	6.5%

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

The $657,000 increase in sales and marketing expenses in 2011 as compared to 2010 is comprised of the following: a $642,000 increase in fees paid to recruiters, consultants and other third party service providers; a $273,000 increase in dues paid for memberships in certain trade organizations; and a $94,000 increase in travel and related expenses; all of which was partially offset by a $232,000 reduction in compensation expense; and $120,000 of decreases in other miscellaneous spending categories. The $232,000 reduction in compensation expense was principally comprised of a $688,000 reduction in non-cash equity compensation charges and a $301,000 reduction in salaries, commissions, and other general compensation related expenses, partially offset by a $738,000 increase in bonus expenses primarily associated with our 2011 management bonus plan. The management bonus plan provides for payments only in the event certain targets for revenue generation and expense control are achieved.

Also contributing to the increase in sales and marketing expenses in 2011 as compared to 2010 was the impact of foreign currency exchange rate fluctuations between the U.S. dollar and the local currencies in several of the foreign countries in which we operate, including the Euro, the British Pound Sterling, and the Japanese Yen. Approximately $346,000, or 52.7%, of the $657,000 increase was the result of these foreign currency exchange rate fluctuations. Excluding the impact of these exchange rate fluctuations, sales and marketing expenses increased by approximately 1.2% between the two periods.

The $1.5 million increase in sales and marketing expenses in 2010 as compared to 2009 was primarily due to a $584,000 increase in compensation expenses, which was driven by a $1.1 million increase in commission expenses partially offset by a $482,000 reduction in non-cash equity compensation charges. Also contributing to year-over-year increase was a $396,000 increase in travel and entertainment expenses, a $323,000 increase in marketing expenses, and $234,000 of other miscellaneous spending increases. Partially offsetting the year-over-year increase was approximately $24,000 of favorable foreign currency exchange rate fluctuations between the United States dollar and the local currencies in several of the foreign countries in which we operate, including the Euro, the British Pound Sterling, and the Japanese Yen. Excluding the impact of these exchange rate fluctuations, sales and marketing expenses increased by approximately 6.6% between the two years.

We currently expect that we will continue investing in our sales and marketing efforts during 2012, and therefore anticipate that our sales and marketing expenses will increase in 2012 as compared to 2011. In addition, our future sales and marketing expenses will continue to be affected by fluctuations in exchange rates between the U.S. dollar and the foreign currencies where we operate. If the United States dollar were to weaken against these currencies, our sales and marketing expenses could increase. Conversely, if the dollar were to strengthen against these currencies, it would have a favorable impact on our sales and marketing expenses.

General and administrative

	Year Ended December 31,			2011 over 2010	2010 over 2009	2011 over 2010	2010 over 2009
(Dollars in thousands)	2011	2010	2009	$ Change	$ Change	% Change	% Change
General and Administrative	$17,897	$17,647	$15,742	$250	$1,905	1.4%	12.1%

General and administrative expenses consist primarily of payroll and related expenses for executive, accounting, and administrative personnel, professional fees for legal and accounting services rendered to our company, facility costs, insurance, and other general corporate expenses.

The $250,000 increase in general and administrative expenses in 2011 as compared to 2010 was primarily due to a $449,000 increase in fees paid to third party service providers, partially offset by a $203,000 reduction in compensation related expenses. The reduction in compensation related expenses was driven by a $222,000 increase in salaries and associated payroll expenses and a $1.0 million increase in bonus expense associated with our 2011 management bonus plan, partially offset by a $1.4 million reduction in equity compensation expenses. The reduction in equity compensation expense was primarily the result of the passing of our former Executive Chairman, Ken Oshman, who died in August 2011. At the time of his death, Mr. Oshman had outstanding and unvested equity compensation awards for which cumulative compensation expense of approximately $976,000 had been recognized as of June 30, 2011. This cumulative compensation expense was reversed in the third quarter of 2011. The management bonus plan provides for payments only in the event certain targets for revenue generation and expense control are achieved.

The $1.9 million increase in general and administrative expenses in 2010 as compared to 2009 was primarily due to a $1.2 million increase in compensation and other employee related expenses, which was driven by a $592,000 increase in salaries primarily related to compensation for our interim and current Chief Executive Officers and to a lesser extent from restoration of full salaries for our non-sales personnel in May 2010, a $293,000 increase in non-cash equity compensation expenses, a $141,000 increase in bonuses, and miscellaneous other compensation and benefit expense increases of $208,000. Also contributing to the year-over-year increase was a $513,000 increase in fees paid to third party service providers and other miscellaneous spending increases of $145,000.

Restructuring Charges

	Year Ended December 31,			2011 over 2010	2010 over 2009	2011 over 2010	2010 over 2009
(Dollars in thousands)	2011	2010	2009	$ Change	$ Change	% Change	% Change
Restructuring charges	$ ---	$1,212	$ ---	($1,212)	$1,212	(100.0%)	N/A

In December 2010, in order to adjust our operating cost structure to more closely align with our 2011 operating plan, we initiated a restructuring program consisting of a headcount reduction of 31 full-time employees worldwide. Of the 31 employees affected, 15 were in product development, 7 were in sales and marketing, 5 were in operations, and 4 were in general and administrative. In connection with this restructuring plan, in the fourth quarter of 2010, we recorded restructuring charges of approximately $1.2 million related to termination benefits for these personnel.

With the exception of $49,000 that remains accrued and reflected in accrued liabilities on our Consolidated Balance Sheets as of December 31, 2011, the restructuring charges of $1.2 million were paid out in the first two quarters of 2011. We expect to pay the remaining $49,000 of accrued termination benefits through the first two quarters of 2012.

Interest and Other Income (Expense), Net

	Year Ended December 31,			2011 over 2010	2010 over 2009	2011 over 2010	2010 over 2009
(Dollars in thousands)	2011	2010	2009	$ Change	$ Change	% Change	% Change
Interest and Other Income (Expense), Net	$6	$393	($28)	($387)	$421	(98.5%)	1,503.6%

Interest and other income (expense), net primarily reflects interest earned by our company on cash and short-term investment balances as well as foreign exchange translation gains and losses related to short-term intercompany balances.

During 2011, interest and other income (expense), net decreased by approximately $387,000 as compared to 2010. This decrease was primarily due to a $219,000 decrease in foreign currency translation gains, an $82,000 decrease in interest income, and a $69,000 increase in losses on disposal of fixed assets. The decrease in foreign currency translation gains is due to our foreign currency denominated short-term intercompany balances. We account for translation gains and losses associated with these balances by reflecting these amounts as either other income or loss in our consolidated statements of operations. During periods when the U.S. dollar strengthens in value against these foreign currencies, as it did during both 2011 and 2010, the associated translation gains favorably impact other income. Conversely, when the U.S. dollar weakens, the resulting translation losses negatively impact other income. The reduction in interest income is primarily the result of a reduction in our average invested cash balance between the periods coupled with reductions in the weighted average yield on our investment portfolio.

During 2010, interest and other income (expense), net increased by approximately $421,000 as compared to 2009. This increase was primarily due to a $682,000 increase in foreign currency translation gains on our short-term intercompany balances, which was partially offset by a $233,000 decrease in interest income. As was the case in 2011, the reduction in interest income was primarily the result of a reduction in our average invested cash balance between the periods coupled with reductions in the weighted average yield on our investment portfolio.

We do not currently anticipate interest income on our investment portfolio will improve during 2012 as we expect interest rates to remain historically low. Future gains or losses associated with translating our foreign currency denominated short-term intercompany balances will depend on exchange rates in effect at the time of translation.

Interest Expense on Lease Financing Obligations

(Dollars in thousands)	Year Ended December 31, 2011	2010	2009	2011 over 2010 $ Change	2010 over 2009 $ Change	2011 over 2010 % Change	2010 over 2009 % Change
Interest Expense on Lease Financing Obligations	$1,468	$1,572	$1,668	($104)	($96)	(6.6%)	(5.8%)

In December 1999 and October 2000, we entered into two separate lease agreements with a local real estate developer for the two buildings we currently occupy at our San Jose headquarters site. As discussed in Note 3 of Notes to Consolidated Financial Statements in Item 15 of this Report, we are considered the "deemed owner" of the two buildings for accounting purposes only.

Accordingly, we have recorded as an asset on our balance sheet the costs paid by our lessor to construct our headquarters facility, along with a corresponding financing liability for an amount equal to these lessor paid construction costs. The monthly rent payments we make to our lessor under our lease agreements are recorded in our financial statements partially as land lease expense and partially as principal and interest on the financing liability. "Interest expense on lease financing obligations" reflects the portion of our monthly lease payments that is allocated to interest expense.

As with any amortizing fixed rate loan, payments made earlier in the term of the loan are comprised primarily of interest expense with little being allocated to principal repayment. Payments made later in the term of the loan, however, have an increasing proportion of principal repayment, with less being attributable to interest expense. Accordingly, we currently expect a higher proportion of the payments we make in 2012 will be allocated to principal repayment and less will be allocated to interest expense.

Income Tax Expense (Benefit)

(Dollars in thousands)	Year Ended December 31, 2011	2010	2009	2011 over 2010 $ Change	2010 over 2009 $ Change	2011 over 2010 % Change	2010 over 2009 % Change
Income Tax Expense (Benefit)	$329	$301	($257)	$28	$558	9.3%	217.1%

The provision for income taxes for 2011, 2010, and 2009 includes a provision for state and foreign taxes based on our annual estimated effective tax rate for the year. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes and our valuation allowance on our deferred tax assets. Income tax expense of $329,000 and $301,000 in 2011 and 2010, respectively, and income tax benefit of $257,000 in 2009, consists primarily of taxes related to profitable foreign subsidiaries and various state minimum taxes. In 2009, the taxes for profitable foreign subsidiaries were more than offset by U.S. federal tax refunds we were able to apply for as a result of federal tax legislation that was passed during the year.

OFF-BALANCE-SHEET ARRANGEMENTS AND OTHER CONTRACTUAL OBLIGATIONS

Off-Balance-Sheet Arrangements. We have not entered into any transactions with unconsolidated entities whereby we have financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose our company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to us.

Lease Commitments. In December 1999, we entered into a lease agreement with a real estate developer for our existing corporate headquarters in San Jose, California. In October 2000, we entered into a second lease agreement with the same real estate developer for an additional building at our headquarters site. These leases were scheduled to expire in 2011 and 2013, respectively.

In June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately $48.9 million. Both leases permit us to exercise an option to extend the respective lease for two sequential five-year terms. In addition, the amended leases eliminated our requirement to provide the landlord with security deposits totaling $6.2 million, which we had previously satisfied through the issuance of standby letters of credit ("LOCs").

In addition, we lease facilities under operating leases for our sales, marketing, and product development personnel located elsewhere within the United States and in eleven foreign countries throughout Europe and Asia, including a land lease for accounting purposes associated with our corporate headquarters facilities (see Notes as referenced above). These operating leases expire on various dates through 2020, and in some instances are cancelable with advance notice. Lastly, we also lease certain equipment and, for some of our sales personnel, automobiles. These operating leases are generally less than five years in duration.

Purchase Commitments. We utilize several contract manufacturers who manufacture and test our products requiring assembly. These contract manufacturers acquire components and build product based on demand information supplied by us in the form of purchase orders and demand forecasts. These purchase orders and demand forecasts generally cover periods up to twelve months, and in rare cases, up to eighteen months. We also obtain individual components for our products from a wide variety of individual suppliers. We generally acquire these components through the issuance of purchase orders, and in some cases through demand forecasts, both of which cover periods up to twelve months. The products covered by these purchase orders are not included in our reported inventory until such time as we receive them. To the extent our sales forecasts are not achieved, and we are unable to cancel or modify our outstanding purchase orders for quantities exceeding our revised requirements, our reported inventories may increase or we may be required to provide a reserve against excess inventories.

We also utilize purchase orders when procuring capital equipment, supplies, and services necessary for our day-to-day operations. These purchase orders generally cover periods ranging up to twelve months, but in some instances cover a longer duration.

Indemnifications. In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant. However, we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that would enable us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

Royalties. We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which was recorded as cost of products revenue in our consolidated statements of income, was approximately $532,000 during 2011, $616,000 during 2010, and $450,000 during 2009.

We will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of our products. While we are currently unable to estimate the maximum amount of these future royalties, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

Taxes. We conduct our operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on Echelon's operations in that particular location. While we strive to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with generally accepted accounting principles, we make a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and we believe that, as of December 31, 2011, we have adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

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 Echelon, seeking the return of approximately $16.7 million in payments received by Echelon in the ordinary course of business for components we sold 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, we 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. We believe that the Italian claw back law is not applicable to our transactions with the Finmek Companies, and the claims of the Finmek Companies' receiver are without merit and we are defending the lawsuit.

From time to time, in the ordinary course of business, we are subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While we believe we have adequately provided for such contingencies as of December 31, 2011, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

As of December 31, 2011, our contractual obligations were as follows (in thousands):

	Payments due by period				
	Total	Less than 1 year	2-3 years	4-5 years	More than 5 years
Lease financing obligations	$ 28,592	$ 3,214	$ 6,582	$ 6,903	$ 11,893
Operating leases	7,640	1,445	2,149	1,590	2,456
Purchase commitments	26,067	26,067	---	---	---
Total	$ 62,299	$ 30,726	$ 8,731	$ 8,493	$ 14,349

The amounts in the table above exclude $966,000 of income tax liabilities and related interest and penalties related to uncertain tax positions as we are unable to reasonably estimate the timing of settlement. See Note 9, "Income Taxes" of Notes to Consolidated Financial Statements for further discussion.

LIQUIDITY AND CAPITAL RESOURCES

Since our inception, we have financed our operations and met our capital expenditure requirements primarily from the sale of preferred stock and common stock, although during the years 2002 through 2004, we were also able to finance our operations through operating cash flow. From inception through December 31, 2011, we raised $295.0 million from the sale of preferred stock and common stock, including the exercise of stock options from our employees and directors.

In March and August 2004, March 2006, and February 2007, our board of directors approved a stock repurchase program, which authorized us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. Since inception, we repurchased a total of 2,204,184 shares under the program at a cost of $16.1 million. The stock repurchase program expired in March 2008.

In April 2008, our board of directors approved a new stock repurchase program, which authorized us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. There were no repurchases under this stock repurchase program during the year ended December 31, 2011. This stock repurchase program expired in April 2011. Since inception, we repurchased a total of 750,000 shares under this program at a cost of $8.9 million.

The following table presents selected financial information for each of the last three fiscal years (dollars in thousands):

	As of December 31,		
	2011	2010	2009
Cash, cash equivalents, and short-term investments	$ 58,656	$ 64,632	$ 80,116
Trade accounts receivable, net	35,215	25,102	21,496
Working capital	74,922	77,259	96,357
Stockholder's equity	89,108	93,989	115,898

As of December 31, 2011, we had $58.7 million in cash, cash equivalents, and short-term investments, a decrease of $6.0 million as compared to December 31, 2010. Historically, our primary source of cash, other than stock sales, has been receipts from revenue, and to a lesser extent, proceeds from the exercise of stock options and warrants by our employees and directors. Our primary uses of cash have been cost of product revenue, payroll (salaries, commissions, bonuses, and benefits), general operating expenses (costs associated with our offices such as rent, utilities, and maintenance; fees paid to third party service providers such as consultants, accountants, and attorneys; travel and entertainment; equipment and supplies; advertising; and other miscellaneous expenses), acquisitions, capital expenditures, and purchases under our stock repurchase programs.

Cash flows from operating activities. Cash flows from operating activities have historically been driven by net loss levels, adjustments for non-cash charges such as stock-based compensation expenses, depreciation, and amortization; changes in accrued investment income; and fluctuations in operating asset and liability balances. Net cash used in operating activities was $225,000 in 2011, a $9.0 million decrease from 2010. During 2011, net cash used in operating activities was primarily the result of our net loss of $13.0 million and a net change in our operating assets and liabilities of $3.0 million, which was partially offset by non-cash charges for stock-based compensation expenses of $9.6 million and depreciation and amortization expenses of $5.9 million. The primary components of the $3.0 million net change in our operating assets and liabilities were a $10.1 million increase in accounts receivable, a $3.9 million increase in deferred cost of goods sold, and a $2.1 million increase in inventories, all of which was partially offset by an $8.0 million increase in accounts payable, a $3.8 million increase in deferred revenues, and a $1.2 million increase in accrued liabilities. Accounts receivable increased due primarily to higher days sales outstanding as of December 31, 2011 as compared to December 31, 2010, and to a lesser extent by an overall increase in revenues in the fourth quarter of 2011 as compared to the same period in 2010. Deferred cost of goods sold increased in conjunction with an increase in deferred revenues. Inventories increased primarily due to the timing of customer shipments during the latter part of the fourth quarter that had not yet reached their destination. During the fourth quarter of 2011, the amount of product shipped in the latter part of the quarter for which customer acceptance had not yet been received was higher than what was observed in the fourth quarter of 2010. Accounts payable increased due to the timing of expenditures during the fourth quarter of 2011. Deferred revenues increased due primarily to the timing of products shipped during the fourth quarter of 2011. Accrued liabilities increased primarily due to amounts accrued for our 2011 management bonus program, which were partially offset by the payment of termination benefits that were accrued as part of our restructuring program in the fourth quarter of 2010.

During 2010, net cash used in operating activities of $9.2 million was primarily the result of our net loss of $31.3 million, which was partially offset by non-cash charges for stock-based compensation expenses of $12.3 million, depreciation and amortization expenses of $6.7 million, and a net change in our operating assets and liabilities of $3.1 million. The primary components of the $3.1 million net change in our operating assets and liabilities were a $3.0 million increase in accounts payable, a $2.0 million decrease in inventories, and a $1.8 million increase in accrued liabilities, the benefits of which were partially offset by a $3.6 million increase in accounts receivable. Accounts payable increased due to the timing of expenditures during the fourth quarter of 2010. Inventories decreased due to continuing improved inventory management in 2010. At the end of 2008, inventory levels were historically high due in part to the world-wide economic slowdown that occurred during the fourth quarter. During 2009 and 2010, inventories were managed back down to more reasonable levels. Accrued liabilities increased primarily due to approximately $1.2 million of accrued termination benefits resulting from a restructuring program we initiated in the fourth quarter of 2010, and to a lesser extent, by a $497,000 increase in customer deposits. Accounts receivable increased due to the timing of revenues generated in the fourth quarter. During the fourth quarter of 2010, a higher percentage of the quarter's revenues were generated in the latter half of the quarter as compared to 2009, which resulted in a higher receivable balance as of December 31, 2010.

During 2009, net cash used in operating activities of $5.8 million was primarily the result of our net loss of $32.0 million, which was partially offset by non-cash charges for stock-based compensation expenses of $14.4 million, depreciation and amortization expenses of $6.5 million, and a net decrease in our operating assets and liabilities of $5.2 million. The primary components of the $5.2 million net decrease in our operating assets and liabilities were a $5.6 million decrease in inventories, a $1.9 million decrease in accounts receivable, and a $1.1 million decrease in other current assets, the benefits of which were partially offset by a $3.1 million decrease in accounts payable. Inventories decreased due to improved inventory management in 2009. At the end of 2008, inventory levels were historically high due in part to the world-wide economic slowdown that occurred during the fourth quarter. Accounts receivable decreased due to the timing of revenues generated in the fourth quarter. During the fourth quarter of 2008, a higher percentage of the quarter's revenues were generated in the latter half of the quarter as compared to 2009, which resulted in a higher receivable balance as of December 31, 2008. Other current assets decreased due to the receipt in 2009 of non-trade related receivables that were outstanding as of December 31, 2008. Accounts payable decreased due to the timing of expenditures during the fourth quarter of 2009.

Cash flows from investing activities. Cash flows from investing activities have historically been driven by transactions involving our short-term investment portfolio, capital expenditures, changes in our long-term assets, and acquisitions. Net cash provided by investing activities was $13.5 million for 2011, a $9.5 million increase in cash inflows compared to 2010. Net cash provided by investing activities in 2011 was primarily the result of net redemptions of available-for-sale short-term investments of $15.9 million, partially offset by capital expenditures of $2.3 million.

Net cash provided by investing activities of $4.0 million in 2010 was primarily the result of net redemptions of available-for-sale short-term investments of $6.0 million, partially offset by capital expenditures of $2.0 million.

Net cash used in investing activities of $14.1 million in 2009 was primarily the result of net purchases of available-for-sale short-term investments of $13.4 million and by capital expenditures of $1.8 million, partially offset by a $1.1 million decrease in our other long-term assets due to the repayment of a loan made to one of our key employees.

Cash flows from financing activities. Cash flows from financing activities have historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase program and principal payments under our lease financing obligations. Net cash used in financing activities was $3.1 million for 2011, an $867,000 decrease in cash outflows compared to 2010. Net cash used in financing activities in 2011 was primarily attributable to $2.3 million of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of options and $1.7 million of principal payments on our lease financing obligations; partially offset by proceeds of $945,000 resulting from issuance of common stock upon exercise of options by our employees.

Net cash used in financing activities of $3.9 million in 2010 was primarily attributable to $2.9 million of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of options and $1.6 million of principal payments on our lease financing obligations; partially offset by proceeds of $615,000 resulting from issuance of common stock upon exercise of options by our employees.

Net cash used in financing activities of $757,000 in 2009 was primarily attributable to $1.5 million of principal payments on our lease financing obligations and $1.3 million of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of options; partially offset by proceeds of $2.0 million from issuance of common stock upon exercise of options by our employees.

As noted above, our cash and investments totaled $58.7 million as of December 31, 2011. Of this amount, approximately 1% was held by our foreign subsidiaries. Our intent is to permanently reinvest a significant portion of our earnings from foreign operations, and current plans do not anticipate that we will need funds generated from foreign operations to fund our domestic operations. In the event funds from foreign operations are needed to fund operations in the United States and if U.S. tax has not already been previously provided, we would provide for and pay any additional U.S. taxes due in connection with repatriating these funds.

We use well-regarded investment managers to manage our invested cash. Our portfolio of investments managed by these investment managers is primarily composed of highly rated U.S. government securities, and to a lesser extent, money market funds. All investments are made according to guidelines and within compliance of policies approved by the Audit Committee of our Board of Directors.

We maintain a $10.0 million line of credit with our primary bank, which expires on July 1, 2012. The letter of credit contains certain financial covenants requiring us to maintain an overall minimum tangible net worth level and to maintain a minimum level of liquid assets. As of December 31, 2011, we were in compliance with these covenants. As of December 31, 2011, our primary bank has issued, against the line of credit, one standby letter of credit totaling $113,000. Other than issuing standby letters of credit, we have never drawn against the line of credit, nor have amounts ever been drawn against the standby letters of credit issued by the bank.

In the future, our cash reserves may be used to strategically acquire other companies, products, or technologies that are complementary to our business. In addition, our combined cash, cash equivalents, and short-term investments balances could be negatively affected by various risks and uncertainties, including, but not limited to, the risks detailed in this Annual Report in Part I, Item 1A - Risk Factors. For example, any continued weakening of economic conditions or changes in our planned cash outlay could negatively affect our existing cash reserves.

Based on our current business plan and revenue prospects, we believe that our existing cash reserves will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. However, we currently expect that our combined cash, cash equivalent, and short-term investment balance will decline during 2012. We expect that cash requirements for our payroll and other operating costs will continue at about existing levels. We also expect that we will continue to acquire capital assets such as computer systems and related software, office and manufacturing equipment, furniture and fixtures, and leasehold improvements, as the need for these items arises. In the event that we require additional financing, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

Related Party Transactions

During the years ended December 31, 2011, 2010, and 2009, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, our former Executive Chairman, M. Kenneth Oshman, used his private plane or charter aircraft for Echelon business for himself and any employees that accompanied him. In August 2008, our board of directors approved a reimbursement arrangement whereby our company would reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. The Compensation Committee of our board of directors reaffirmed this arrangement in February 2011. Such costs included flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. This arrangement was discontinued upon Mr. Oshman's death in August 2011. During the year ended December 31, 2011, we incurred no expenses pursuant to the reimbursement arrangement. While the arrangement was in effect, the Audit Committee of the board of directors regularly reviewed these reimbursements.

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for $130.7 million (see Note 11 to our accompanying consolidated financial statements for additional information on our transactions with Enel). The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our 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 our board of directors. A representative of Enel served on our board until March 14, 2012; no Enel representative is presently on our board.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the "R&D Agreement"). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we 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 us. Under the software enhancement agreement, we provide 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.

During 2011, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $7.1 million, none of which was included in accounts receivable, net at December 31, 2011. During 2010, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $4.6 million, none of which was included in accounts receivable, net at December 31, 2010. During 2009, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $10.5 million.

RECENTLY ISSUED ACCOUNTING STANDARDS

There have been no new recent accounting pronouncements or changes in accounting pronouncements during the year ended December 31, 2011, that are of significance, or potential significance, to our company.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk Disclosures. The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments to hedge these exposures.

Interest Rate Sensitivity. We maintain a short-term investment portfolio consisting mainly of fixed income securities with a weighted average maturity of less than one year. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately and uniformly by 100 basis points from levels at December 31, 2011, the fair market value of the portfolio would decline by an immaterial amount, due primarily to the fact that current interest rates remain at historically low levels. We currently intend to hold our fixed income investments until maturity or for a period of time as needed to recover any decline in value due to interest rate fluctuation, and therefore we would not expect our operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates. However, in the unlikely event it was necessary, we could decide to sell some or all of our short-term investments prior to maturity to meet the liquidity needs of the company.

Foreign Currency Exchange Risk. We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant. Due to our modest exposure to foreign currency fluctuations, if foreign exchange rates were to fluctuate by 10% from rates at December 31, 2011, our financial position and results of operations would not be materially affected. However, it is possible that there could be a material impact in the future.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Financial Statements and Supplementary Data required by this item are set forth in Item 6 and at the pages indicated in Item 15(a).

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

(a) Evaluation of Effectiveness of Disclosure Controls and Procedure

We have designed our disclosure controls and procedures to ensure that information we are required to disclose in reports that we file or submit under the Securities and Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. As of the end of the period covered by this Annual Report on Form 10-K, under the supervision of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such terms are defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities and Exchange Act of 1934. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of December 31, 2011.

(b) Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934). Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2011. This evaluation was based on the framework in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control — Integrated Framework*, our management concluded that our internal control over financial reporting is effective at this reasonable assurance level as of December 31, 2011. The Company's independent registered public accounting firm, KPMG LLP, has issued an attestation report on the Company's internal control over financial reporting. The report on the audit of internal control over financial reporting appears on page 48 of this Form 10-K.

(c) Changes in Internal Control Over Financial Reporting

There were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended December 31, 2011 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

On March 14, 2012, Livio Gallo informed us that, for personal reasons, he was retiring as a member of our Board of Directors. We accepted his retirement effective immediately.

Echelon is scheduled to hold its 2012 annual meeting of stockholders on May 22, 2012. The meeting will commence at 10:00 a.m., PDT, and will be held at our corporate headquarters located at 570 Meridian Avenue, San Jose, California 95126. The date of record for the annual meeting is March 27, 2012.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information regarding our executive officers required by this Item is incorporated herein by reference from the section titled "Executive Officers of Registrant" in Part I of this annual report on Form 10-K. The remaining information required by this Item is incorporated herein by reference from our Proxy Statement for the 2012 Annual Meeting of Stockholders (the "2012 Proxy Statement"), which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year ended December 31, 2011.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference from our 2012 Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item is incorporated herein by reference from our 2012 Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference from our 2012 Proxy Statement.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item is incorporated herein by reference from our 2012 Proxy Statement.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) The following documents are filed as part of this Form:

1. Financial Statements

2. Financial Statement Schedule

All other schedules have been omitted because they are not applicable or the required information is included in the Consolidated Financial Statements or the Notes thereto.

3. Exhibits

Item 601 of Regulation S-K requires the following exhibits listed below. Each management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K has been identified.

Exhibit No.	Description of Document
3.2[1]	Amended and Restated Certificate of Incorporation of Registrant.
3.3[2]	Amended and Restated Bylaws of Registrant.
4.1[3]	Form of Registrant's Common Stock Certificate.
4.2[4]	Second Amended and Restated Modification Agreement dated May 15, 1997.
10.1[4]	Form of Indemnification Agreement entered into by Registrant with each of its directors and executive officers.
10.2[10]+	1997 Stock Plan (as amended and restated March 26, 2004)
10.2(a)[5]+	Form of 1997 Stock Plan Stock Option Agreement with early exercise feature
10.2(b)[5]+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement with early exercise feature
10.2(c)[6]+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement
10.2(d)[5]+	Form of 1997 Stock Plan Performance Share Agreement (re: non-standard vesting schedule)
10.2(e)[5]+	Form of 1997 Stock Plan Performance Share Agreement for non-US employees
10.2(f)[5]+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria for non-US employees
10.2(g)[5]+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for non-US employees
10.2(h)[5]+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria
10.2(i)[5]+	Form of 1997 Stock Plan Performance Share Agreement
10.2(j)[13]+	Form of 1997 Stock Plan Stock Appreciation Right Agreement
10.2(k)[7]+	Form of 1997 Stock Plan Performance Share Agreement for US-based corporate officers
10.2(l)[11]+	Form of 1997 Stock Plan Performance Share Agreement for non US-based corporate officers
10.2(m)[7]+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for US-based corporate officers
10.2(n)[7]+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for non US-based corporate officers
10.2(o)[12]+	Form of 1997 Stock Plan Restricted Stock Award Agreement
10.3[4]+	1988 Stock Option Plan and forms of related agreements.
10.4[4]	Second Amended and Restated Modification Agreement dated May 15, 1997 (included in Exhibit 4.2).
10.5[4]	Form of International Distributor Agreement.
10.6[4]	Form of OEM License Agreement.
10.7[4]	Form of Software License Agreement.
10.8[4]	International Distributor Agreement between the Company and EBV Elektronik GmbH as of December 1, 1997.
10.9[8]+	1998 Director Option Plan.
10.10[9]	Building 1 Lease Agreement dated December 30, 1999
10.11[9]	First Amendment to Building 1 Lease Agreement dated May 10, 2000
10.12[9]	Echelon Corporation Common Stock Purchase Agreement with ENEL S.p.A. dated June 30, 2000
10.13[9]	Second Amendment to Building 1 Lease Agreement dated September 22, 2000
10.14[9]	Building 2 Lease Agreement dated November 15, 2001
10.15[9]	Third Amendment to Building 1 Lease Agreement dated April 10, 2008
10.16[9]	First Amendment to Building 2 Lease Agreement dated April 10, 2008
10.17[14]	Form of Value Added Reseller Agreement
10.18	Assignment and Amendment dated April 29, 2011 between the Company and Avnet Europe Comm VA (assigning and modifying the International Distributor Agreement filed as Exhibit 10.8 to the Registration Statement on Form S-1 filed on June 1, 1998)
10.19+	Echelon Corporation Employment Agreement by and between Echelon Corporation and Ronald A. Sege dated August 18, 2010
10.20+	Echelon Corporation Employment letter with William R. Slakey dated September 6, 2011
21.1[3]	Subsidiaries of the Registrant.
23.1	Consent of KPMG LLP, Independent Registered Public Accounting Firm.
24.1[4]	Power of Attorney (see signature page).
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase
101.DEF*	XBRL Taxonomy Extension Definition Linkbase
101.LAB*	XBRL Taxonomy Extension Label Linkbase

101.PRE* XBRL Taxonomy Extension Presentation Linkbase

* The financial information contained in these XBRL documents is unaudited and is furnished, not filed with the Securities and Exchange Commission.

\+ Indicates management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 14(c) of Form 10-K.

(1) Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2000, filed on November 14, 2000.

(2) Incorporated herein by reference to the Registrant's Current Report on Form 8-K dated August 16, 2007, filed on August 17, 2007.

(3) Incorporated herein by reference to the Registrant's Registration Statement on Form S-1/A filed on July 9, 1998.

(4) Incorporated herein by reference to the Registrant's Registration Statement on Form S-1 filed on June 1, 1998.

(5) Incorporated herein by reference to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2006, filed on March 16, 2007.

(6) Incorporated herein by reference to the Registrant's Current Report Form 8-K dated April 12, 2007, filed on April 18, 2007.

(7) Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2008, filed on August 11, 2008.

(8) Incorporated herein by reference to the Registrant's Registration Statement on Form S-8 filed on August 21, 2000.

(9) Incorporated herein by reference to the Registrant's Annual Report on Form 10-K/A for the fiscal year ended December 31, 2008, filed on March 11, 2010.

(10) Incorporated herein by reference to the Registrant's Registration Statement on Form S-8 filed on June 1, 2005.

(11) Incorporated herein by reference to the Registrant's Registration Statement on Form S-8 filed on August 6, 2010.

(12) Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2010, filed on November 3, 2010

(13) Incorporated herein by reference to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed on March 17, 2008

(14) Incorporated herein by reference to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2009, filed on March 16, 2010

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders
Echelon Corporation:

We have audited the accompanying consolidated balance sheets of Echelon Corporation and subsidiaries (the Company) as of December 31, 2011 and 2010, and the related consolidated statements of operations, comprehensive loss, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2011. We also have audited the Company's internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting included in Item 9A(b). Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Echelon Corporation and subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles. Also in our opinion, Echelon Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

The Company changed its method of accounting for multiple element revenue transactions in the year ended December 31, 2010, resulting from the adoption of new accounting pronouncements.

/s/ KPMG LLP

Santa Clara, California
March 14, 2012

ECHELON CORPORATION
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	December 31, 2011	December 31, 2010
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 17,658	$ 7,675
Short-term investments	40,998	56,957
Accounts receivable, net of allowances of $1,801 in 2011 and $945 in 2010	35,215	25,102
Inventories	11,125	8,993
Deferred cost of goods sold	6,536	2,588
Other current assets	4,044	3,962
Total current assets	115,576	105,277
Property and equipment, net	27,201	31,020
Goodwill	8,235	8,316
Other long-term assets	693	957
TOTAL ASSETS	$ 151,705	$ 145,570
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 18,313	$ 10,399
Accrued liabilities	7,755	6,713
Current portion lease financing obligations	1,870	1,731
Deferred revenues	12,716	9,175
Total current liabilities	40,654	28,018
Long-Term Liabilities:		
Lease financing obligations, excluding current portion	20,193	22,062
Other long-term liabilities	1,750	1,501
Total long-term liabilities	21,943	23,563
Commitments and Contingencies (Note 8)		
Stockholders' Equity:		
Preferred stock, $0.01 par value:		
Authorized – 5,000,000 shares; none outstanding	—	—
Common stock, $0.01 par value:		
Authorized – 100,000,000 shares		
Issued – 45,740,637 shares in 2011 and 45,211,460 shares in 2010		
Outstanding – 42,521,453 shares in 2011 and 41,992,276 shares in 2010	457	452
Additional paid-in capital	346,952	338,521
Treasury stock, at cost (3,219,184 shares in 2011 and 2010)	(28,130)	(28,130)
Accumulated other comprehensive income	244	561
Accumulated deficit	(230,415)	(217,415)
Total stockholders' equity	89,108	93,989
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 151,705	$ 145,570

See accompanying notes to the consolidated financial statements.

ECHELON CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)

	Year Ended December 31, 2011	2010	2009
REVENUES:			
Product	$ 152,699	$ 107,441	$ 100,187
Service	3,788	3,596	3,151
Total revenues [1]	156,487	111,037	103,338
COST OF REVENUES:			
Cost of product	87,063	59,722	56,813
Cost of service	2,262	2,464	2,418
Total cost of revenues	89,325	62,186	59,231
Gross profit	67,162	48,851	44,107
OPERATING EXPENSES:			
Product development	34,755	34,762	35,435
Sales and marketing	25,719	25,062	23,525
General and administrative	17,897	17,647	15,742
Restructuring charges	—	1,212	—
Total operating expenses	78,371	78,683	74,702
Loss from operations	(11,209)	(29,832)	(30,595)
Interest and other income (expense), net	6	393	(28)
Interest expense on lease financing obligations	(1,468)	(1,572)	(1,668)
Loss before income taxes	(12,671)	(31,011)	(32,291)
Income tax expense (benefit)	329	301	(257)
NET LOSS	$ (13,000)	$ (31,312)	$ (32,034)
Loss per share:			
Basic	$ (0.31)	$ (0.76)	$ (0.79)
Diluted	$ (0.31)	$ (0.76)	$ (0.79)
Shares used in per share calculation:			
Basic	42,083	41,365	40,724
Diluted	42,083	41,365	40,724

[1] Includes related party amounts of $7,119 in 2011, $4,645 in 2010, and $10,518 in 2009. See Note 11 for additional information on related party transactions.

See accompanying notes to the consolidated financial statements.

ECHELON CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(in thousands)

	Year Ended December 31,		
	2011	2010	2009
Net loss	$ (13,000)	$ (31,312)	$ (32,034)
Other comprehensive income (loss), net of tax:			
Foreign currency translation adjustment	(302)	(500)	335
Unrealized holding gain (loss) on available-for-sale securities	(15)	15	(73)
Comprehensive loss	$ (13,317)	$ (31,797)	$ (31,772)

See accompanying notes to the consolidated financial statements.

ECHELON CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock Shares	Common Stock Amount	Treasury Stock Shares	Treasury Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
BALANCE AT DECEMBER 31, 2008	43,676	$ 437	(3,219)	$ (28,130)	$ 313,549	$ 784	$ (154,069)	$ 132,571
Exercise of stock options	428	4	—	—	2,879	—	—	2,883
Release of performance shares	365	3	—	—	(3)	—	—	—
Stock received for payment of option exercise price	(119)	(1)	—	—	(835)	—	—	(836)
Stock received for payment of employee taxes on vesting of performance shares and upon exercise of stock options	(124)	(1)	—	—	(1,343)	—	—	(1,344)
Repurchase of employee shares	(1)	—	—	—	(7)	—	—	(7)
Stock-based compensation	—	—	—	—	14,403	—	—	14,403
Foreign currency translation adjustment	—	—	—	—	—	335	—	335
Unrealized holding loss on available-for-sale securities	—	—	—	—	—	(73)	—	(73)
Net loss	—	—	—	—	—	—	(32,034)	(32,034)
BALANCE AT DECEMBER 31, 2009	44,225	$ 442	(3,219)	$ (28,130)	$ 328,643	$ 1,046	$ (186,103)	$ 115,898
Exercise of stock options	1,647	16	—	—	12,516	—	—	12,532
Release of performance shares	723	7	—	—	(7)	—	—	—
Issuance of restricted stock	250	3	—	—	(3)	—	—	—
Stock received for payment of option exercise price	(1,291)	(13)	—	—	(11,946)	—	—	(11,959)
Stock received for payment of employee taxes on vesting of performance shares and upon exercise of stock options	(343)	(3)	—	—	(3,010)	—	—	(3,013)
Stock-based compensation	—	—	—	—	12,328	—	—	12,328
Foreign currency translation adjustment	—	—	—	—	—	(500)	—	(500)
Unrealized holding gain on available-for-sale securities	—	—	—	—	—	15	—	15
Net loss	—	—	—	—	—	—	(31,312)	(31,312)
BALANCE AT DECEMBER 31, 2010	45,211	$ 452	(3,219)	$ (28,130)	$ 338,521	$ 561	$ (217,415)	$ 93,989
Exercise of stock options	505	5	—	—	3,600	—	—	3,605
Release of performance shares	549	5	—	—	(5)	—	—	—
Stock received for payment of option exercise price	(281)	(3)	—	—	(2,657)	—	—	(2,660)
Stock received for payment of employee taxes on vesting of performance shares and upon exercise of stock options	(243)	(2)	—	—	(2,156)	—	—	(2,158)
Stock-based compensation	—	—	—	—	9,649	—	—	9,649
Foreign currency translation adjustment	—	—	—	—	—	(302)	—	(302)
Unrealized holding gain on available-for-sale securities	—	—	—	—	—	(15)	—	(15)
Net loss	—	—	—	—	—	—	(13,000)	(13,000)
BALANCE AT DECEMBER 31, 2011	45,741	$ 457	(3,219)	$ (28,130)	$ 346,952	$ 244	$ (230,415)	$ 89,108

See accompanying notes to the consolidated financial statements.

ECHELON CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Year Ended December 31, 2011	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	$ (13,000)	$ (31,312)	$ (32,034)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	5,921	6,721	6,468
Increase in allowance for doubtful accounts	25	28	27
Loss on disposal of fixed assets	128	5	37
Reduction of (increase in) accrued investment income	70	(31)	43
Stock-based compensation	9,649	12,328	14,403
Change in operating assets and liabilities:			
Accounts receivable	(10,121)	(3,580)	1,943
Inventories	(2,106)	2,006	5,553
Other current assets	164	(402)	1,148
Accounts payable	8,033	2,999	(3,076)
Deferred cost of goods sold	(3,926)	608	(732)
Accrued liabilities	1,185	1,795	(492)
Deferred revenues	3,806	(275)	920
Deferred rent	(53)	(75)	(26)
Net cash used in operating activities	(225)	(9,185)	(5,818)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of available-for-sale short-term investments	(71,978)	(62,848)	(137,715)
Proceeds from sales and maturities of available-for-sale short-term investments	87,850	68,847	124,335
Changes in other long-term assets	(17)	27	1,082
Capital expenditures	(2,349)	(1,995)	(1,824)
Net cash provided by (used in) investing activities	13,506	4,031	(14,122)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net proceeds from exercise of stock options	945	615	2,004
Principal payments of lease financing obligations	(1,731)	(1,588)	(1,452)
Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options	(2,265)	(2,945)	(1,309)
Net cash used in financing activities	(3,051)	(3,918)	(757)
EFFECT OF EXCHANGE RATES ON CASH	(247)	(459)	234
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	9,983	(9,531)	(20,463)
CASH AND CASH EQUIVALENTS:			
Beginning of year	7,675	17,206	37,669
End of year	$ 17,658	$ 7,675	$ 17,206
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid for interest on lease financing obligations	$ 1,459	$ 1,564	$ 1,659
Cash paid for income taxes	$ 429	$ —	$ 122

See accompanying notes to the consolidated financial statements.

ECHELON CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING POLICIES:

(a) Operations

Echelon Corporation (the "Company") was incorporated in California in February 1988 and was reincorporated in Delaware in January 1989. The Company is based in San Jose, California, and maintains offices in eleven foreign countries throughout Europe and Asia. Echelon develops, markets, and sells 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. The Company's products enable everyday devices — such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves — to be made "smart" and inter-connected.

The Company's products are based on its LonWorks networking technology, an open standard for interoperable networked control. In a LonWorks control network, intelligent control devices, called nodes, communicate using the Company's LonWorks protocol. The Company's open standard, multi-application energy control networking platform powers energy-savings applications for the smart grid, smart cities and smart buildings that help customers save on their energy usage, reduce outage duration or prevent outages from happening entirely, reduce carbon footprint and more. The Company classifies its products and services into two primary categories: Systems, such as its smart metering solutions, which are targeted for use by utilities and that were previously referred to as Utility products and services; and Sub-systems that include 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 the Company's Sub-systems products and services were previously referred to as Commercial and Enel Project revenues. The Company sells its products and services directly or through its partners around the world to the building, industrial, transportation, utility/home and other automation markets.

(b) Basis of Presentation

The Company's consolidated financial statements reflect operations of the Company and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated.

(c) 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 69% of net revenues for the year ended December 31, 2011 was derived from five 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 the Company, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. In addition, if any of these customers are unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to the Company.

- The Company utilizes third-party contract electronic manufacturers to manufacture, assemble, and test its products. 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.

(d) 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 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.

(e) 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 the Company's 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.

Multiple Element Arrangements

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 year ended December 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 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 December 31, 2011, 2010, and 2009, approximately \$9.4 million, \$3.7 million, and \$5.2 million, respectively, of the Company's Systems revenue was deferred. All of the \$9.4 million of deferred revenue at 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.

(f) 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.

(g) Stock-Based Compensation

The Company accounts for stock-based payment transactions in which the Company receives employee services in exchange for equity instruments of the enterprise. Stock-based compensation cost for restricted stock units ("RSUs") granted to employees is measured based on the closing fair market value of the Company's common stock on the date of grant. Stock-based compensation cost for RSUs granted to non-employee consultants is measured based on the closing fair market value of the Company's common stock at the earlier of the date at which a commitment for performance by the consultant to earn the performance shares is reached, or the date at which the consultant's performance necessary for the performance shares to vest has been completed. Stock-based compensation cost for stock options and stock appreciation rights granted to employees ("SARs") is estimated at the grant date based on each award's fair-value as calculated using uses the Black-Scholes-Merton ("BSM") option-pricing model. The Company recognizes stock-based compensation cost as expense using the accelerated multiple-option approach over the requisite service period. Further information regarding stock-based compensation can be found in Note 5 of these Notes to Consolidated Financial Statements.

(h) Cash and Cash Equivalents

The Company considers bank deposits, money market investments and all debt and equity securities with an original maturity of three months or less to be cash and cash equivalents.

(i) Short-Term Investments

The Company classifies its investments in marketable debt securities as available-for-sale. Securities classified as available-for-sale are reported at fair value with the related unrealized holding gains and losses, net of tax, being included in accumulated other comprehensive income (loss).

(j) Fair Value Measurements

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

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

This hierarchy requires the Company to minimize the use of unobservable inputs and to use observable market data, if available, when estimating fair value. Other than cash and money market funds, the Company's only financial assets or liabilities required to be measured at fair value on a recurring basis at December 31, 2011, are fixed income available-for-sale securities. See Note 2 for a summary of the input levels used in determining the fair value of the Company's cash equivalents and short-term investments as of December 31, 2011.

(k) 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):

	December 31,	
	2011	2010
Purchased materials	$ 2,346	$ 4,306
Work-in-process	86	48
Finished goods	8,693	4,639
	$ 11,125	$ 8,993

(l) Impairment of Long-Lived Assets Including Goodwill

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability is measured by comparing the asset's carrying value to the future undiscounted cash flows the asset is expected to generate. If long-lived assets are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair value. For the three years ended December 31, 2011, the Company recognized no material impairments.

Costs in excess of the fair value of tangible and other identifiable intangible assets acquired and liabilities assumed in a purchase business combination are recorded as goodwill, which is tested for impairment using a two-step approach. The Company evaluates goodwill, at a minimum, on an annual basis during the first quarter and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. For purposes of this analysis, the Company considers itself as a single reporting unit. If the carrying amount of the reporting unit exceeds its fair value, goodwill is considered impaired and a second step is performed to measure the amount of impairment loss, if any. To date, the Company has recorded no impairment of goodwill.

(m) Software Development Costs

For software to be sold, leased, or otherwise marketed, the Company capitalizes eligible computer software development costs upon the establishment of technological feasibility, which the Company has defined as completion of a working model. For the three years ended December 31, 2011, costs that were eligible for capitalization were insignificant and, thus, the Company has charged all software development costs to product development expense in the accompanying consolidated statements of operations.

(n) Accrued Liabilities

Accrued liabilities consisted of the following (in thousands):

	December 31,	
	2011	2010
Accrued payroll and related costs	$ 5,673	$ 3,727
Warranty reserve	823	877
Accrued taxes	170	167
Customer deposits	101	197
Restructuring charges	49	1,158
Payments received toward design and development expenses	--	300
Other accrued liabilities	939	287
	$ 7,755	$ 6,713

(o) Foreign Currency Translation

The functional currency of the Company's subsidiaries is the local currency. Accordingly, all assets and liabilities are translated into U.S. dollars at the current exchange rate as of the applicable balance sheet date. Revenues and expenses are translated at the average exchange rate prevailing during the period. Gains and losses resulting from the translation of the financial statements are included in accumulated other comprehensive income (loss).

Remeasurement adjustments for non-functional currency monetary assets and liabilities, including short-term intercompany balances, are included in other income (expense) in the accompanying consolidated statements of operations. Currently, the Company does not employ a foreign currency hedge program utilizing foreign currency exchange contracts as the foreign currency transactions and risks to date have not been significant.

(p) Concentrations of Credit Risk and Suppliers

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 investments, 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, such as a bank guarantee, to mitigate the risk of uncollectibility. 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.

With the exception of amounts owed the Company on sales made to certain significant customers, concentrations of credit risk with respect to trade receivables are generally limited due to the Company's large number of customers and their dispersion across many different industries and geographies. As of December 31, 2011 and 2010, the percentage of the Company's total accounts receivable balance that were due from the following significant customers is as follows (refer to Note 6 "Significant Customers" for a discussion of revenues generated from the Company's significant customers):

	December 31,	
	2011	2010
Telvent Energia y Medioambiente SA	46.2%	5.0%
Duke Energy Corporation	15.7%	16.3%
Eltel Networks A/S	7.5%	39.3%
EBV Electronik GmbH / Avnet Europe Comm VA	2.5%	7.4%
Total	71.9%	68.0%

For most of the Company's products requiring assembly, it relies on a limited number of contract electronic manufacturers, principally Jabil and TYCO. The Company also maintains manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products, including those used in the Company's Systems products.

The Neuron Chip is an important component that the Company and its customers use in control network devices. In addition to those sold by the Company, the Neuron Chip is currently manufactured and distributed only by Cypress Semiconductor. The other former producer of the Neuron Chip, Toshiba, ceased production due to earthquake damage at its factory in Japan in March 2011. Cypress has recently informed the Company that it has experienced a sharp increase in Neuron Chip demand due to Toshiba's inability to manufacture parts and satisfy demand. To address this, Cypress has informed the Company that they intend to add additional manufacturing capacity.

Another semiconductor supplier, STMicroelectronics, manufactures the Company's power line smart transceiver products, for which the Company has no alternative source. In addition, the Company currently purchases several key products and components from sole or limited source suppliers with which it does not maintain signed agreements that would obligate them to supply to the Company on negotiated terms.

If any of the Company's key suppliers were to stop manufacturing the Company's products or cease supplying the Company with its key components, it could be expensive and time consuming to find a replacement. Also, as the Company's Systems business grows, it will be required to expand its business with its key suppliers or find additional sources of supply. There is no guarantee that the Company would be able to find acceptable alternatives or additional sources.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with the Company's product, assembly and test specifications could adversely affect the Company's revenues and gross profit, and could result in claims against the Company by its customers, which could harm the Company's results of operations and financial position.

(q) Computation of Basic and Diluted Net Loss Per Share

Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted average shares of common stock outstanding during the period. Diluted net income per share is calculated by adjusting the weighted average number of outstanding shares assuming conversion of all potentially dilutive stock options and warrants under the treasury stock method.

The following is a reconciliation of the numerators and denominators of the basic and diluted net income (loss) per share computations for the years ended December 31, 2011, 2010, and 2009 (in thousands, except per share amounts):

	Year Ended December 31,		
	2011	2010	2009
Net loss (Numerator):			
Net loss, basic and diluted	$ (13,000)	$ (31,312)	$ (32,034)
Shares (Denominator):			
Weighted average shares used in basic computation	42,083	41,365	40,724
Weighted average shares used in diluted computation	42,083	41,365	40,724
Net loss per share:			
Basic	$ (0.31)	$ (0.76)	$ (0.79)
Diluted	$ (0.31)	$ (0.76)	$ (0.79)

For the years ended December 31, 2011, 2010, and 2009, the diluted net loss per share calculation is equivalent to the basic net loss per share calculation as there are no potentially dilutive stock options due to the Company's net loss position. The number of stock options and performance shares excluded from these calculations in 2011, 2010, and 2009 were 5,625,065, 6,476,817, and 7,392,866, respectively.

(r) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Company takes a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon effective settlement. The Company re-evaluates its income tax positions on a quarterly basis to consider factors such as changes in facts or circumstances, changes in or interpretations of tax law, effectively settled issues under audit, and new audit activity. Such a change in recognition or measurement would result in recognition of a tax benefit or an additional charge to the tax provision. Interest and penalties on unrecognized tax benefits are classified as income tax expense.

(s) 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.

2. FINANCIAL INSTRUMENTS

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 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	$ ---

There have been no transfers between fair value measurement levels during the year ended December 31, 2011.

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):

	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 consolidated balance sheets

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

Of the $46.0 million of fixed income available-for-sale securities at December 31, 2011, approximately $5.0 million are classified as cash equivalents while the remaining $41.0 million are classified as short-term investments. All of the $57.0 million of fixed income available-for-sale securities at December 31, 2010 are classified as short-term investments. As discussed in Note 1, 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.

The amortized cost basis, aggregate fair value and gross unrealized holding gains and losses for the Company's available-for-sale short-term investments, by major security type, were as follows as of December 31, 2011 (in thousands):

	Amortized Cost	**Aggregate Fair Value**	**Unrealized Holding Gains**	**Unrealized Holding Losses**
U.S. government securities	$ 45,997	$ 45,999	$ 3	$ 1
Total investments in debt securities	$ 45,997	$ 45,999	$ 3	$ 1

The amortized cost basis, aggregate fair value and gross unrealized holding gains and losses for the Company's available-for-sale short-term investments, by major security type, were as follows as of December 31, 2010 (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. government securities	$ 56,940	$ 56,957	$ 17	$ --
Total investments in debt securities	$ 56,940	$ 56,957	$ 17	$ --

As of December 31, 2011 and 2010, the Company's available-for-sale securities had original contractual maturities of between three to twelve months. As of December 31, 2011 and 2010, the average remaining term to maturity for the Company's available-for-sale securities was two and five months, respectively.

The following table shows the gross unrealized losses and fair value for those investments that were in an unrealized loss position as of December 31, 2011, aggregated by investment category and the length of time that individual securities have been in a continuous loss position (in thousands). As of December 31, 2010, there were no investments that were in an unrealized loss position.

	December 31, 2011					
	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government securities	$ 27,999	$ (1)	$ ---	$ ---	$ 27,999	$ (1)
Total	$ 27,999	$ (1)	$ ---	$ ---	$ 27,999	$ (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. In performing its review, the Company considers factors such as the length of time and extent to which the market value has been less than the cost, the financial condition and near-term prospects of the issuer, and the Company's intent to sell (or whether it is more likely than not that the Company will be required to sell) the investment before recovery of the investment's amortized cost basis. If the Company believes that an other-than-temporary decline exists, that investment is written down to fair value. In writing the investment down to fair value, any other-than-temporary declines related to a credit loss would be recorded to interest and other income (expense), net in the Company's Consolidated Statements of Operations. Any portion not related to credit loss would be recorded to accumulated other comprehensive income (loss), which is reflected as a separate component of stockholders' equity. For each of the three years ended December 31, 2011, gross realized gains and losses on the Company's investment portfolio were not material and there were no other-than-temporary impairments.

3. PROPERTY AND EQUIPMENT

A summary of property and equipment, net as of December 31, 2011 and December 31, 2010 is as follows (in thousands):

	December 31, 2011	December 31, 2010
Buildings and improvements	$ 37,356	$ 37,356
Computer and other equipment	23,771	23,496
Software	4,942	4,933
Furniture and fixtures	2,698	2,729
Leasehold improvements	3,826	3,978
	72,593	72,492
Less: Accumulated depreciation and amortization	(45,392)	(41,472)
Property and equipment, net	$ 27,201	$ 31,020

Property and equipment are stated at cost. The cost of buildings and improvements for the Company's leased San Jose, California headquarters facilities, for which it is the "deemed owner" for accounting purposes only, includes both the costs paid for directly by the Company and the costs paid for by the builder (lessor) from the period commencing with the start of construction through the lease commencement date for each building. These "building assets" are reflected as "Buildings and Improvements" in the schedule above. Building improvements paid for by the Company subsequent to the lease commencement date of each building are reflected as "Leasehold Improvements" in the schedule above.

Effective June 2008, the building leases were amended, resulting in an extension of the lease term for both buildings through March 2020. As a result of the lease extensions, the lease financing obligations for each building were increased based on the present value of the revised lease payments on the date of the extension, with a corresponding increase to the net carrying amount of the cost of the building assets (see further information below).

Depreciation is provided using the straight-line method as follows:

- Building assets and leasehold improvements are depreciated over the shorter of the remaining lease term or estimated useful lives (see further information below);
- Computer equipment and related software, other equipment, and furniture and fixtures are depreciated over their estimated useful lives of two to five years; and
- Certain telecommunications equipment is depreciated over its estimated useful life of 10 years.

Accounting for buildings and improvements

In December 1999, the Company entered into a lease agreement with a real estate developer for its existing corporate headquarters in San Jose, California. In October 2000, the Company entered into a second lease agreement with the same real estate developer for an additional building at its headquarters site. These leases were scheduled to expire in 2011 and 2013, respectively.

Effective June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately $48.9 million. Both leases permit the Company to exercise an option to extend the respective lease for two sequential five-year terms. In addition, the amended leases eliminated the Company's requirement to provide the landlord with security deposits totaling $6.2 million, which the Company had previously satisfied through the issuance of standby letters of credit ("LOCs").

The Company has historically accounted for the two buildings at its San Jose, California headquarters site under authoritative guidance pertaining to leases in which the Company is both involved in the construction of the lease assets and for which certain sale-leaseback criteria are not met. This results in the Company being the "deemed owner" of the two buildings for accounting purposes only. Accordingly, the leases associated with these facilities are accounted for as financing obligations.

For the December 1999 and October 2000 lease agreements, the Company initially recorded lease financing obligations of $12.0 million and $15.2 million, respectively, which corresponded to the building asset costs paid for by the lessor. As a result of the lease extension in June 2008, the Company increased the carrying amount of its lease financing obligations by approximately $12.5 million to approximately $27.6 million (an amount equal to the present value of the revised lease payments at the date of the lease extension), with a corresponding increase to the net carrying amount of the building assets. In addition, all of the accumulated depreciation on the building assets at the date of the lease extensions (approximately $16.0 million) was eliminated with a corresponding decrease to the gross carrying amount of the building assets. As a result of the extension in lease terms, the Company also extended the estimated useful lives of the building assets and the leasehold improvements to equal the amended lease term.

For each of the years ended December 31, 2011, 2010, and 2009, the Company has recorded depreciation expense associated with the building assets of $2.0 million. As of December 31, 2011 and December 31, 2010, the net book value of the building assets was $16.6 million and $18.6 million, respectively.

Under the lease agreements, a portion of the total lease payments is accounted for as an operating lease of land and recorded as expense on a straight-line basis over the term of the lease. The remaining portions of the monthly lease payments are considered to be payments of principal and interest on the lease financing obligations. For each of the years ended December 31, 2011, 2010, and 2009, land lease expense was $741,000. For the years ended December 31, 2011, 2010, and 2009, principal reductions on the lease financing obligations were $1.7 million, $1.6 million and $1.4 million, respectively; and interest expense was $1.5 million, $1.6 million, and $1.7 million, respectively. See Note 8 for further information on commitments for future minimum lease payments associated with the lease financing obligations.

4. STOCKHOLDERS' EQUITY AND EMPLOYEE STOCK OPTION PLANS

(a) Preferred Stock

As of December 31, 2011, the Company was authorized to issue 5,000,000 shares of new $0.01 par value preferred stock, of which none was outstanding.

(b) Common Stock

As of December 31, 2011, the Company was authorized to issue 100,000,000 shares of $0.01 par value common stock, of which 42,521,453 were outstanding.

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. There were no repurchases under the new stock repurchase program during the year ended December 31, 2011. 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.

(c) Stock Option Programs

The Company grants equity compensation awards under the 1997 Stock Plan (the "1997 Plan"). Prior to July 2008, the Company also issued options to certain members of its Board of Directors under the 1998 Director Option Plan (the "Director Option Plan"). A more detailed description of each plan can be found below.

Stock option and other equity compensation grants are designed to reward employees, officers, directors, and certain non-employee consultants for their long-term contribution to the Company, to align their interest with those of the Company's stockholders in creating stockholder value, and to provide incentives for them to remain with the Company. The number and frequency of equity compensation grants is based on competitive practices, operating results of the Company, and accounting regulations. Since the inception of the 1997 Plan, the Company has granted equity compensation awards to all of its employees.

Historically, the Company has issued new shares upon the exercise of stock options. However, treasury shares are also available for issuance, although the Company does not currently intend to use treasury shares for this purpose.

1997 Stock Plan

During 1997, the Company adopted the 1997 Stock Plan for employees, officers, directors, and non-employee consultants, which was amended and restated in May 2004. As of December 31, 2011, a total of 16,016,208 shares of Common Stock were reserved for issuance under the 1997 Plan. This plan includes annual increases on the first day of the Company's fiscal year (beginning in 2000) not to exceed the lesser of (i) 5,000,000 shares or (ii) 4% of the outstanding shares on such date. Incentive stock options to purchase shares of common stock may be granted at not less than 100% of the fair market value. Options granted prior to June 15, 2000 and after May 5, 2003, generally have a term of five years from the date of grant. Options granted June 15, 2000 through May 5, 2003, generally have a term of ten years. The exercise price of stock options granted under the 1997 Plan is determined by the Board of Directors (or a Committee of the Board of Directors), but will be at least equal to 100% of the fair market value per share of common stock on the date of grant (or at least 110% of such fair market value for an incentive stock option granted to a stockholder with greater than 10% voting power of all our stock), except that up to 10% of the aggregate number of shares reserved for issuance under the 1997 Plan (including shares that have been issued or are issuable in connection with options exercised or granted under the 1997 Plan) may have exercise prices that are from 0% to 100% of the fair market value of the common stock on the date of grant. Options generally vest ratably over four years.

The 1997 Plan also allows for the issuance of stock purchase rights and options that are immediately exercisable through execution of a restricted stock purchase agreement. Shares purchased pursuant to a stock purchase agreement generally vest ratably over four years. In the event of termination of employment, the Company, at its discretion, may repurchase unvested shares at a price equal to the original issuance price. In addition, the 1997 Plan allows for the issuance of stock appreciation rights ("SARs"), restricted stock awards ("RSAs"), and restricted stock units ("RSUs"). SARs are rights to receive, in cash or shares of our common stock, as designated on the grant date, the appreciation in fair market value of common stock between the exercise date and the date of grant. To date, the Company has only issued SARs that can be settled in shares of the Company's common stock. SARs may be granted alone or in tandem with options. The exercise price of a SAR will be at least equal to 100% of the fair market value per share of common stock on the date of grant. SARs issued by the Company generally vest in equal, annual installments over four years, and expire on the fifth anniversary of the grant date. RSUs are awards that result in a payment to a participant, generally in the form of an issuance of shares of the Company's common stock, at such time as specified performance goals or other vesting criteria are achieved or the awards otherwise vest. RSUs and RSAs issued by the Company generally vest in equal, annual installments over four years, although certain of these awards vest monthly over twelve months, or 100% after one or two years. In addition, certain of these RSU and RSA grants have additional financial-based performance requirements that must be met before vesting can occur. RSUs and RSAs with performance-based vesting conditions expire no later than the fifth anniversary of the grant date if the performance criteria have not been met.

(d) Stock Award Activity

The following table summarizes stock award activity under all plans for the years ended December 31, 2011, 2010, and 2009:

	Shares Available for Grant	Options Outstanding: Number Outstanding	Options Outstanding: Weighted-Average Exercise Price Per Share
BALANCE AT DECEMBER 31, 2008	9,727,337	5,658,325	$ 8.69
Options and stock appreciation rights granted	(1,161,442)	1,161,442	8.07
RSUs granted	(748,019)	---	---
Options and stock appreciation rights cancelled	463,439	(463,439)	12.01
RSUs cancelled	120,612	---	---
Options exercised	---	(427,552)	6.74
Unissued shares returned to plan	3,490	---	---
1998 Directors Plan shares expired	(40,000)	---	---
Additional shares reserved	1,618,282	---	---
BALANCE AT DECEMBER 31, 2009	9,983,699	5,928,776	$ 8.45
Options and stock appreciation rights granted	(342,900)	342,900	7.68
RSUs granted	(1,628,183)	---	---
Options and stock appreciation rights cancelled	348,913	(348,913)	10.42
RSUs cancelled	168,298	---	---
Options exercised	---	(1,647,115)	7.61
Unissued shares returned to plan	1,260,465	---	---
1998 Directors Plan shares expired	(10,000)	---	---
Additional shares reserved	1,640,230	---	---
BALANCE AT DECEMBER 31, 2010	11,420,522	4,275,648	$ 8.55
Options and stock appreciation rights granted	(313,750)	313,750	8.26
RSUs granted	(1,381,070)	---	---
Options and stock appreciation rights cancelled	981,365	(981,365)	8.64
RSUs cancelled	480,571	---	---
Options exercised	---	(504,561)	7.15
Unissued shares returned to plan	190,406	---	---
1998 Directors Plan shares expired	(10,000)	---	---
Additional shares reserved	1,679,692	---	---
BALANCE AT DECEMBER 31, 2011	13,047,736	3,103,472	$ 8.71

The total intrinsic value of options and SARs exercised during the years ended December 31, 2011, 2010, and 2009 was approximately $1.2 million, $2.8 million, and $1.0 million, respectively. 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 following table provides additional information regarding RSU and RSA activity for the years ended December 31, 2011, 2010, and 2009:

	Number Nonvested and Outstanding	Weighted-Average Grant Date Fair-Value
BALANCE AT DECEMBER 31, 2008	1,201,773	$ 13.11
RSUs granted	748,019	7.87
RSUs vested and released	(365,090)	12.74
RSUs cancelled	(120,612)	13.17
BALANCE AT DECEMBER 31, 2009	1,464,090	$ 10.52
RSUs and RSAs granted	1,628,183	8.02
RSUs vested and released	(722,806)	10.06
RSUs cancelled	(168,298)	9.76
BALANCE AT DECEMBER 31, 2010	2,201,169	$ 8.88
RSUs and RSAs granted	1,381,070	8.74
RSUs vested and released	(580,075)	10.55
RSUs cancelled	(480,571)	8.96
BALANCE AT DECEMBER 31, 2011	2,521,593	$ 8.40

The fair value of each RSU and RSA granted to employees was estimated on the date of grant by multiplying the number of shares granted times the fair market value of the Company's stock on the grant date.

The total intrinsic value of RSUs and RSAs vested and released during the years ended December 31, 2011, 2010, and 2009 was approximately $5.1 million, $6.2 million, and $3.9 million, respectively. The intrinsic value of vested and released RSUs and RSAs is calculated by multiplying the fair market value of the Company's stock on the vesting date by the number of shares vested. As of December 31, 2011, the number of RSUs and RSAs outstanding and expected to vest was 2,368,063, with a total intrinsic value of $11.5 million. The intrinsic value of the outstanding and expected to vest RSUs and RSAs is calculated based on the market value of the Company's closing stock price of $4.87 as of December 30, 2011, the last market trading day of 2011.

The following table provides additional information for significant ranges of outstanding and exercisable stock options and stock appreciation rights as of December 31, 2011:

	Exercise Price Range	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price per Share	Aggregate Intrinsic Value
	$5.53-$7.46	602,213	3.67	$ 6.67	$ ---
	7.47	635,022	2.37	7.47	---
	7.69	912,303	1.57	7.69	---
	7.89-10.62	475,475	3.00	9.39	---
	10.65-18.55	443,359	1.47	13.30	---
	$20.34-$28.65	35,100	0.56	25.66	---
Outstanding		3,103,472	2.33	$ 8.71	$ ---
Vested and expected to vest		3,055,147	2.33	$ 8.72	$ ---
Exercisable		2,090,675	1.79	$ 9.04	$ ---

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company's closing stock price of $4.87 as of December 30, 2011, which would have been received by the option holders had all option holders exercised their options as of that date.

5. STOCK-BASED COMPENSATION:

(a) Valuation of Options, SARs, and Performance Shares Granted

The Company has elected to use the BSM option-pricing model to estimate the fair value of stock options and SARs that it grants. The BSM model incorporates various assumptions including volatility, expected term of the option from the date of grant to the time of exercise, risk-free interest rates, and dividend yields. The weighted average fair value of options and SARs granted during the years ended December 31, 2011, 2010, and 2009, was $4.05, $3.94, and $4.48, respectively, and was determined using the following weighted average assumptions:

	Year Ended December 31,		
	2011	2010	2009
Expected dividend yield	0.0%	0.0%	0.0%
Risk-free interest rate	1.2%	1.2%	1.8%
Expected volatility	64.2%	67.5%	71.9%
Expected term (in years)	4.1	4.2	4.3

The expected dividend yield reflects the fact that the Company has not paid any dividends in the past and does not currently intend to pay dividends in the foreseeable future. The risk-free interest rate assumption is based on U.S. Treasury yields in effect at the time of grant for the expected term of the option. The expected volatility is based on both the historical volatility of the Company's common stock over the most recent period commensurate with the expected life of the option as well as on implied volatility calculated from the market traded options on the Company's stock. The expected term has been calculated by applying a Monte Carlo simulation model that incorporates the Company's historical data on post-vest exercise activity and employee termination behavior.

The grant date fair value of RSUs and RSAs granted to employees is determined by multiplying the fair market value of the Company's stock on the grant date times the number of RSUs and RSAs awarded. During 2011, the Company issued a limited number of performance shares to non-employee consultants. The final measurement date for these awards is determined at the earlier of the date at which a commitment for performance by the consultant to earn the performance shares is reached, or the date at which the consultant's performance necessary for the performance shares to vest has been completed. Between the date of issuance and the final measurement date, which is expected to be the date the consultants' performance is complete and the awards vest, the awards are remeasured based on the fair market value of the Company's stock at each reporting date. During the year ended December 31, 2011, awards granted to non-employee consultants and the related share-based payment expense was not significant.

(b) Equity Compensation Expense for RSUs and RSAs with Financial or other Performance-Based Vesting Requirements

As of December 31, 2011, there were 654,090 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 December 31, 2011 (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
May 2009	72,019	$ 529	$ 463	$ 66	May 2014
Aug 2010	330,000	2,449	1,521	928	April 2015
April 2011	35,000	311	153	158	April 2015
May 2011	40,000	425	188	237	April 2015
Aug 2011	127,071	1,150	754	396	March 2012
Nov 2011	50,000	276	17	259	April 2015
Total	654,090	$ 5,140	$ 3,096	$ 2,044	

Through December 31, 2011, cumulative compensation expense of $3.1 million associated with these 654,090 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 654,090 awards that are considered probable of achievement, the unearned compensation expense of $2.0 million is expected to be recognized over estimated service and performance periods ranging from 2.5 months to 3.9 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.

(c) Expense Allocation

Compensation expense for all share-based payment awards has been recognized using the accelerated multiple-option approach. As stock-based compensation expense recognized in the Consolidated Statements of Operations for the years ended December 31, 2011, 2010, and 2009 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. Forfeitures are required to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures have been estimated based on historical experience.

As of December 31, 2011, total compensation cost related to non-vested stock options and other equity based awards not yet recognized was $13.6 million, which is expected to be recognized over the next 18 months on a weighted-average basis, and of which $2.0 million relates to awards subject to certain financial-based performance requirements.

The following table summarizes the stock-based compensation expense related to employee stock options and share awards for the years ended December 31, 2011, 2010, and 2009, which was allocated as follows (in thousands):

	Year Ended December 31,		
	2011	2010	2009
Cost of sales – product	$ 864	$ 1,172	$ 1,534
Cost of sales – service	112	125	183
Stock-based compensation expense included in cost of sales	976	1,297	1,717
Product development	3,891	4,185	5,651
Sales and marketing	2,251	2,939	3,421
General and administrative	2,531	3,907	3,614
Stock-based compensation expense included in operating expenses	8,673	11,031	12,686
Total stock-based compensation expense related to stock options and share awards	9,649	12,328	14,403
Tax benefit	--	--	--
Stock-based compensation expense related to stock options and share awards, net of tax	$ 9,649	$ 12,328	$ 14,403

As of December 31, 2011, approximately $38,000 and $23,000 of stock-based compensation expense was capitalized as part of the cost of inventory and deferred cost of goods sold, respectively. As of December 31, 2010, approximately $60,000 and $18,000 of stock-based compensation expense was capitalized as part of the cost of inventory and deferred cost of goods sold, respectively.

6. 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 years ended December 31, 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 Telvent Energia y Medioambiente SA ("Telvent") and Eltel Networks A/S ("Eltel"), value added resellers of the Company's Systems products. For the years ended December 31, 2011, 2010, and 2009, the percentages of the Company's revenues attributable to sales made to these customers were as follows:

	Year Ended December 31,		
	2011	2010	2009
Duke	27.2%	6.3%	10.7%
Telvent	15.7%	2.8%	1.2%
Eltel	11.5%	28.5%	25.3%
EBV/Avnet	9.5%	12.8%	13.6%
Total	63.9%	50.4%	50.8%

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.

Of the percentage of sales made to EBV in 2009, approximately 0.5% related to sales of components the Company sold to EBV, which EBV in turn sold to one of Enel's third party meter manufacturers. Elsewhere in these Consolidated Financial Statements, those sales are reported as Enel Project revenues.

7. GOODWILL:

The carrying amount of goodwill as of December 31, 2011, 2010, and 2009 relates to three acquisitions, including ARIGO Software GmbH ("ARIGO") in 2001, BeAtHome in 2002, and MTC in 2003. The goodwill acquired as part of the ARIGO transaction is valued in Euros, and is therefore subject to foreign currency translation gains and losses. The changes in the carrying amount of goodwill, net for the years ended December 31, 2011 and 2010 are as follows (in thousands):

		Amount
Balance as of December 31, 2009	$	8,496
Unrealized foreign currency translation loss		(180)
Balance as of December 31, 2010		8,316
Unrealized foreign currency translation loss		(81)
Balance as of December 31, 2011	$	8,235

8. COMMITMENTS AND CONTINGENCIES:

(a) Lease Commitments

As discussed in Note 3, the Company accounts for the leases of its corporate headquarters facilities as lease financing obligations. As of December 31, 2011, the future minimum lease payments for the lease financing obligations were as follows (in thousands):

2012	$	3,214
2013		3,254
2014		3,328
2015		3,410
2016		3,493
2017 and thereafter		11,893
Total payments	$	28,592
Amount representing interest		(6,529)
Present value of future minimum lease payments	$	22,063
Lease financing obligations classified as current	$	1,870
Lease financing obligations classified as long-term	$	20,193

The Company also leases facilities under operating leases for its sales, marketing, and product development personnel located elsewhere within the United States and in several foreign countries throughout Europe and Asia, including a land lease for accounting purposes associated with the Company's corporate headquarters facilities. These operating leases expire on various dates through 2020, and in some instances are cancelable with advance notice. Lastly, the Company also leases certain equipment and, for some of its sales personnel, automobiles. These operating leases are generally less than five years in duration. As of December 31, 2011, future minimum lease payments under all operating leases, including $6.3 million related to the land lease associated with the Company's corporate headquarters facilities (see Note 3), were as follows (in thousands):

2012	$	1,445
2013		1,161
2014		988
2015		814
2016		776
2017 and thereafter		2,456
Total	$	7,640

Rent expense for all operating leases was approximately $1.9 million for 2011, $2.1 million for 2010, and $2.0 million for 2009. Although certain of the operating lease agreements provide for escalating rent payments over the term of the lease, rent expense under these agreements is recognized on a straight-line basis. As of December 31, 2011, the Company has accrued approximately $294,000 of deferred rent related to these agreements, of which approximately $44,000 is reflected in current liabilities while the remainder is reflected in other long-term liabilities in the accompanying consolidated balance sheet. As of December 31, 2010, the Company has accrued approximately $347,000 of deferred rent related to these agreements, of which approximately $56,000 is reflected in current liabilities while the remainder is reflected in other long-term liabilities in the accompanying consolidated balance sheet. See Note 3 for explanation of land lease expense on the Company's corporate headquarters facilities.

(b) Royalties

The Company has certain royalty commitments associated with the shipment and licensing of certain of its products. Royalty expense is generally based on a dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which is recorded as a component of cost of product revenues in the Company's consolidated statements of income, was approximately $532,000, $616,000, and $450,000 for the years ended December 31, 2011, 2010, and 2009, respectively.

The Company will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of its products. The Company is currently unable to estimate the maximum amount of these future royalties. However, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

(c) Guarantees

In the normal course of business, the Company provides indemnifications of varying scope to its customers against claims of intellectual property infringement made by third parties arising from the use of its products. Historically, costs related to these indemnification provisions have not been significant. However, the Company is unable to estimate the maximum potential impact of these indemnification provisions on its future results of operations.

As permitted under Delaware law, the Company has entered into agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company's request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. However, the Company has directors and officers insurance coverage that would enable it to recover a portion of any future amounts paid. The Company believes the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

(d) Taxes

The Company conducts operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on the Company's operations in that particular location. While the Company strives to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with accounting principles generally accepted in the United States of America, the Company makes a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and the Company believes that, as of December 31, 2011, it has adequately provided for such contingencies. However, it is possible that the Company's results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where the Company conducts its operations.

(e) 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 December 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.

(f) 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 December 31, 2011, the Company was in compliance with these covenants. As of December 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.

9. INCOME TAXES:

The provision for income taxes attributable to continuing operations is based upon income (loss) before income taxes from continuing operations as follows (in thousands):

	Year Ended December 31,		
	2011	2010	2009
Domestic	$ (13,782)	$ (31,730)	$ (32,793)
Foreign	1,111	719	502
	$ (12,671)	$ (31,011)	$ (32,291)

The provision for income taxes consists of the following (in thousands):

	Year Ended December 31,		
	2011	2010	2009
Federal:			
Current	$ ---	$ ---	$ (392)
Deferred	---	---	---
Total federal provision	---	---	(392)
State:			
Current	4	4	4
Deferred	---	---	---
Total state provision	4	4	4
Foreign:			
Current	325	297	131
Deferred	---	---	---
Total foreign provision	325	297	131
Total income tax expense (benefit)	$ 329	$ 301	$ (257)

The provision for income taxes differs from the amount estimated by applying the statutory Federal income tax rate to income before taxes as follows (in thousands):

	Year Ended December 31, 2011	2010	2009
Federal tax at statutory rate of 35%	$ (4,435)	$ (10,854)	$ (11,302)
State taxes, net of federal benefit	3	2	2
U.S.-Foreign rate differential	(46)	42	140
Change in Valuation Allowance	4,825	11,136	11,052
Others	(18)	(25)	(149)
Total income tax expense (benefit)	$ 329	$ 301	$ (257)

As of December 31, 2011 and 2010, a valuation allowance has been recorded for the entire gross deferred tax asset as a result of uncertainties regarding the realization of the asset balance. As of December 31, 2011 and 2010, the Company had no significant deferred tax liabilities. The components of the net deferred income tax asset are as follows (in thousands):

	December 31, 2011	2010
Net operating loss carry forwards	$ 53,477	$ 59,724
Tax credit carry forwards	19,902	18,274
Fixed and intangible assets	7,501	7,349
Capitalized research and development costs	37	37
Reserves and other cumulative temporary differences	22,878	24,924
Gross deferred income tax assets	103,795	110,308
Valuation allowance	(103,795)	(110,308)
Net deferred income tax assets	$ ---	$ ---

As of December 31, 2011, part of the Company's valuation allowance on deferred tax assets pertains to certain tax credits and net operating loss carry forwards. In the future, we will reduce the valuation allowance associated with these credits and losses upon the earlier of the period in which we utilize them to reduce the amount of income tax we would otherwise be required to pay on our income tax returns, or when it becomes more likely than not that the deferred tax assets are realizable. In addition, the Internal Revenue Code of 1986, as amended, contains provisions that limit the net operating loss and credit carryforwards available for use in any given period upon the occurrence of certain events, including a significant change in ownership interests. The Company performed an analysis of the ownership changes in 2001. Since that time, some ownership changes may have occurred, which could cause certain of the Company's net operating loss and credit carryforwards to be limited in future periods.

As of December 31, 2011, the Company had net operating loss carryforwards of $179.1 million for federal income tax reporting purposes and $78.9 million for state income tax reporting purposes, which expire at various dates through 2031. Of these amounts, a significant portion represents federal and state tax deductions from stock option compensation. The tax benefit from these deductions will be recorded as an adjustment to additional paid-in capital in the year in which the benefit is realized. In addition, as of December 31, 2011, the Company had approximately $11.1 million and $13.4 million of tax credit carryforwards for increased research expenditures for federal and California purposes, respectively. The federal research tax credits will expire at various dates if not utilized by 2031 and the state tax credit can be carried over indefinitely. In accordance with current Internal Revenue Code rules, federal net operating loss carryforwards must be utilized in full before federal research and development tax credits can be used to offset current tax liabilities. As a result, depending on the Company's future taxable income in any given year, some or all of the federal increased research tax credits, as well as portions of the Company's federal and state net operating loss carryforwards, may expire before being utilized.

Amounts held by foreign subsidiaries are generally subject to United States income taxation on repatriation to the United States. The Company currently intends to permanently reinvest its undistributed earnings from its foreign subsidiaries outside the United States and United States income taxes have not been provided on cumulative total earnings of $9.2 million. It is not practicable to determine the income tax liability that might be incurred if these earnings were to be distributed.

The following is a rollforward of the Company's uncertain tax positions for the years ended December 31, 2011 and 2010 (in thousands):

	Year Ended December 31, 2011	Year Ended December 31, 2010
Balance as of the beginning of the year	$ 4,537	$ 4,629
Tax positions related to current year:		
Additions	241	340
Reductions	---	---
Tax positions related to prior years:		
Additions	167	575
Reductions	---	(1)
Settlements	---	---
Lapses in statute of limitations	(590)	(1,006)
Balance as of the end of the year	$ 4,355	$ 4,537

Included in the balance of total unrecognized tax benefits at December 31, 2011 are potential benefits of $755,000, which if recognized, would affect the effective rate on income from continuing operations.

On January 1, 2010, the Company had accrued interest and penalties related to the uncertain tax benefits of approximately $224,000. During 2010, the Company decreased the prior year balance by $82,000 and accrued $65,000 of additional penalties and interest. During 2011, the Company decreased the prior year balance by $53,000 and accrued $47,000 of additional penalties and interest.

The Company is subject to taxation in the United States and various state and foreign jurisdictions. In the United States, the tax years from 1993 remain open to examination by federal and most state tax authorities due to certain net operating loss and credit carryforward positions. In the foreign jurisdictions, the number of tax years open to examination by local tax authorities ranges from three to six years.

On December 17, 2010, President Obama signed into law "The Tax Relief, Unemployment Reinsurance Reauthorization and Job Creation Act of 2010." Among many other tax initiatives, the new law extends the 50% bonus depreciation on eligible property through December 31, 2012 and allows for 100% bonus depreciation on eligible property from September 9, 2010 through December 31, 2011. In addition, the federal credit for increased research expenditures has been extended for two years retroactive to January 1, 2010. As the Company anticipates it will continue to be in a tax loss position for 2011, it will forego the bonus depreciation in its U.S. tax filings for the year ended December 31, 2011.

10. WARRANTY RESERVES:

When evaluating the reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical return rates, and historical costs of repair. In addition, certain other applicable factors, such as technical complexity, may also be taken into consideration when historical information is not yet available for recently introduced products. Estimated reserves for warranty costs are generally provided for when the associated revenue is recognized. In addition, additional warranty reserves may be established when the Company becomes aware of a specific warranty related problem, such as a product recall. Such additional warranty reserves are based on the Company's current estimate of the total out-of-pocket costs expected to be incurred to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. The reserve for warranty costs was $875,000 as of December 31, 2011 and $904,000 as of December 31, 2010. Of these amounts, $823,000 and $877,000 were included in Accrued Liabilities as of December 31, 2011 and 2010, respectively, while the remaining $52,000 and $27,000 were included in Other Long-Term Liabilities as of December 31, 2011 and 2010, respectively.

11. RELATED PARTIES:

During the years ended December 31, 2011, 2010, and 2009, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, our former Executive Chairman, M. Kenneth Oshman, used his private plane or charter aircraft for Echelon business for himself and any employees that accompanied him. In August 2008, our board of directors approved a reimbursement arrangement whereby our company would reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. The Compensation Committee of our board of directors reaffirmed this arrangement in February 2011. Such costs included flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. This arrangement was discontinued upon Mr. Oshman's death in August 2011. During the year ended December 31, 2011, we incurred no expenses pursuant to the reimbursement arrangement. While the arrangement was in effect, the Audit Committee of the board of directors regularly reviewed these reimbursements.

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for $130.7 million (see Note 11 to our accompanying consolidated financial statements for additional information on our transactions with Enel). The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our 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 our board of directors. A representative of Enel is not presently serving on our board.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the "R&D Agreement"). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we 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 us. Under the software enhancement agreement, we provide 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.

During 2011, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $7.1 million, none of which was included in accounts receivable, net at December 31, 2011. During 2010, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $4.6 million, none of which was included in accounts receivable, net at December 31, 2010. During 2009, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $10.5 million.

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 the restructuring program (in thousands):

	December 31, 2010	Costs Incurred	Cash Payments	December 31, 2011
Termination benefits	$ 1,158	$ --	$ (1,109)	$ 49

Accrued restructuring charges of approximately $49,000 as of December 31, 2011 comprise the remaining liability balance and are reflected in accrued liabilities on the Consolidated Balance Sheets. The Company expects to pay these accrued termination benefits prior to June 30, 2012.

13. VALUATION AND QUALIFYING ACCOUNTS (in thousands):

	Balance at Beginning of Period	Charged/ (Credited) to Revenues and Expenses	Write-Off of Previously Provided Accounts	Balance at End of Period
Year Ended December 31, 2011:				
Allowance for Doubtful Accounts	$ 361	$ 30	$ 1	$ 390
Allowance for Customer Returns and Sales Credits	$ 584	$ 6,750	$ 5,923	$ 1,411
Year Ended December 31, 2010:				
Allowance for Doubtful Accounts	$ 350	$ 22	$ 11	$ 361
Allowance for Customer Returns and Sales Credits	$ 827	$ 5,396	$ 5,639	$ 584
Year Ended December 31, 2009:				
Allowance for Doubtful Accounts	$ 323	$ 27	$ ---	$ 350
Allowance for Customer Returns and Sales Credits	$ 687	$ 5,441	$ 5,301	$ 827

14. SEGMENT:

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 December 31, 2011 and 2010, long-lived assets of approximately $33.2 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.

The Company has two primary product lines: Systems and Sub-systems. Systems revenue is primarily composed of what the Company previously referred to as Utility revenue, whereas Sub-systems revenue is principally composed of was was previously reported as Commercial and Enel Project revenues. Summary revenue information by product line for the years ended December 31, 2011, 2010, and 2009 is as follows (in thousands):

	Year Ended December 31,		
	2011	2010	2009
Systems	$ 99,428	$ 57,257	$ 48,271
Sub-systems	57,059	53,780	55,067
Total	$ 156,487	$ 111,037	$ 103,338

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 years ended December 31, 2011, 2010, and 2009 is as follows (in thousands):

	Year Ended December 31,		
	2011	2010	2009
Americas:			
United States	$ 58,182	$ 24,275	$ 25,930
Other Americas	2,524	2,494	1,816
Total Americas	60,706	26,769	27,746
EMEA:			
Finland	23,633	2,577	107
Germany	18,455	19,637	18,259
Denmark	17,959	31,680	26,234
Other EMEA	20,201	19,649	21,056
Total EMEA	80,248	73,543	65,656
APJ	15,533	10,725	9,936
Total	$ 156,487	$ 111,037	$ 103,338

For information regarding the Company's major customers, please refer to Note 6, Significant Customers.

15. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED):

The following tables set forth certain consolidated statement of operations data for each of the quarters in 2011 and 2010. This information has been derived from our quarterly unaudited consolidated financial statements. The quarterly unaudited consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements included in this report and include all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of such information when read in conjunction with our annual audited consolidated financial statements and notes appearing in this report. The operating results for any quarter do not necessarily indicate the results for any subsequent period or for the entire fiscal year.

Selected Quarterly Financial Data

	Three Months Ended							
	Dec. 2011	Sep. 2011	June 2011	March 2011	Dec. 2010	Sep. 2010	June 2010	March 2010
Consolidated Statement of Operations Data:	(in thousands, except per share data)							
Revenues:								
Product	$ 39,484	$ 43,010	$ 42,526	$ 27,679	$ 37,897	$ 26,441	$ 25,784	$ 17,319
Service	1,051	817	1,217	703	913	683	1,173	827
Total revenues	40,535	43,827	43,743	28,382	38,810	27,124	26,957	18,146
Cost of revenues:								
Cost of product	24,026	25,419	22,966	14,652	21,325	14,083	15,147	9,167
Cost of service	601	501	573	587	594	567	706	597
Total cost of revenues	24,627	25,920	23,539	15,239	21,919	14,650	15,853	9,764
Gross profit	15,908	17,907	20,204	13,143	16,891	12,474	11,104	8,382
Operating expenses:								
Product development	8,750	7,533	8,874	9,598	10,164	8,438	7,857	8,303
Sales and marketing	6,536	5,885	6,056	7,242	6,599	6,003	5,963	6,497
General and administrative	4,489	3,747	4,771	4,890	4,532	4,756	4,129	4,230
Restructuring charges	---	---	---	---	1,212	---	---	---
Total operating expenses	19,775	17,165	19,701	21,730	22,507	19,197	17,949	19,030
Income (loss) from operations	(3,867)	742	503	(8,587)	(5,616)	(6,723)	(6,845)	(10,648)
Interest and other income (expense), net	129	390	(153)	(360)	13	(559)	504	435
Interest expense on lease financing obligations	(357)	(363)	(371)	(377)	(384)	(390)	(396)	(402)
Income (loss) before provision for income taxes	(4,095)	769	(21)	(9,324)	(5,987)	(7,672)	(6,737)	(10,615)
Income tax expense (benefit)	100	114	120	(5)	49	170	136	(54)
Net income (loss)	$ (4,195)	$ 655	$ (141)	$ (9,319)	$ (6,036)	$ (7,842)	$ (6,873)	$ (10,561)
Income (loss) per share:								
Basic	$ (0.10)	$ 0.02	$ (0.00)	$ (0.22)	$ (0.14)	$ (0.19)	$ (0.17)	$ (0.26)
Diluted	$ (0.10)	$ 0.02	$ (0.00)	$ (0.22)	$ (0.14)	$ (0.19)	$ (0.17)	$ (0.26)
Shares used in net income (loss) per share calculation:								
Basic	42,290	42,232	42,038	41,783	41,639	41,560	41,298	41,072
Diluted	42,290	42,987	42,038	41,783	41,639	41,560	41,298	41,072

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

March 14, 2012

ECHELON CORPORATION

By: /s/ WILLIAM R. SLAKEY

William R. Slakey
Executive Vice President and Chief Financial Officer
(Duly Authorized Officer and Principal Financial Officer)

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Ronald Sege and William R. Slakey his true and lawful attorney-in-fact and agent, with full power of substitution and, for him and in his name, place and stead, in any and all capacities to sign any and all amendments to this Report on Form 10-K, and to file the same, with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

PURSUANT TO THE REQUIREMENTS OF THE SECURITIES EXCHANGE ACT OF 1934, THIS REPORT HAS BEEN SIGNED BY THE FOLLOWING PERSONS ON BEHALF OF THE REGISTRANT AND IN THE CAPACITIES AND ON THE DATES INDICATED.

Signatures	Title	Date
/s/ RONALD SEGE Ronald Sege	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	March 14, 2012
/s/ WILLIAM R. SLAKEY William R. Slakey	Executive Vice President and Chief Financial Officer (Principal Financial Officer)	March 14, 2012
/s/ C. MICHAEL MARSZEWSKI C. Michael Marszewski	Vice President Corporate Controller (Principal Accounting Officer)	March 14, 2012
/s/ ARMAS CLIFFORD MARKKULA, JR. Armas Clifford Markkula, Jr.	Vice Chairman	March 7, 2012
/s/ ROBYN M. DENHOLM Robyn M. Denholm	Director	March 12, 2012
/s/ ROBERT J. FINOCCHIO, JR. Robert J. Finocchio, Jr.	Director	March 10, 2012
/s/ ROBERT R. MAXFIELD Robert R. Maxfield	Director	March 5, 2012
/s/ RICHARD M. MOLEY Richard M. Moley	Director	March 11, 2012
/s/ LARRY W. SONSINI Larry W. Sonsini	Director	March 12, 2012

EXHIBIT INDEX

Exhibit No.	Description of Document
3.2[1]	Amended and Restated Certificate of Incorporation of Registrant.
3.3[2]	Amended and Restated Bylaws of Registrant.
4.1[3]	Form of Registrant's Common Stock Certificate.
4.2[4]	Second Amended and Restated Modification Agreement dated May 15, 1997.
10.1[4]	Form of Indemnification Agreement entered into by Registrant with each of its directors and executive officers.
10.2[10]+	1997 Stock Plan (as amended and restated March 26, 2004)
10.2(a)[5]+	Form of 1997 Stock Plan Stock Option Agreement with early exercise feature
10.2(b)[5]+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement with early exercise feature
10.2(c)[6]+	Form of 1997 Stock Plan Nonqualified Stock Option Agreement
10.2(d)[5]+	Form of 1997 Stock Plan Performance Share Agreement (re: non-standard vesting schedule)
10.2(e)[5]+	Form of 1997 Stock Plan Performance Share Agreement for non-US employees
10.2(f)[5]+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria for non-US employees
10.2(g)[5]+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for non-US employees
10.2(h)[5]+	Form of 1997 Stock Plan Performance Share Agreement with performance based vesting criteria
10.2(i)[5]+	Form of 1997 Stock Plan Performance Share Agreement
10.2(j)[13]+	Form of 1997 Stock Plan Stock Appreciation Right Agreement
10.2(k)[7]+	Form of 1997 Stock Plan Performance Share Agreement for US-based corporate officers
10.2(l)[11]+	Form of 1997 Stock Plan Performance Share Agreement for non US-based corporate officers
10.2(m)[7]+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for US-based corporate officers
10.2(n)[7]+	Form of 1997 Stock Plan Stock Appreciation Right Agreement for non US-based corporate officers
10.2(o)[12]+	Form of 1997 Stock Plan Restricted Stock Award Agreement
10.3[4]+	1988 Stock Option Plan and forms of related agreements.
10.4[4]	Second Amended and Restated Modification Agreement dated May 15, 1997 (included in Exhibit 4.2).
10.5[4]	Form of International Distributor Agreement.
10.6[4]	Form of OEM License Agreement.
10.7[4]	Form of Software License Agreement.
10.8[4]	International Distributor Agreement between the Company and EBV Elektronik GmbH as of December 1, 1997.
10.9[8]+	1998 Director Option Plan.
10.10[9]	Building 1 Lease Agreement dated December 30, 1999
10.11[9]	First Amendment to Building 1 Lease Agreement dated May 10, 2000
10.12[9]	Echelon Corporation Common Stock Purchase Agreement with ENEL S.p.A. dated June 30, 2000
10.13[9]	Second Amendment to Building 1 Lease Agreement dated September 22, 2000
10.14[9]	Building 2 Lease Agreement dated November 15, 2001
10.15[9]	Third Amendment to Building 1 Lease Agreement dated April 10, 2008
10.16[9]	First Amendment to Building 2 Lease Agreement dated April 10, 2008
10.17[14]	Form of Value Added Reseller Agreement
10.18	Assignment and Amendment dated April 29, 2011 between the Company and Avnet Europe Comm VA (assigning and modifying the International Distributor Agreement filed as Exhibit 10.8 to the Registration Statement on Form S-1 filed on June 1, 1998)
10.19+	Echelon Corporation Employment Agreement by and between Echelon Corporation and Ronald A. Sege dated August 18, 2010
10.20+	Echelon Corporation Employment letter with William R. Slakey dated September 6, 2011
21.1[3]	Subsidiaries of the Registrant.
23.1	Consent of KPMG LLP, Independent Registered Public Accounting Firm.
24.1[4]	Power of Attorney (see signature page).
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase
101.DEF*	XBRL Taxonomy Extension Definition Linkbase
101.LAB*	XBRL Taxonomy Extension Label Linkbase

101.PRE* XBRL Taxonomy Extension Presentation Linkbase

* The financial information contained in these XBRL documents is unaudited and is furnished, not filed with the Securities and Exchange Commission.

+ Indicates management contract or compensatory plan or arrangement required to be filed as an exhibit pursuant to Item 14(c) of Form 10-K.

(1) Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2000, filed on November 14, 2000.

(2) Incorporated herein by reference to the Registrant's Current Report on Form 8-K dated August 16, 2007, filed on August 17, 2007.

(3) Incorporated herein by reference to the Registrant's Registration Statement on Form S-1/A filed on July 9, 1998.

(4) Incorporated herein by reference to the Registrant's Registration Statement on Form S-1 filed on June 1, 1998.

(5) Incorporated herein by reference to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2006, filed on March 16, 2007.

(6) Incorporated herein by reference to the Registrant's Current Report Form 8-K dated April 12, 2007, filed on April 18, 2007.

(7) Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2008, filed on August 11, 2008.

(8) Incorporated herein by reference to the Registrant's Registration Statement on Form S-8 filed on August 21, 2000.

(9) Incorporated herein by reference to the Registrant's Annual Report on Form 10-K/A for the fiscal year ended December 31, 2008, filed on March 11, 2010.

(10) Incorporated herein by reference to the Registrant's Registration Statement on Form S-8 filed on June 1, 2005.

(11) Incorporated herein by reference to the Registrant's Registration Statement on Form S-8 filed on August 6, 2010.

(12) Incorporated herein by reference to the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2010, filed on November 3, 2010

(13) Incorporated herein by reference to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2007, filed on March 17, 2008

(14) Incorporated herein by reference to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2009, filed on March 16, 2010

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