SIMTEK CORP
Form DEF 14A
June 07, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Schedule 14A

Proxy Statement Pursuant to Section 14(a)
of the Securities Exchange Act of 1934

Filed by the Registrant [X]
Filed by a Party other than the Registrant [ ]

Check the appropriate box:
[ ] Preliminary Proxy Statement
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[X] Definitive Proxy Statement
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[ ] Soliciting Material Pursuant to s. 240.14a-12

SIMTEK CORPORATION

(Name of Registrant as Specified in its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

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[SIMTEK LOGO]

Dear Fellow Shareholder:

You are invited to attend the annual meeting of the shareholders of Simtek Corporation, a Colorado corporation ("Simtek"), which will be held at The Embassy Suites Hotel, 7290 Commerce Center Dr., Colorado Springs, Colorado, 80919 on June 29, 2006, at 2:00 p.m., local time. We have enclosed a notice of the annual meeting, a proxy statement, a proxy card and a copy of our annual report for the year ended December 31, 2005.

At the annual meeting, our shareholders will:

(i) consider and vote on a proposal to elect two directors to our board of directors, each to serve until the 2007 annual meeting of shareholders and until their successors have been duly elected and qualified;

(ii) consider and vote on a proposal to reincorporate Simtek in the State of Delaware;

(iii) consider and vote on a proposal to effect a reverse split of the outstanding shares of the common stock of Simtek, with the ratio of the reverse split being in the range of one for five (1:5) to one for twenty (1:20), the exact ratio being determined by the board of directors;

(iv) consider and vote on a proposal to ratify the selection of Hein & Associates LLP, independent auditors, as our auditors for the year ending December 31, 2006; and

(v) transact such other business as may properly come before the meeting.

Our board of directors has unanimously approved the proposals and recommends that you vote in favor of the proposals. Whether or not you are personally able to attend the annual meeting, please complete, sign and date the enclosed proxy card and return it in the enclosed prepaid envelope as soon as possible. This action will not limit your right to vote in person if you do wish to attend the meeting and vote personally.

Only holders of our common stock at the close of business on May 17, 2006, the record date, will be entitled to notice of, and to vote at, the annual meeting.

Please review the entire proxy statement carefully. If you would like assistance in completing your proxy card, or if you have any questions about the procedure for voting your shares described in the attached proxy statement, please contact Mr. Brian Alleman, our Chief Financial Officer, at (719) 531-9444 or Mr. Sheldon Lutch, our Investor Representative, at (212) 268-1816.

Sincerely yours,

/s/Harold Blomquist
Harold Blomquist
Chief Executive Officer

SIMTEK CORPORATION
4250 Buckingham Dr. #100
Colorado Springs, CO 80907
(719) 531-9444

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS
To be held on June 29, 2006

To the Shareholders of Simtek Corporation:

The annual meeting of shareholders of Simtek Corporation, a Colorado corporation ("Simtek"), will be held at 2:00 p.m., local time, on June 29, 2006, at The Embassy Suites Hotel, 7290 Commerce Center Drive, Colorado Springs, Colorado 80919, for purposes of:

(i) considering and voting on a proposal to elect two directors to our board of directors, each to serve until the 2007 annual meeting of shareholders and until their successors have been duly elected and qualified;

(ii) considering and voting on a proposal to reincorporate Simtek in the State of Delaware;

(iii) considering and voting on a proposal to effect a reverse split of the outstanding shares of the common stock of Simtek, with the ratio of the reverse split being in the range of one for five (1:5) to one for twenty (1:20), the exact ratio being determined by the board of directors;

(iv) considering and voting on a proposal to ratify the selection of Hein & Associates LLP, independent auditors, as our auditors for the year ending December 31, 2006; and

(v) transacting such other business as may properly come before the meeting.

Only shareholders of record at the close of business on May 17, 2006, the record date for the meeting, will be entitled to notice of, and to vote at, the annual meeting. A copy of Simtek's annual report for the year ended December 31, 2005, is enclosed. A list of shareholders entitled to vote at the meeting will be kept on file at Simtek's principal office for inspection by any shareholder, for any purpose germane to the meeting, during usual business hours for ten days prior to the meeting.

YOU ARE INVITED TO ATTEND THE ANNUAL MEETING, BUT WHETHER OR NOT YOU PLAN TO BE PRESENT, PLEASE COMPLETE, DATE, SIGN, AND PROMPTLY RETURN THE ACCOMPANYING PROXY IN THE ENCLOSED ENVELOPE, WHICH REQUIRES NO POSTAGE IF MAILED IN THE UNITED STATES.

Our board of directors believes that the proposals are advisable to and in the best interests of us and our shareholders. Our board of directors unanimously recommends that you vote in favor of the proposals.

This notice and the attached proxy statement, proxy card, and annual report are first being mailed to Simtek's shareholders on or about June 8, 2006.

By Order of the Board of Directors,

/s/Brian Alleman
Brian P. Alleman
Corporate Secretary

Colorado Springs, Colorado
June 8, 2006

SIMTEK CORPORATION

4250 Buckingham Dr. #100
Colorado Springs, Colorado 80907
(719) 531-9444

PROXY STATEMENT

The accompanying proxy is being solicited by the board of directors (the "Board") of Simtek Corporation, a Colorado corporation (the "Company" or "Simtek") for use at the Company's annual meeting of shareholders, including any adjournment thereof (the "Annual Meeting").

Time and Place; Purpose

The Annual Meeting will be held at 2:00 p.m., local time, Thursday, June 29, 2006, at The Embassy Suites Hotel, 7290 Commerce Center Drive, Colorado Springs, Colorado 80919. At the Annual Meeting, our shareholders will be asked to consider and vote upon the following proposals (the "Proposals"):

(i) a proposal to elect two directors to the Board, each to serve until the 2007 annual meeting of shareholders and until their successors have been duly elected and qualified;

(ii) a proposal to reincorporate Simtek in the State of Delaware;

(iii) a proposal to effect a reverse split of the outstanding shares of the common stock of Simtek, with the ratio of the reverse split being in the range of one for five (1:5) to one for twenty (1:20), the exact ratio being determined by the Board; and

(iv) a proposal to ratify the selection of Hein & Associates LLP, independent auditors, as our auditors for the year ending December 31, 2006;

and to transact such other business as may properly come before the Annual Meeting.

The Board has determined that the Proposals are advisable to and in the best interests of us and our shareholders. The Board recommends that you vote in favor of the Proposals.

Voting Rights; Record Date

The Board has fixed the close of business on May 17, 2006 as the record date (the "Record Date") for the determination of holders of common stock entitled to receive notice of and to vote at the Annual Meeting. Accordingly, only holders of record of shares of common stock at the close of business on the Record Date are entitled to receive notice of, and to vote at, the meeting. At the close of business on the Record Date, we had outstanding 147,160,823 shares of common stock, par value $0.01 per share (the "Common Stock").

The holders of shares of Common Stock are entitled to one vote per share on each matter that properly comes before the Annual Meeting. The presence, in person or by proxy, of the holders of a majority of the outstanding shares of Common Stock entitled to vote at the Annual Meeting is necessary to constitute a quorum.

Votes Required

In the election of directors, the two candidates receiving the highest number of votes cast (in person or by proxy) in favor of their election are elected to the Board; any shares not voted (whether by withholding the vote, broker non-vote or otherwise) have no impact in the election of directors,

except to the extent the failure to vote for an individual results in another candidate receiving a larger number of votes. With respect to each other proposal, the affirmative vote of a majority of the shares of Common Stock represented in person or by proxy, and entitled to vote, at the Annual Meeting will be required to approve such Proposal; consequently, abstentions and broker non-votes will be treated as votes against for purposes of approving such Proposal.

Proxies

Unless otherwise specified, the shares of Common Stock represented by the accompanying form of proxy, properly executed and returned, will be voted FOR the Proposals as described below. As to any other matters that may properly come before the Annual Meeting, the persons named in the accompanying form of proxy will vote thereon in accordance with their best judgment. Votes will be tabulated by Continental Stock Transfer & Trust Company, the Company's transfer agent for the Common Stock.

Proxies marked "Abstain" with respect to a particular Proposal, shares represented by "broker non-votes" (i.e., shares held by brokers or nominees which are represented at the Annual Meeting but with respect to which the broker or nominee is not empowered to vote on a particular Proposal) and proxies marked "Withhold" as to nominee(s) for the Board will be counted for purposes of determining whether there is a quorum at the meeting, but will not be included in determining the number of votes cast with respect to such matter.

Any person giving a proxy has the right to revoke the proxy at any time before it is voted by giving written notice to the Secretary of the Company. The Company will bear the cost of preparing and mailing proxy materials as well as the cost of soliciting proxies. In addition to solicitation by mail, employees or representatives of the Company may personally solicit proxies. Such persons will receive no additional compensation for such work.

This proxy statement and accompanying form of proxy and annual report are first being mailed to shareholders on or about June 8, 2006.

Annual Report

The Company's annual report to shareholders for the year ended December 31, 2005 is being mailed to the Company's shareholders with this proxy statement.

Common Questions and Answers

Q: WHY AM I RECEIVING THIS PROXY STATEMENT AND PROXY CARD?

A: You are receiving this proxy statement and proxy card from us because you own shares of Common Stock of Simtek. This proxy statement describes issues on which we would like you and that you are entitled, as a shareholder, to vote. It also gives you information on these issues so that you can make an informed decision.

When you sign the proxy card, you appoint Harold A. Blomquist, Chief Executive Officer, and Brian Alleman, Chief Financial Officer, as your representatives at the annual meeting of shareholders. Harold A. Blomquist and Brian Alleman will vote your shares, as you have instructed them in the proxy card, at the meeting. This way, your shares will be voted whether or not you attend the annual meeting. Even if you plan to attend the meeting, it is a good idea to complete, sign and return your proxy card in advance of the meeting just in case your plans change. If you have signed and returned the proxy card and an issue comes up for a vote at the meeting that is not identified in this proxy statement, Harold A. Blomquist and Brian Alleman will vote your shares on such issue in accordance with their best judgment.

Q: WHY IS THE BOARD PROPOSING TO REINCORPORATE IN DELAWARE?

A: Delaware is a nationally recognized leader in adopting, implementing and interpreting comprehensive and flexible corporate laws. Such laws are frequently revised and updated to accommodate changing legal and business needs and are more comprehensive, widely used and interpreted than other state corporate laws, including the Colorado corporate laws. Delaware courts have developed considerable expertise in dealing with corporate legal issues and produced a

substantial body of case law construing Delaware corporate law, with multiple cases concerning areas that no Colorado court has considered. Because our judicial system is based largely on legal precedents, the abundance of Delaware case law should serve to enhance the relative clarity and predictability of many areas of corporate law, which should offer added advantages to Simtek by allowing the Board and management to make corporate decisions and take corporate actions with greater assurance as to the validity and consequences of those decisions and actions.

Reincorporation from Colorado to Delaware may also make it easier to attract future candidates willing to serve on the Board, because many such candidates are already familiar with Delaware corporate law, including provisions relating to director indemnification, from their past business experience. Based on publicly available data, over half of publicly-traded corporations in the United States and 58% of the Fortune 500 companies are incorporated in Delaware. See the section entitled, "Proposal 2--Reincorporation as a Delaware Corporation--Reasons for the Reincorporation", on page 25 for more information.

Q: WHAT ARE THE PRINCIPAL FEATURES AND EFFECTS OF THE REINCORPORATION?

A: If Simtek reincorporates into Delaware, the affairs of Simtek will cease to be governed by Colorado corporation laws and will become subject to Delaware corporation laws. Upon the reincorporation, Simtek would be governed by a new Delaware certificate of incorporation and new Delaware bylaws. Apart from being governed by these new charter documents and Delaware corporation law, for all other purposes, the resulting Delaware corporation will be the same entity as Simtek: it will continue with all of the assets, properties and liabilities of Simtek and will continue with all of the same officers and directors of Simtek. The reincorporation will not result in any change in headquarters, business, jobs, management, location of any of our offices or facilities, number of employees. The reincorporation will not result in a change in the name of the company and will not result in a change in Simtek's current trading status on the Over-The-Counter Electronic Bulletin Board. Our subsidiaries will remain unchanged as a result of the reincorporation.

The reincorporation will be effected pursuant to a conversion agreement to be entered into by Simtek, which will provide, among other things, that each outstanding share of Common Stock of Simtek will automatically be converted into one share of common stock of the resulting Delaware corporation. If the reverse split proposal (as discussed below) is approved and the reverse split is effected incident to the reincorporation, the conversion agreement will instead provide that the outstanding shares of Common Stock of Simtek would be automatically converted into a lesser number of shares of common stock of the resulting Delaware corporation, such lesser number to be calculated in accordance with the selected reverse split ratio. See the sections entitled, "Proposal 2--Reincorporation as a Delaware Corporation--Summary", "--General", "--No Change in Business, Jobs, Physical Location, Etc." "--The Conversion Agreement", on pages 25 to 27 for more information.

Q: WHY IS THE BOARD PROPOSING A REVERSE STOCK SPLIT?

A: The reverse split is primarily intended to increase Simtek's per share stock price to enable Simtek to be listed on either the NASDAQ Capital Market (formerly the NASDAQ SmallCap Market) or the American Stock Exchange and to increase the attractiveness of the Common Stock to prospective investors and the financial community. Currently, the Common Stock is traded on the Over-The-Counter Electronic Bulletin Board or the "pink sheets" (under the symbol "SRAM"). The Company believes that current and prospective investors will view an investment in the Common Stock more favorably if the shares are listed on the NASDAQ Capital Market or the American Stock Exchange than if the Common Stock trades on the Over-The-Counter Electronic Bulletin Board. In addition, the Company also believes that prospective and actual customers, partners and employees will view being listed on the NASDAQ Capital Market or the American Stock Exchange more favorably.

Q: WHAT ARE THE PRINCIPAL FEATURES AND EFFECTS OF THE REVERSE STOCK SPLIT?

The Board is proposing a reverse split of all of the outstanding shares of Common Stock, with the ratio of the reverse split being in the range of one for five (1:5) to one for twenty (1:20), the exact ratio to be determined by the Board. The table below demonstrates the effect on the number of shares of Common Stock outstanding as a result of the reverse split at various ratios. The table below assumes there are 147,160,823 shares of Common Stock outstanding on the date the reverse split is effected (which was the share number on May 17, 2006).

Ratio of Reverse Split	Resulting # of Shares Outstanding
One for Five (1:5)	29,432,164.6
One for Ten (1:10)	14,716,082.3
One for Fifteen (1:15)	9,810,721.5
One for Twenty (1:20)	7,358,041.2

The immediate effect of reducing the number of shares of our Common Stock outstanding would be to increase the trading price of our Common Stock. However, we cannot assure you that the trading price of our Common Stock after the reverse split will rise in inverse proportion to the reduction in the number of shares of our Common Stock outstanding. The share price following the reverse split will depend on the ratio selected and the reaction of the public market for Common Stock, as well as other factors, all as discussed in greater detail in the section entitled, "Proposal 3--Reverse Split--Certain Risk Factors Associated With the Reverse Split", on page 39.

The reverse split will not have any dilutive effect on the Company's shareholders since each shareholder would hold the same percentage of Common Stock outstanding immediately following the reverse split as such shareholder held immediately prior to the reverse split. The Reverse Split would not affect the relative voting and other rights that accompany the shares of Common Stock. The Board also proposes to reduce the number of authorized shares following the reverse split so that there is not an excessive amount of authorized shares and so that, if Simtek reincorporates into Delaware, Simtek is not obligated to pay an excessive amount of franchise taxes (which are calculated in Delaware, in part, by the number of authorized shares). See the section entitled, "Proposal 3--Reverse Split--Proportionate Reduction of Authorized Shares", on page 37 for more information.

Q: DOES THE BOARD RECOMMEND VOTING IN FAVOR OF THE PROPOSALS?

A: Yes, the Board recommends that the shareholders vote "FOR" all the Proposals.

Election of Directors. The Board recommends that the shareholders vote "FOR" the two nominees to the Board, Messrs. Ronald Sartore and Alfred J. Stein, whose terms of office will expire at the Annual Meeting.

Reincorporation. The Board has determined that the reincorporation into Delaware is in the best interests of Simtek and its shareholders because Delaware has adopted, implemented and interpreted comprehensive and flexible corporate laws responsive to the legal and business needs of corporations, providing more flexibility in practice and more certainty in interpretation and application than currently exists under the corporate laws of Colorado; accordingly, the Board recommends that Simtek shareholders vote "FOR" the reincorporation into Delaware.

Reverse Split. The Board has determined that the reverse split is in the best interests of Simtek and its shareholders in order to increase Simtek's per share stock price to enable Simtek to be listed on either the NASDAQ Capital Market (formerly the NASDAQ SmallCap Market) or the American Stock Exchange and to increase the attractiveness of the Common Stock to prospective investors and the financial community; accordingly, the Board recommends that Simtek shareholders vote "FOR" the reverse split.

Ratification of Auditors. The Board recommends that the shareholders vote "FOR" the ratification of the selection of Hein & Associates LLP, independent auditors, as Simtek's auditors for the year ending December 31, 2006.

Q: WHAT IS THE PROCEDURE FOR VOTING?

A: You may vote either by mail or in person at the annual meeting. To vote by mail, please complete, date, sign, and promptly return the accompanying proxy card in the enclosed envelope, which requires no postage if mailed in the United States. If you mark your proxy card to indicate how you want your shares voted on each Proposal, your shares will be voted as you instruct. If you sign and return your proxy card but do not mark the card to provide voting instructions, the shares represented by your proxy card will be voted "FOR" each of the Proposals.

If you want to vote in person, please come to the annual meeting. We will be passing out written ballots to anyone who wants to vote at the meeting.

Please note, however, that if your shares are held in the name of your broker (or in what is usually referred to as "street name"), you will need to arrange to obtain a proxy from your broker in order to vote in person at the meeting.

Q: DO I HAVE DISSENTERS' RIGHTS?

A: No, under Colorado law shareholders are not entitled to dissenters' rights with respect to the reincorporation/conversion or the reverse split, and we will not independently provide shareholders with any such right.

Q: WHAT DO I DO WITH MY STOCK CERTIFICATES?

A: Only if and when the reverse split is effected will shareholders need to exchange their stock certificates. If and when the reverse split is effected, Simtek's transfer agent will send you a transmittal letter containing instructions on how to exchange your certificate(s) representing your shares of the Common Stock of Simtek for certificates representing the appropriate number of whole shares of Common Stock of Simtek (or, if the reincorporation is effected, common stock of the resulting Delaware corporation) as a result of the reverse split. See the section entitled, "Proposal 3--Reverse Split--Effect On Registered Certificated Shares", on page 39 for more information.

PROPOSAL 1 - ELECTION OF DIRECTORS

The Company's amended and restated articles of incorporation and bylaws provide that if the Board consists of six or more persons, then the members of the Board shall be divided into three classes, each class to be as nearly equal in number as possible. The Board is currently divided into three classes, two classes consisting of two directors and the third consisting of one director, with each class having a three-year term. Vacancies on the Board may be filled only by persons elected by a majority of the remaining directors. A director elected by the Board to fill a vacancy (including a vacancy created by an increase in the Board) will serve for the remainder of the full term of the class of directors in which the vacancy occurred and until the director's successor is elected and qualified.

The Board presently consists of five members. There are two Class 2 Directors, Messrs. Ronald Sartore and Alfred J. Stein, whose terms of office will expire at the Annual Meeting. The Board has nominated each of Mr. Sartore and Mr. Stein for re-election. Proxies cannot be voted for a greater number of persons than the number of nominees named. If elected at the Annual Meeting, each of the nominees would serve until the 2009 annual meeting and until his successor is elected and has qualified, or until such director's earlier death, resignation or removal.

If the Company reincorporates as a Delaware corporation pursuant to Proposal 2 below, the Company's initial Delaware certificate of incorporation and bylaws will not provide that the Board will be divided into classes and will, instead, provide that each director be elected annually. Consequently, assuming that Proposal 2 is approved, our initial Delaware certificate of incorporation and bylaws will provide that all of our directors (including Messrs. Sartore and Stein) would be subject to re-election at the 2007 annual meeting for one-year terms (and not for three-year terms). The provisions of the reincorporation as a Delaware corporation, including the election of directors of such Delaware corporation, are explained in greater detail in Proposal 2 below.

Directors are elected by a plurality of the votes present in person or represented by proxy, and entitled to vote, at the meeting. Shares represented by executed proxies will be voted, if authority to do so is not withheld, for the election of Messrs. Sartore and Stein. In the event that any nominee should be unavailable for election as a result of an unexpected occurrence, such shares will be voted for the election of such substitute nominee as management may propose. Each person nominated for election has agreed to serve if elected, and management has no reason to believe that any nominee will be unable to serve.

Set forth below is biographical information for each person nominated and each person whose term of office as a director will continue after the Annual Meeting. Ages are as of May 17, 2006, the Record Date.

Nominees for Election for a Three-Year Term Expiring at the 2009 Annual Meeting (If Proposal 2 is NOT Approved) or a One-Year Term (If Proposal 2 is Approved)

Ronald Sartore has served as a director since March 2004, which term expires in 2006. Mr. Sartore has over 30 years experience in the industry and is currently an executive consultant in the field of computers and semiconductors. From May of 1999 until May of 2006 he served various engineering and business roles as a Vice President within Cypress Semiconductor Corporation's Consumer and Computation Division. Mr. Sartore joined Cypress Semiconductor Corporation, or "Cypress," after Cypress's May 1999 accretive acquisition of Anchor Chips, where he was its CEO and President. Mr. Sartore founded Anchor Chips in 1995 and secured $9.5 million in funding from its majority owner: South Korea's LG Semicon. Prior to that, Mr. Sartore worked as a systems architect for San Diego based AMCC. Previous to AMCC, Mr. Sartore was a technical consultant for Array Microsystems, and an employee of Maximum Storage, both in Colorado Springs. In 1985, Mr. Sartore co-founded Cheetah International, a manufacturer of personal computers and peripherals until its acquisition by Northgate Computers in 1990. Cheetah's products, designed by Mr. Sartore, have received acclaim for their high performance and were the subject of articles in numerous trade magazines. Prior to Cheetah, Mr. Sartore has held technical design positions in the following companies: Inmos, in Colorado Springs, Colorado; Synercom Technology, in Sugarland, Texas; Texas Instruments, in Stafford, Texas; NCR, in Millsboro, Delaware; and Sperry Univac, in Blue Bell, Pennsylvania. Mr. Sartore currently holds 13 US patents and obtained a BS degree in Electrical Engineering from Purdue University.

Alfred J. Stein has served as a director since March 2004, which term expires in 2006. He is currently a Consultant and Advisor to startup companies in the high technology industry. He previously served at VLSI Technology, Inc. as Chairman of the Board and Chief Executive Officer from 1982 until its acquisition by Philips Electronics in 1999. During his tenure, VLSI grew from a venture capital funded start-up to a publicly traded company with revenues in excess of $600 million and over 2,200 employees in more than 25 locations around the world. For more than 45 years, Mr. Stein has played a significant role in the high tech industry, including senior management assignments at both Texas Instruments and Motorola. Mr. Stein was with Texas Instruments for 18 years from 1958 through 1976; his last position was Vice President and General Manager for the Electronics Devices Division. Mr. Stein was with Motorola for five years where he was Vice President and Assistant General Manager of Motorola's Semiconductor Sector. He joined VLSI Technology from Arrow Electronics where he had been that company's Chief Executive Officer. Mr. Stein is on the Board of Directors of two publicly traded companies, Advanced Power Technology and ESS Technology, as well as several private startup companies. He also has served on the board of directors at Applied Materials, Radio Shack Corporation and was Chairman of the Board for the Semiconductor Industry Association (SIA). He served on the Board of Trustees for St. Mary's University of Texas.

THE BOARD RECOMMENDS THAT SHAREHOLDERS VOTE "FOR" EACH NAMED NOMINEE.

Director Continuing in Office Until the 2007 Annual Meeting (Regardless of Whether Proposal 2 is Approved)

Robert H. Keeley has served as a director since May 1993. Dr. Keeley's current term of office as a director expires at the 2007 annual meeting. He is currently Professor (Emeritus) at the University of Colorado at Colorado Springs where he served as the El Pomar Professor of Business Finance from 1992 until 2004. From 1986 to 1992, Dr. Keeley was a professor in the Department of Industrial Engineering and Engineering Management at Stanford University. Prior to joining Stanford, he was a general partner of Hill and Carmen (formerly Hill, Keeley and Kirby), a venture capital firm. Dr. Keeley holds a Bachelor's degree in electrical engineering from Stanford University, an M.B.A. from Harvard University, where he was a Baker Scholar, and a Ph.D. in business administration from Stanford University. Dr. Keeley is a director and president of a private company in the wind energy business, and a director of two other private companies.

Directors Continuing in Office Until the 2008 Annual Meeting (If Proposal 2 is NOT Approved) or Until the 2007 Annual Meeting (If Proposal 2 is Approved)

Harold A. Blomquist was originally appointed as a director in May 1998, resigned from the Board in July 2001 to avoid a potential conflict of interest with his employer and was re-appointed in January 2002. Mr. Blomquist's current term of office as a director expires at the 2008 annual meeting (or, if the reincorporation is consummated, at the 2007 annual meeting). In October 2003, Mr. Blomquist was elected to the position of Chairman of the Board of Directors. Mr. Blomquist has served as Chief Executive Officer and President of the Company since May 2005. He served as a Director on the Board of Microsemi, Inc. from February 2003 to February 2006, and as a consultant to venture investors and early stage technology companies in the semiconductor and electronic components areas. In the past, he was employed as President and Chief Executive Officer of Morpho Technologies, Inc., and Chief Executive Officer of Tower Semiconductor, USA, Inc. Mr. Blomquist served as a member of the Board of Directors of AMIS Holding Co. and Sr. Vice President of AMI Semiconductors. Prior to joining AMI in April 1990, Mr. Blomquist held positions in engineering, sales, and marketing for several semiconductor firms, including Texas Instruments, Inmos Corporation, and General Semiconductor. Mr. Blomquist was granted a BSEE degree from the University of Utah and also attended the University of Houston, where he pursued a joint Juris Doctor/MBA course of study.

Robert C. Pearson has served as a director since July 2002. Mr. Pearson's current term of office as a director expires at the 2008 annual meeting (or, if the reincorporation is consummated, at the 2007 annual meeting). He joined RENN Capital Group in April 1997 and is Senior Vice President-Investments. From May 1994 to May 1997, Mr. Pearson was an independent financial management consultant

primarily engaged by RENN Capital Group. From May 1990 to May 1994, he served as Chief Financial Officer and Executive Vice President of Thomas Group, Inc., a management consulting firm, where he was instrumental in moving a small privately held company from a start-up to a public company with over $40 million in revenues. Prior to 1990, Mr. Pearson spent 25 years at Texas Instruments where he served in several positions including Vice President-Controller and later as Vice President-Finance. Mr. Pearson holds a BS in Business from the University of Maryland and was a W.A. Paton Scholar with an MBA from the University of Michigan. He is currently a Director of CaminoSoft Corporation and Laserscope, Inc., both of which are publicly held. He is also a Director of eOriginal, Inc., a privately held company.

INFORMATION REGARDING THE BOARD AND ITS COMMITTEES

Meetings and Committees of the Board

Our business, property and affairs are managed under the direction of the Board and its committees. Members of the Board are kept informed of our business through discussions with our Chairman and our Chief Executive Officer and other officers and employees, by reviewing materials provided to them, by visiting our offices and by participating in meetings of the Board and its committees.

During the fiscal year ended December 31, 2005, the Board held eleven meetings. During that same period, the Board acted by unanimous consent six times.

The Board has an Audit Committee, a Compensation Committee, and a Governance Committee. Below is the information that provides membership and meeting information for each of the Board committees. In fiscal year 2005, each committee member attended 100% of the meetings of each applicable committee held after becoming a member of that committee.

Audit Committee. The Audit Committee consists of Robert Keeley, who serves as the committee's chairperson, and Alfred Stein. The Audit Committee held two meetings during the fiscal year 2005.

Compensation Committee. The Compensation Committee consists of Ronald Sartore, who serves as the committee's chairperson, Robert Pearson and Harold Blomquist. The Compensation Committee held two meetings during the fiscal year 2005. During that same period, the Compensation Committee acted by unanimous consent five times.

Governance Committee. The Governance Committee consists of Alfred Stein, who serves as the committee's chairperson, Harold Blomquist, and Ronald Sartore. The Governance Committee acts by unanimous consent and they acted zero times during the fiscal year 2005.

Below is a description of each committee of the Board. Each of the committees has authority to engage legal counsel or other experts or consultants as it deems appropriate to carry out its responsibilities

Audit Committee. The Board has established an Audit Committee in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended. The Audit Committee consists of Robert Keeley, who serves as the committee's chairperson, and Alfred Stein. The Audit Committee assists the Board in its oversight of the integrity of the Company's accounting, auditing, and reporting practices. The Board has determined that Dr. Keeley has the requisite education, background or experience to be considered an "audit committee financial expert" as that term is defined by applicable SEC rules. All members of the Audit Committee are "independent" under current NASDAQ Stock Market, Inc. listing standards.

Compensation Committee. The primary responsibilities of the Compensation Committee are to review and recommend to the Board the compensation of the Chief Executive Officer of the Company, determine the amounts and recipients of stock options and perform such other functions regarding compensation as the Board may delegate. The Compensation Committee consists of Messrs. Sartore, Blomquist, and Pearson. Mr. Pearson is independent and Messrs. Sartore and Blomquist are not independent, in each case according to standards for independence under current NASDAQ Stock Market, Inc. listing standards. Mr. Sartore was independent according to standards for independence under current NASDAQ Stock Market, Inc. listing standards until the Company entered into a preliminary consulting agreement with him in May 2006, as described in further detail in the Form 8-K filed by the Company on May 30, 2006.

Governance Committee. The primary responsibilities of the Governance Committee are to ensure company compliance with the SEC and other government regulations concerning the conduct of the Company, its officers, directors and employees. The Governance Committee does not have a written charter. The Governance Committee responsibilities also include nomination for membership to the Board. The Governance Committee consists of Messrs. Stein, Blomquist, and Sartore. Mr. Stein is independent, and Messrs. Sartore and Blomquist are not independent, in each case according to standards for independence under current NASDAQ Stock Market, Inc. listing standards. Mr. Sartore was independent according to standards for independence under current NASDAQ Stock Market, Inc. listing standards until the Company entered into a preliminary consulting agreement with him in May 2006, as described in further detail in the Form 8-K filed by the Company on May 30, 2006. The governance committee will consider Board nominees recommended by shareholders. Any such suggestions in connection with the 2007 annual meeting should be made to the Governance Committee (in care of the Company at its principal executive offices) by delivering notice to our Secretary at our principal executive offices in accordance with the provisions of our bylaws and the provisions set forth herein under the heading "Shareholder Proposals." The notice must contain certain prescribed information about the proponent and the nominee(s), including such information about the nominee(s) as would have been required to be included in a proxy statement filed pursuant to the rules of the SEC had such nominee been nominated by the Board. There is not a specific, minimum set of qualifications that must be met by a nominee for such nominee to be recommended for a position by the Governance Committee on the Board. On a case by case basis the Governance Committee will assess the specific needs of the Board in terms of a desirable skill set in a potential nominee. The background of a potential nominee should include extensive executive experience in an area of specific interest to the Board. The Company operates to the highest ethical standards; consequently, any potential nominee must also.

The Governance Committee conducts informal self-evaluations of the composition and size of the Board on a periodic basis. As a need is observed, the Governance Committee will recommend to the Board that it consider new directors and seek input from the Board regarding desired skills in new candidates. The Committee has, in the past, used formal and informal networking to identify and evaluate potential candidates. Similar to any nominee identified by the Committee, any potential nominee submitted for consideration by a shareholder would first be vetted against a perceived need existing on the Board, and would then be evaluated against other candidates for the position based on the merits of his/her background in comparison to other candidates. We have not, in the past, used a third party to identify or evaluate potential nominees.

The Board has not established a formal process for shareholders to follow to send communications to the Board or its members. The Company's policy is to forward to the directors any shareholder correspondence it receives that is addressed to them. Shareholders who wish to communicate with the directors may do so by sending their correspondence addressed to the Board at the Company's headquarters at 4250 Buckingham Drive, Suite 100, Colorado Springs, CO 80907 or via an email weblink "information @Simtek.com" on the Company's website.

Statement on Corporate Governance

We regularly monitor developments in the area of corporate governance by reviewing new federal laws affecting corporate governance, such as the Sarbanes-Oxley Act of 2002, as well as rules adopted by the SEC. In response to those developments, we review our processes and procedures and implement corporate governance practices which we believe are in the best interest of the Company and its shareholders.

The Board has approved a Code of Business Conduct and Ethics (collectively, the "Code of Conduct"), posted on the Company's website under "Company." Employees and directors are required to report any conduct that they believe in good faith to be an actual or apparent violation of the Code of Conduct.

Director Compensation Overview

Beginning March 2004, each director who was not an employee received $1,500 for each meeting of the Board, attended in person, and $500 for each meeting of a committee of the Board. Beginning January 1, 2005, each director of the Board also received a $10,000 annual stipend; the stipend is paid quarterly. Beginning

May 25, 2006, each director who was not an employee received half of the normal fees for Board and committee meetings attended telephonically. Upon initial appointment or election to the Board, each newly appointed or elected member receives options to purchase 150,000 shares of the Company's Common Stock. Each member of the Board receives, within the first month of each calendar year, while serving as a member of the Board, a grant of options to purchase 37,500 shares of the Company's Common Stock. Along with the above compensation, the Chairman of the Board receives $4,000 per calendar quarter, as long as the Chairman is not an employee. Directors are also reimbursed for their reasonable out-of-pocket expenses incurred in connection with their duties to us.

Director's Attendance at Annual Shareholder Meetings

The Company has no written policy regarding the attendance of its board members at annual shareholder meetings. However, all board members attended the Company's 2005 annual shareholder meeting.

Compensation Committee Interlocks and Insider Participation

The Compensation Committee, during fiscal year 2005, consisted of Ronald Sartore, Robert Pearson, Douglas Mitchell (until May 2005) and Harold Blomquist (beginning May 2005). Mr. Mitchell was our Chief Executive Officer, President and Chief Financial Officer (acting), as well as the Chairman of our subsidiary, Q-DOT, Inc., until he resigned from such positions on May 9, 2005. Mr. Blomquist has been the Chairman of the Board of Directors since October 2003, and has been our Chief Executive Officer and President since May 9, 2005. On June 28, 2005, we issued to Renaissance Capital Growth and Income Fund III, Inc., Renaissance US Growth Investment Trust PLC and BFSUS Special Opportunities Trust PLC, which are managed by RENN Capital Group, warrants to purchase 200,000 shares of our common stock at $0.50 per share with an exercise period of 5 years. These warrants were issued in exchange for an agreement to delay making principal redemption installments under the 7.50% Convertible Debentures issued by Simtek in 2002 in the aggregate principal amount of $3,000,000. In connection with the sale of $11,000,000 of our common stock on December 30, 2005, instead of lowering the conversion price of the Convertible Debentures, as required by the terms of the Convertible Debentures, from $0.312 per share to $0.16 per share as a result of the December 30, 2005 offering at $0.16 per share, we agreed with the RENN Capital Group that the conversion price would only be lowered to $0.22 per share as a result of the December 30, 2005 offering. As a result, instead of just 9,615,384 shares issuable upon conversion of the Convertible Debentures (which would be the case were the conversion price still $0.312 per share), there are currently a total of 13,636,364 shares of common stock that are issuable upon conversion of the debentures as a result of the reduction of the conversion price to $0.22 per share. Also on December 30, 2005, we issued a total of 9,375,000 shares of common stock to Renaissance Capital Growth and Income Fund III, Inc., Renaissance US Growth Investment Trust PLC and BFSUS Special Opportunities Trust PLC in exchange for a total of $1,500,000. RENN Capital Group is the agent for these three investment funds. One of our directors, Robert Pearson, holds the position of Senior Vice President of RENN Capital Group.

DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS

Our directors and executive officers are as follows:

Name	Age	Position
Harold Blomquist.............	54	Chairman of the Board, Chief Executive Officer and
Brian Alleman................	49	Vice President and Chief Financial Officer, Corpora
Alfred Stein.................	73	Director
Robert H. Keeley.............	65	Director
Ronald Sartore...............	56	Director

Robert Pearson................	70	Director

See "Proposal 1--Election of Directors" for the biographies of Messrs. Blomquist, Keeley, Pearson, Sartore and Stein.

Brian Alleman has served as Vice President and Chief Financial Officer at the Company since June of 2005. Mr. Alleman is a partner in the Denver office of Tatum LLC, a national firm of experienced executives serving as full-time, part-time, interim, project, or on-staff professionals to provide executive solutions to companies undertaking significant change. Mr. Alleman has over 25 years of experience in financial management, with 10 years of experience in leading international accounting firms. For nine years prior to joining Tatum, Mr. Alleman served as Vice President and Chief Financial Officer with Centuri Corporation in Penrose, Colorado. Mr. Alleman intends to remain a partner in Tatum, which should allow Simtek access to a variety of professional resources provided by Tatum to its clients. Mr. Alleman holds a Bachelors Degree in Accounting from Seton Hall University and became a Certified Public Accountant in the State of New Jersey in 1980.

Officers serve at the discretion of the Board.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The table below sets forth information regarding ownership of our common stock as of May 17, 2006 by each person who is known by us to beneficially own more than five percent of our common stock, by each director, by each current or former executive officer named in the summary compensation table, and by all directors and current executive officers as a group. Shares issuable within sixty days after May 17, 2006 upon the exercise of options, warrants or debentures are deemed outstanding for the purpose of computing the percentage ownership of persons beneficially owning such options, warrants or debentures but are not deemed outstanding for the purpose of computing the percentage ownership of any other person. Percentage of beneficial ownership of common stock prior to and after the offering is based on 147,160,823 shares of common stock outstanding as of May 17, 2006.

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership	Percent of Class
Robert H. Keeley P. O. Box 240 Hillside, CO 81232	180,007 (1)	*
Harold A. Blomquist 18595 Lake Drive Monument, CO 80132	2,062,978 (2)	1.39%
Robert Pearson 8080 N. Central Expressway, Suite 210-LB59 Dallas, TX 75203	110,007 (3)	*
Ronald Sartore 14445 Cypress Point Poway, CA 92064	257,924 (4)	*
Alfred Stein 410 Old Oak Court Los Altos, CA 94022	198,924 (5)	*
Douglas Mitchell 1775 Sunshine Circle Woodland Park, CO 80863	809,386 (6)	*
Renaissance Capital Growth & Income Fund III, Inc. c/o RENN Capital Group 8080 N. Central Expressway, Suite 210-LB59 Dallas, TX 75203	9,537,782 (7)	6.27%
Renaissance US Growth Investment Trust PLC c/o RENN Capital Group 8080 N. Central Expressway, Suite 210-LB59 Dallas, TX 75203	9,537,783 (8)	6.27%
BFSUS Special Opportunities Trust PLC. c/o RENN Capital Group 8080 N. Central Expressway, Suite 210-LB59 Dallas, TX 75203	8,537,783 (9)	5.62%

SF Capital Partners, Ltd 3600 South Lake Drive St. Francis, WI 53235	10,107,367	6.87%
Cypress Semiconductor Corporation 3901 N. First Street	21,796,428 (10)	13.44%

San Jose, CA 95134		
Crestview Capital Master LLC 95 Revere Drive, Suite A Northbrook, IL 60062	24,296,440	16.51%
Big Bend XXVII Investments, L.P. 3401 Armstrong Avenue Dallas, TX 75205-4100	14,375,000	9.77%
Toibb Investment LLC 6355 Topanga Canyon Blvd., Suite 335 Los Angeles, CA 91367	11,875,000	8.07%
All current executive officers and directors as a group (6 persons)	2,840,396 (11)	1.91%

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* Less than one percent.

(1) Includes 10,000 shares of our common stock held by Dr. Keeley's wife, Sandra D. Keeley. Dr. Keeley disclaims beneficial ownership of these shares. Includes 121,250 shares issuable upon exercise of options. Includes 33,757 shares of restricted common stock that are due, but have not been issued to Dr. Keeley as part of his directors' compensation for the period January 1, 2005 through March 31, 2006.

(2) Includes 800 shares of our common stock that Mr. Blomquist's son personally owns and includes 1,108,472 shares issuable upon exercise of options. Includes 3,706 shares of restricted common stock that are due, but have not been issued to Mr. Blomquist as part of his directors' compensation for the period January 1, 2005 through March 31, 2005, the end of the last quarter before the date he became our chief executive officer.

(3) Includes 76,250 shares issuable upon exercise of options. Includes 33,757 shares of restricted common stock that are due, but have not been issued to Mr. Pearson as part of his directors' compensation for the period January 1, 2005 through March 31, 2006.

(4) Includes 164,167 shares issuable upon exercise of options. Includes 33,757 shares of restricted common stock that are due, but have not been issued to Mr. Sartore as part of his directors' compensation for the period January 1, 2005 through March 31, 2006.

(5) Includes 164,167 shares issuable upon exercise of options. Includes 33,757 shares of restricted common stock that are due, but have not been issued to Mr. Stein as part of his directors' compensation for the period January 1, 2005 through March 31, 2006.

(6) Includes 440,000 shares issuable upon exercise of options. Mr. Mitchell resigned as an officer and director of Simtek and Q-DOT, Inc. on May 9, 2005.

(7) Assumes conversion, at a conversion price of $0.22 per share, of debentures issued to Renaissance Capital Growth & Income Fund III, Inc. for 4,545,455 shares of our common stock. Assumes exercise of warrants held by Renaissance Capital Growth & Income Fund III, Inc. for 316,666 shares of our common stock.

(8) Assumes conversion, at a conversion price of $0.22 per share, of debentures issued to Renaissance US Growth & Investment Trust PLC for 4,545,455 shares of our common stock. Assumes exercise of warrants held by Renaissance US Growth Investment Trust PLC for 316,667 shares of our common stock.

(9) Assumes conversion, at a conversion price of $0.22 per share, of debentures issued to BFSUS Special Opportunities Trust PLC for 4,545,455 shares of our common stock. Assumes exercise of warrants held by BFSUS Special Opportunities Trust PLC for 316,667 shares of our common stock.

(10) Assumes exercise of warrants held by Cypress for 15,055,612 shares of our common stock.

(11) Includes 1,664,862 shares issuable upon exercise of options. Includes 138,734 shares of restricted stock required to be issued for director compensation. Includes 10,000 shares of our common stock held by Dr. Keeley's wife, Sandra D. Keeley, with respect to which Dr. Keeley disclaims beneficial ownership. Includes 800 shares of our common stock that Mr. Blomquist's son personally owns. Does not include the 27,613,348 shares beneficially owned by Renaissance Capital Growth & Income Fund III, Inc., Renaissance US Growth Investment Trust PLC and BFSUS Special Opportunities Trust PLC. RENN Capital Group is agent for these three investment funds. Mr. Robert Pearson is a Senior Vice President of RENN Capital Group. Mr. Pearson also holds the position of a director on Simtek's board of directors.

Section 16(a) Beneficial Ownership Reporting Compliance

To our knowledge, based solely upon a review of reports furnished to us and written representations that no other reports were required, during the fiscal year ended December 31, 2005, all filing requirements applicable to officers, directors and greater than 10% beneficial owners of our common shares under Section 16(a) of the Securities Exchange Act of 1934, as amended, were complied with except as noted below. Mr. Blomquist filed one amendment to Form 4 on October 25, 2005 (which amended a Form 4 previously filed on July 1, 2005, with respect to a transaction occurring on May 9, 2005 and May 17, 2005).

EXECUTIVE COMPENSATION

The following table sets forth information for each of our last three fiscal years with respect to the annual and long-term compensation of the individuals acting as the Chief Executive Officer during the fiscal year ended December 31, 2005. There were no other executive officers of the Company who served during any part of 2005 whose annual salary and bonus for the fiscal year ended December 31, 2005 exceeded $100,000.

Summary Compensation Table

		Annual Compensation		
Name and Principal Position	Year	Salary ($)	Bonus ($)	Other Annua Compensation
Harold A. Blomquist(1)	2005	$ 209,375	50,000	150,490
Chief Executive Officer,	2004	$ --	--	--
President and Chairman of the Board	2003	$ --	--	--
Douglas M. Mitchell(2)	2005	$ 174,922	--	118,027
Chief Executive Officer, Chief	2004	$ 175,000	--	--
Financial Officer (acting) and President	2003	$ 175,000	--	--

(1) Mr. Blomquist became Chief Executive Officer and President on May 9, 2005.

(2) Mr. Mitchell resigned as Chief Executive Officer, Chief Financial Officer (acting) and President on May 9, 2005.

Option Grant Table

The following table sets forth certain information with respect to options granted by us during the fiscal year ended December 31, 2005 to the individuals named in the summary compensation table above.

Name	Shares Subject to Options Granted in Fiscal Year	Shares subject to Options Granted to Employees in Fiscal Year % of Total	Exercise Price Per Share	Market Price per Share on Date of Grant	Expiration Date
Harold A. Blomquist(1)	35,000	2.29%	$0.62	$0.62	2/15/2012
Harold A. Blomquist	1,096,125	71.86%	$0.66	$0.66	5/9/2012
Harold A. Blomquist	1,403,875	92.03%	$0.54	$0.54	5/17/2012

(1) Mr. Blomquist became Chief Executive Officer and President on May 9, 2005.

Year-End Option Table

The following table sets forth, as of December 31, 2005, the number of shares subject to unexercised options held by the individuals named in the summary compensation table above. 2,030,556 exercisable options had an exercise price less than the last sale price of our common stock underlying the options as reported by the OTC Electronic Bulletin Board on the last trading day of the fiscal year ended December 31, 2005.

	Shares		Number of Unexercised Options at Fiscal Year-End		Value in-the- Fis
Name	Acquired on Exercise (#)	Value Realized ($)	Exercisable (#)	Unexercisable (#)	Exercisab ($)
Harold A. Blomquist(1)	0	$ 0	622,361	2,013,889	$ 0
Douglas M. Mitchell(2)	250,000	$ 9,866	553,333	16,667	$32,700

(1) Mr. Blomquist became Chief Executive Officer and President on May 9, 2005.

(2) Mr. Mitchell resigned as Chief Executive Officer, Chief Financial Officer (acting) and President on May 9, 2005.

Employment Contracts and Termination of Employment Arrangements

The material terms of Harold Blomquist's employment with the Company are as set forth below, as previously disclosed in Item 5.02(c) of the Current Report on Form 8-K filed on May 12, 2005. Mr. Blomquist will be employed for one year with automatic extensions for additional one-year periods unless otherwise terminated. Mr. Blomquist's base salary will be $325,000 per year and he will be eligible to receive a yearly cash bonus, based on performance, of up to 100% of his salary. In addition, Mr. Blomquist will receive a yearly bonus of options to purchase between 100,000 and 400,000 shares of the Company's Common Stock; the exact amount will be based on performance. Upon beginning employment, Mr. Blomquist received options to purchase 2.5 million shares of the Company's Common Stock and a $50,000 bonus. Within four months of beginning employment, Mr. Blomquist was required to purchase 200,000 shares of common stock from the Company, which Mr. Blomquist did on May 19, 2005. The agreement provided that for each share of common stock Mr. Blomquist purchased from the Company within six months of beginning employment, including the 200,000 shares he was required to purchase, the Company would grant him an additional share, up to a maximum of 500,000 matching shares. In addition to the 200,000 shares he purchased on May 19, 2005, Mr. Blomquist purchased 275,000 shares on November 9, 2005; in each case, the purchase price was determined by calculating the average close price for the five trading days prior to the purchase date. We issued an additional 475,000 shares of our common stock to Mr. Blomquist for no additional consideration to match these previous stock purchases. Upon termination, Mr. Blomquist will be restricted from competing against the Company for a period of 18 months. If Mr. Blomquist is terminated by the Company without cause, all of

Mr. Blomquist's unvested stock options will immediately vest and he will continue to receive his base salary, benefits, and cash and stock bonuses for 18 months. If Mr. Blomquist terminates employment due to good cause or as a result of constructive termination relating to a change of control of the Company, all of Mr. Blomquist's unvested stock options will immediately vest and he will continue to receive his base salary, benefits and cash and stock bonuses for 18 months.

Incident to Douglas Mitchell's resignation as director, Chief Executive Officer, President and Chief Financial Officer (acting) of Simtek, and as Chairman of the Board of Simtek's subsidiary, Q-DOT, Inc., Simtek entered into a Separation Agreement, dated May 9, 2005 (the "Separation Agreement") with Mr. Mitchell. The Separation Agreement provides that for six months following the

date of the Separation Agreement, Mr. Mitchell would receive a base salary (prorated from an annualized base salary of $225,000), and for an additional 12 months following the six months mentioned above, he will receive $1,875 per month in exchange for providing consulting services to Simtek. Mr. Mitchell's stock options will continue to vest and his vested stock options will remain exercisable during the period that he continues to receive his base salary and during the period that he provides consulting services to Simtek. Per the terms of the Separation Agreement, the Company granted to Mr. Mitchell 150,000 shares of common stock on June 15, 2005 and 50,000 shares of common stock on November 25, 2005. The Separation Agreement also contains a mutual release.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

On July 1, 2002, we received a total of $3,000,000 from Renaissance Capital Growth and Income Fund III, Inc., Renaissance US Growth Investment Trust PLC and BFSUS Special Opportunities Trust PLC (collectively, the "RENN Entities") in return for issuing 7.5% convertible debentures with an aggregate principal amount of $3,000,000. The convertible debentures have a maturity date of June 28, 2009 and originally had a conversion rate of $0.312, which would have resulted in 9,615,384 shares being issued upon conversion. In connection with the sale of $11,000,000 of our common stock on December 30, 2005, instead of lowering the conversion price of the 2002 convertible debentures, as required by the terms of the 2002 convertible debentures, from $0.312 per share to $0.16 per share as a result of the December 30, 2005 offering at $0.16 per share, we agreed with the RENN Entities that the conversion price would only be lowered to $0.22 per share as a result of the December 30, 2005 offering. As a result, instead of just 9,615,384 shares issuable upon conversion of the 2002 debentures (which would be the case were the conversion price still $0.312 per share), there are currently a total of 13,636,364 shares of common stock that are issuable to the RENN Entities upon conversion of the debentures as a result of the reduction of the conversion price to $0.22 per share. Also on December 30, 2005, we issued 9,375,000 shares of common stock to the RENN Entities in exchange for $1,500,000. On June 28, 2005, we issued warrants to purchase 200,000 shares of our common stock to the RENN Entities in exchange for a waiver of certain provisions relating to the 7.5% debentures. These warrants have 5-year terms with an exercise price of $0.50 per share. RENN Capital Group, Inc. is the agent for the RENN Entities. One of our directors, Mr. Robert Pearson, holds the position of Senior Vice President of RENN Capital Group, Inc.

On October 12, 2004, we issued in a private placement to SF Capital Partners Ltd. 3,857,367 shares of our common stock and a warrant to acquire 2,063,984 shares of our common stock. The warrant has a 5-year term and originally had an exercise price of $0.627 per share. In connection with the sale of $11,000,000 of our common stock on December 30, 2005, we agreed with SF Capital Partners Ltd. that in exchange for their waiver of certain participation rights held by them in connection with the December 30, 2005 offering, the exercise price of their warrant to acquire 2,063,984 shares of our common stock would be lowered from $0.627 per share to $0.265 per share. Also on December 30, 2005, we issued 6,250,000 shares to SF Capital Partners Ltd. in exchange for $1,000,000. As of the date of this report, SF Capital Partners Ltd. owns 10,107,367 shares as a result of the October 12, 2004 and December 30, 2005 transactions, and has a warrant to purchase 2,063,984 shares with an exercise price of $0.265 per share as a result of the October 12, 2004 transaction. By its terms, the warrant issued to SF Capital Partners Ltd. may not be exercised if the exercise would cause SF Capital Partners Ltd. to be a 5% or more holder of all of our outstanding common stock; however, SF Capital Partners Ltd. may waive such restriction on 61 days notice to us. Given the number of shares of our common stock that SF Capital Partners Ltd. holds as of the date of this report, SF Capital Partners Ltd. cannot exercise such warrant unless it waives the restriction and gives us 61 days notice of the waiver; as such, the 2,063,984 shares issuable under the warrant are not included in SF Capital Partner Ltd.'s entry in the "Security Ownership of Certain Beneficial Owners and Management" table above under the column entitled "Amount and Nature of Beneficial Ownership."

On May 4, 2005, we received $4,000,000 from Cypress in return for issuing 6,740,816 shares of our common stock and warrants to acquire 5,055,612 shares of our common stock. The warrants have a 10-year term with an exercise price of $0.7772. On March 24, 2006, we entered into a License and Development Agreement with Cypress pursuant to which, among other things, Cypress agreed to license certain intellectual property from us to develop and manufacture standard, custom and embedded nvSRAM products, we agreed with Cypress to co-develop certain nvSRAM products and Cypress agreed to pay us $4 million in pre-paid royalties paid in certain installments. Under the License and Development Agreement, we issued on March 24, 2006 a warrant granting Cypress the right to purchase 10 million shares of our common stock. We also agreed to issue, upon payment by Cypress of an installment of pre-paid royalties on June 30, 2006, a warrant granting Cypress the right to purchase 5 million shares of our common stock and we agreed to issue, upon payment by Cypress of an installment of

pre-paid royalties on December 31, 2006, a warrant granting Cypress the right to purchase 5 million shares of our common stock. Each of these warrants has, or will have when issued, an exercise price per share of $0.75 with a term of 10 years from the date of issuance.

On May 19, 2005 and pursuant to his employment agreement with us, Mr. Harold Blomquist, our President and Chief Executive Officer, purchased 200,000 shares of our common stock directly from us at a purchase price of $0.542 per share. On November 9, 2005 and pursuant to his employment agreement with us, Mr. Blomquist purchased 275,000 shares of our common stock directly from us at a purchase price of $0.298 per share. In each case, the purchase price was determined by calculating the average close price for the five trading days prior to the purchase date. On January 20, 2006 and also pursuant to his employment agreement with us, we issued an additional 475,000 shares of our common stock to Mr. Blomquist for no additional consideration to match his previous stock purchases.

On December 30, 2005, as part of our sale of $11,000,000 of our common stock, we issued (in addition to the shares issued to SF Capital Partners Ltd. and the RENN Entities on such date, as described above, as well as certain other individual and institutional investors): Crestview Capital Master LLC 24,687,500 shares in exchange for $3,950,000; Big Bend XXVII Investments, L.P. 14,375,000 shares for $2,300,000; and Toibb Investment LLC 11,875,000 shares for $1,900,000.

On May 23, 2006, we entered into a preliminary agreement with Ronald Sartore, a director of the Company, whereby Mr. Sartore would provide certain consulting services with respect to new nvSRAM-based product definitions and other engineering-related matters at the Company. Although we have not yet entered into a definitive written agreement with Mr. Sartore (and neither party has agreed to all terms of Mr. Sartore's engagement), we anticipate doing so in the near future and intend to disclose the material terms of such definitive written agreement by amending the Form 8-K used to disclose the preliminary agreement, which Form 8-K was filed on May 30, 2006. We anticipate that we will engage Mr. Sartore for a period of approximately 13 weeks (four days per week) and expect to compensate Mr. Sartore $1,400 per day for his services.

Confidentiality and Nondisclosure Agreements

We generally require our employees to execute confidentiality and nondisclosure agreements upon the commencement of employment with us. The agreements generally provide that all inventions or discoveries by the employee related to our business and all confidential information developed or made known to the employee during the term of employment shall be the exclusive property of us and shall not be disclosed to third parties without the prior approval of us.

Directors' Compensation

During the fiscal year ended December 31, 2005, each director was granted 35,000 stock options (on February 15, 2005 at $0.62 per share).

We have adopted a Code of Business Conduct and Ethics that applies to our Chief Executive Officer, the Chief Financial Officer, and the Controller, as well as to our directors and employees. The Code of Business Conduct and Ethics can be found at our Internet website at

REPORT OF THE AUDIT COMMITTEE

Notwithstanding anything to the contrary set forth in any of our previous or future filings with the SEC that might incorporate this proxy statement, in whole or in part, the following report of the Audit Committee shall not be deemed to be "soliciting materials" or "filed" or incorporated by reference in our filings with the SEC, or subject to the liabilities of Section 18 of the Exchange Act, except to the extent that we specifically incorporate it by reference into a document filed under the Securities Act of 1933, as amended (the "Securities Act"), or the Exchange Act.

The Audit Committee

As of the date of this proxy statement, the Audit Committee of the Board (the "Audit Committee") was composed of two (2) directors appointed by the Board. All of the committee members, namely Dr. Keeley and Mr. Stein, satisfy the independence requirements of the Audit Committee Policy of the NASDAQ Stock Market, Inc. and Dr. Keeley has been designated by the Board as the Audit Committee's "financial expert." For a description of Dr. Keeley's relevant experience, please see his biographical information contained in Proposal 1 of this proxy statement. On March 24, 2003, the Board adopted a written charter for the Audit Committee (the "Charter").

Management is responsible for the preparation, presentation, and integrity of the Company's financial statements, accounting and financial reporting principles, internal controls and procedures designed to ensure compliance with accounting standards, applicable laws and regulations. The Company's independent accountants, Hein & Associates LLP, are responsible for performing an independent audit of the financial statements and expressing an opinion on the conformity of those financial statements with generally accepted accounting principles.

The Audit Committee's primary responsibilities are to:

1. monitor the integrity of the Company's financial reporting process and the Company's systems of internal accounting and financial controls regarding finance, accounting, and legal compliance;

2. monitor the independence and performance of the Company's external auditors;

3. provide an avenue of communication among the independent auditors, management, and the Board;

4. pre-approve all audit and permitted non-audit services; and

5. develop procedures for receiving, on an anonymous basis, and responding to concerns about the Company's accounting and auditing practices.

Review of Fiscal Year 2005 Financial Statements

In connection with its review of the Company's Fiscal Year 2005 Financial Statements, the Audit Committee has:

(1) reviewed and discussed the audited financial statements with management;

(2) discussed with Hein & Associates LLP, the Company's independent accountants, the matters required to be disclosed by SAS 61, as modified and supplement; and

(3) received from Hein & Associates LLP the written disclosures and letter required by Independence Standards Board Standard No. 1 ("ISB 1") and discussed with Hein & Associates LLP its independence.

Based upon the review and discussions described above, the Audit Committee recommended to the Board that the audited financial statements for fiscal year ended December 31, 2005 be included in the Company's 2005 Annual Report on Form 10-K.

BY THE AUDIT COMMITTEE OF THE BOARD:
Robert Keeley
Alfred Stein

REPORT OF THE COMPENSATION COMMITTEE ON EXECUTIVE COMPENSATION

The Compensation Committee of the Board establishes and recommends the Chief Executive Officer's compensation levels to the Board of Directors and reviews certain aspects of executive compensation.

The Committee is currently responsible for setting the Company's policies regarding compensation for the Chief Executive Officer, administering the Company's stock option plan and setting compensation levels for the Company's Board of Directors.

Compensation Philosophy

The general philosophy of the Compensation Committee is to provide executive compensation designed to attract, retain, and motivate executives critical to the Company's long-term growth and profitability. Compensation of the Chief Executive Officer consists of base salary and bonus awards, and long-term compensation consisting of stock options.

The primary components of compensation paid to the Chief Executive Officer are discussed below:

Annual Compensation

Base Salary

The Committee (with Mr. Blomquist abstaining) periodically reviews and approves the base salary paid to the Chief Executive Officer. Adjustments to base salaries are determined based upon a number of factors, including the Company's financial and strategic performance (to the extent such performance can fairly be attributed or related to executive's performance), as well as the nature of executive's responsibilities, capabilities and contributions. The Compensation Committee believes that the base salary of the Chief Executive Officer is comparable to the base salaries of chief executive officers of other companies in the Company's industry that are of similar size and situation.

Annual Incentive Bonus

The Company's Annual Incentive Bonus Plan provides for the payment of cash bonuses based on the Company's financial and strategic performance in relation to predetermined objectives and individual executive performance for the year then ended. Based on the Company's performance, no bonuses were paid during 2005.

Long-Term Compensation

Equity Based Compensation

The Compensation Committee grants to the executive officers, including the Chief Executive Officer (with Mr. Blomquist abstaining), options to purchase shares of the Company's Common Stock under the Company's stock option plan that was adopted by the Company in 1994. These options are granted at an exercise price equal to the close price of the common stock on the date of grant. All options granted prior to March 24, 2006, began vesting after six months after the date of grant, and would become fully vested after three years and expire seven years from date of grant. On March 24, 2006, the Board of Directors changed the vesting schedule of stock options granted after March 24, 2006 to officers to be as follows:

- If an officer has been employed for 12 months or more, stock options will vest over 48 months at 1/48th per month, and vesting will begin immediately at 1/48th per month for the four year period.

- If an officer has been employed for less than 12 months, no vesting will occur until the officer has been employed for 12 months at which time the officer will be caught up at 1/48th per month for each month since the option grant and then the options will continue to vest at 1/48th per month for the remaining portion of the four year period.

- If an officer is a new hire, no vesting will occur until the officer has been employed for 12 months at which time the officer will receive 12/48th of the vesting and then the options will continue to vest at 1/48th per month for the remaining portion of the four year period.

- All options will expire seven years from date of grant.

The objective of these grants is to align the interests of the officers with those of shareholders because stock options produce value for the executive officers only if the Company's stock appreciates in value.

Compensation of Chief Executive Officer

During 2005, the Company's Chief Executive Officer, Mr. Blomquist, received a salary compensation of $209,375 (for the period from May through December 2005, as Mr. Blomquist became Chief Executive Officer in May 2005), a signing bonus of $50,000 and other compensation of $150,490, consisting of $9,500 in Board of Director Fees, $24,000 in consulting fees paid prior to Mr. Blomquist becoming the Company's Chief Executive Officer and President and $116,990 related to taxable relocation expenses and taxable income related to stock grants.

BY THE COMPENSATION COMMITTEE OF THE BOARD:

Robert Pearson
Ronald Sartore
Harold Blomquist

The report of the Compensation Committee and the information contained therein shall not be deemed to be "solicited material" or "filed" or incorporated by reference in any filing we make under the Securities Act or under the Exchange Act, irrespective of any general statement incorporating by reference this proxy statement into any such filing, or subject to the liabilities of Section 18 of the Exchange Act, except to the extent that we specifically incorporate this information by reference into a document we file under the Securities Act or the Exchange Act.

COMPANY STOCK PRICE PERFORMANCE

The graph below compares the percentage change in the cumulative total return to our shareholders during the period from December 29, 2000 to December 31, 2005 with the percentage change in the cumulative total return for the S&P SmallCap 600 index and the PHLX Semiconductor Sector Index, or SOXX. The graph assumes the investment on December 31, 2000 of $100 in Simtek's common stock and each of the foregoing indices, and that dividends, if any, were reinvested in all cases, except for SOXX. The stock price performance shown on the graphs is not necessarily indicative of future price performance.

[STOCK PERFORMANCE PRICE GRAPH]
Cumulative Total Return Based Upon Initial Investment of $100
On December 29, 2000 With Dividends Reinvested]

Total Return Analysis

	12/29/00	12/31/01	12/31/02	12/31/03	12/31/04
Simtek Corporation	$100	$124	$47	$353	$176
SOXX	$100	$74	$41	$72	$62
S&P SmallCap 600	$100	$119	$102	$141	$173

The preceding graph and table shall not be deemed to be "solicited material" or "filed" or incorporated by reference in any filing we make under the Securities Act or under the Exchange Act, irrespective of any general statement incorporating by reference this proxy statement into any such filing, or subject to the liabilities of Section 18 of the Exchange Act, except to the extent that we specifically incorporate this information by reference into a document we file under the Securities Act or the Exchange Act.

EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth information with respect to our equity compensation plans as of December 31, 2005.

Plan Category	Number of securities to be issued upon exercise of outstanding options warrants and rights	Weighted-average exercise price of outstanding options warrants and rights	Number remaini future equity (exclud reflect
Equity compensation plans not approved by security holders	7,969,363	$0.62	
Total	7,969,363	$0.62	

Material Features of the 1994 Non-Qualified Stock Option Plan

Effective September 27, 1994, the Company's board of directors adopted the Simtek Corporation 1994 Non-Qualified Stock Option Plan, or the "Option Plan." On December 13, 1994, September 15, 1995, October 30, 1998, April 26, 2000, January 2, 2001, November 1, 2001, February 10, 2004, July 29, 2004, May 17, 2005, October 27, 2005 and March 24, 2006, the board of directors of the Company amended the Option Plan to provide for an increase in the number of authorized shares. The amendment adopted on March 24, 2006 increased the number of authorized shares to 20,600,000. The amendment adopted on July 29, 2004 extended the termination date for the Plan from September 27, 2004 to September 27, 2014.

The purpose of the Option Plan is to provide the directors, employees, and consultants who are selected for participation in the Option Plan with added incentives to continue in the long-term service of the Company and to create in such persons a more direct interest in the future success of the Company's operations by relating increases in compensation to increases in shareholder value, so that the income of the participants in the Option Plan is more closely aligned with the income of the Company's shareholders.

A committee appointed by the board of directors administers the Option Plan. The committee has the power to select the participants to be granted options, determines the time or times when options will be granted, and determines the number of shares of Common Stock subject to the option, and all the terms, conditions, restrictions and/or limitations, if any, of options, including the time and conditions of exercise or vesting. Only Non-Qualified Options may be granted under the Option Plan.

There are currently 20,600,000 shares of Common Stock reserved for the grant of awards under the Option Plan. If Proposal 3, is approved, the number will be reduced according to the ratio described in Proposal 3. After considering exercises and forfeitures under the Option Plan, as of May 9, 2006, there were approximately 4,880,000 shares of Common Stock available for grant under the Option Plan. If Proposal 3 is approved, the number of shares available will be reduced according to the ratio described in Proposal 3.

The committee determines the exercise price for each option, but no option may be granted at an exercise price that is less than the fair market value of the Common Stock on the date of grant. Options must expire no later than 10 years from the date of grant. If an option holder dies or becomes disabled during the term of the option while performing services for the Company or while serving on the Board, the option will become fully vested, and the option holder or the option holder's representative may exercise the option within one year after the option holder's death or disability. If the option holder's services to the Company or service as a member of the Board terminates for any reason other than death or disability, the option holder may exercise the option, to the extent that it was vested on the date of termination, for 3 months after the date of termination so long as it is within the term of the option.

PROPOSAL 2 - REINCORPORATION AS A DELAWARE CORPORATION

Summary

The principal effects of the reincorporation will be that:

1. The affairs of Simtek will cease to be governed by Colorado corporation laws and will become subject to Delaware corporation laws.

2. The resulting Delaware corporation will be the same entity as Simtek and will continue with all of the rights, privileges and powers of Simtek, will continue with the same officers and directors of Simtek, will possess all of the properties of Simtek and will continue with all of the debts, liabilities and obligations of Simtek.

General

The Board has unanimously approved and recommends that the shareholders approve the reincorporation of Simtek from the State of Colorado to the State of Delaware (the "Reincorporation Proposal"). Simtek would effect the reincorporation by converting into a Delaware corporation also called Simtek Corporation. Simtek would effect the conversion by entering into a plan of conversion, a draft copy of which is attached hereto as Appendix A (the "Conversion Agreement"). At the effective time of the conversion, Simtek would file with the Delaware Secretary of State a certificate of incorporation that would govern Simtek as a Delaware corporation, a draft copy of which is attached as Appendix B (the "Delaware Certificate of Incorporation"). In addition, the Board of Directors of Simtek would adopt bylaws for the resulting Delaware corporation going forward, a draft copy of which are attached as Appendix C (the "Delaware Bylaws"). Apart from being governed by the Delaware Certificate of Incorporation, the Delaware Bylaws and Delaware corporation law, for all other purposes, Simtek as a Delaware corporation will be the same entity as Simtek as a Colorado corporation: it will continue with all of the rights, privileges and powers of Simtek, it will continue with the same officers and directors of Simtek, it will possess all of the properties of Simtek and it will continue with all of the debts, liabilities and obligations of Simtek.

Reasons for the Reincorporation

Delaware is a nationally recognized leader in adopting and implementing comprehensive and flexible corporate laws. The General Corporation Law of the State of Delaware (the "DGCL") is frequently revised and updated to accommodate changing legal and business needs and is more comprehensive, widely used and interpreted than other state corporate laws, including the Colorado Business Corporation Act (the "CBCA").

In addition, Delaware has established a specialized court, the Court of Chancery, that has exclusive jurisdiction over matters relating to the DGCL. The Chancery Court has no jurisdiction over criminal or tort cases, and corporate cases are heard by judges, without juries, who have many years of experience with corporate issues. Traditionally, this has meant that the Delaware courts are able in most cases to process corporate litigation relatively quickly and effectively. By comparison, many states, including Colorado, do not have a specialized judiciary for matters relating to corporate issues.

Delaware courts have developed considerable expertise in dealing with corporate legal issues and produced a substantial body of case law construing the DGCL, with multiple cases concerning areas that no Colorado court has considered. Because our judicial system is based largely on legal precedents, the abundance of Delaware case law should serve to enhance the relative clarity and predictability of many areas of corporate law, which should offer added advantages to Simtek by allowing the Board and management to make corporate decisions and take corporate actions with greater assurance as to the validity and consequences of those decisions and actions.

Reincorporation from Colorado to Delaware may also make it easier to attract future candidates willing to serve on the Board, because many such candidates are already familiar with Delaware corporate law, including provisions relating to director indemnification, from their past business experience.

Based on publicly available data, over half of publicly-traded corporations in the United States and 58% of the Fortune 500 companies are incorporated in Delaware.

No Change in Business, Jobs, Physical Location, Etc.

The reincorporation will effect a change in the legal domicile of Simtek and other changes of a legal nature, the most significant of which are described below under the heading "Comparison of Shareholder Rights Before and After the Reincorporation." The reincorporation will not result in any change in headquarters, business, jobs, management, location of any of our offices or facilities, number of employees, taxes payable to the State of Colorado, assets, liabilities or net worth (other than as a result of the costs incident to the reincorporation). The reincorporation will not result in a change in the name of the company and will not result in a change in Simtek's current trading status on the Over-The-Counter Electronic Bulletin Board. Our management, including all directors and officers, will remain the same in connection with the reincorporation and will assume identical positions with Delaware-incorporated Simtek. None of the Company's subsidiaries will be changing their respective states or jurisdictions of incorporation, or making any other changes, in connection with the reincorporation. The Reincorporation Proposal will not affect any of the Company's material contracts with any third parties and the Company's rights and obligations under such material contractual arrangements will continue as rights and obligations of Simtek as a Delaware corporation

Mechanism for Reincorporation into Delaware

The process for converting Simtek to a Delaware corporation calls for the Delaware Certificate of Incorporation, as well as a certificate of conversion, to be filed with the Delaware Secretary of State at approximately the time desired for the conversion to take effect.

The Conversion Agreement

The reincorporation will be effected pursuant to the Conversion Agreement to be entered into by Simtek. The Conversion Agreement provides that the Company will convert into a Delaware corporation, with all of the assets, rights, privileges and powers of Simtek, and all property owned by Simtek, all debts due to Simtek, as well as all other causes of action belonging to Simtek, remaining vested in Delaware-incorporated Simtek. Simtek will remain as the same entity following the conversion. The directors and officers of Simtek immediately prior to the conversion will be the directors and officers of Delaware-incorporated Simtek and the subsidiaries of Simtek will be the subsidiaries of Delaware-incorporated Simtek.

If the reverse split (as described in Proposal 3 below) is approved by the shareholders and if the Board decides to effect the reverse split incident to the reincorporation, at the effective time of the conversion, the outstanding shares of Common Stock would be automatically converted into a lesser number of shares of common stock of the resulting Delaware corporation calculated in accordance with the selected ratio of between one for five (1:5) to one for twenty (1:20). If the reverse split is not approved by the shareholders or if the Board decides not to effect the reverse split incident to the reincorporation, at the effective time of the conversion, each outstanding share of Common Stock of Simtek will automatically be converted into one share of common stock of the resulting Delaware corporation. All fractional shares (which would only result if Simtek were to effect the reverse split incident to the reincorporation) that would otherwise result from the conversion/reverse split will be rounded up to the next nearest whole share. If Simtek effects the reverse split incident to the conversion, you will have to exchange your existing Simtek stock certificates for stock certificates of the resulting Delaware corporation (see "Effect on Registered Certificated Shares" in the discussion on Proposal 3 below). If only the conversion is effected, you do not have to exchange your existing Simtek stock certificates of the Company for stock certificates of the resulting Delaware corporation; however, after the conversion, any shareholder desiring a new form of stock certificate may submit the existing stock certificate to Simtek's transfer agent for cancellation and obtain a new certificate.

Pursuant to the reincorporation, the resulting Delaware corporation will assume all of Simtek's obligations under the 1994 Non-Qualified Stock Option Plan. Each outstanding option to purchase shares of Simtek Common Stock under the 1994 Non-Qualified Stock Option Plan will be converted into an option to

purchase a number of shares of the resulting Delaware corporation's common stock on the same terms and conditions as in effect immediately prior to the reincorporation. The exact number of shares of the resulting Delaware corporation's common stock an option-holder is entitled to purchase depends on whether the shareholders approve the reverse split and whether the Board decides to effect the reverse split incident to the reincorporation. If the reverse stock split is implemented, the number of shares subject to each outstanding option will be adjusted to a lesser number of shares and the exercise price will be increased, both adjustments to be made in accordance with the Code and the selected ratio so that the economic value of the options at the time of the reverse stock split is unchanged. If the reverse stock split is implemented, the number of shares of common stock authorized for issuance under the 1994 Non-Qualified Stock Option Plan will be adjusted to a lower number of shares, the adjustment to be made in accordance with the selected ratio. Options granted under the 1994 Non-Qualified Stock Option Plan in the future will be for shares of the resulting Delaware corporation's common stock.

Similarly, each outstanding warrant to purchase shares of Simtek Common Stock will be converted into a warrant to purchase a number of shares of the resulting Delaware corporation's common stock on the same terms and conditions as in effect immediately prior to the reincorporation. The exact number of shares of Delaware-incorporated Simtek that a warrant-holder is entitled to purchase depends on whether the shareholders approve the reverse split and whether the Board decides to effect the reverse split incident to the reincorporation. If the reverse stock split is implemented, the number of shares subject to each outstanding warrant will be adjusted to a lesser number of shares and the exercise price will be increased, both adjustments to be made in accordance with the selected ratio so that the economic value of the warrants at the time of the reverse stock split is unchanged.

Required Vote for the Reincorporation

Approval of the Reincorporation Proposal requires the affirmative vote of a majority of the shares of Common Stock represented in person or by proxy, and entitled to vote, at the Annual Meeting. Consequently, abstentions and broker non-votes will be treated as votes against for purposes of approving this proposal.

A vote in favor of the Reincorporation Proposal is a vote to approve the Conversion Agreement and therefore the reincorporation/conversion. A vote in favor of the Reincorporation Proposal is also effectively a vote in favor of the Delaware Certificate of Incorporation and the Delaware Bylaws.

Effective Time

If the Reincorporation Proposal is approved, the reincorporation will become effective upon the filing of, and at the date and time specified in (as applicable), the Certificate of Conversion filed with the Secretary of State of Colorado and the Certificate of Conversion and the Delaware Certificate of Incorporation filed with the Secretary of State of Delaware, in each case upon acceptance thereof by the Colorado Secretary of State and the Delaware Secretary of State. If the Reincorporation Proposal is approved, it is anticipated that the Board will cause the reincorporation to be effected as promptly as reasonably possible following such approval. However, the reincorporation may be delayed by the Board or the Conversion Agreement may be terminated and abandoned by action of the Board at any time prior to the effective time of the reincorporation, whether before or after the approval by Simtek's shareholders, if the Board determines for any reason, in its sole judgment and discretion, that the consummation of the reincorporation should be delayed or would be inadvisable or not in the best interests of Simtek and its shareholders, as the case may be.

Effect of Not Obtaining the Required Vote for Approval

If the Reincorporation Proposal fails to obtain the requisite vote for approval, the reincorporation will not be consummated and Simtek will continue to be incorporated in Colorado.

Comparison of Shareholder Rights Before and After the Reincorporation

Because of differences between the CBCA and the DGCL, as well as differences between the governing documents before and after the reincorporation, the reincorporation will effect certain changes in the rights of Simtek's shareholders. Summarized below are the most significant differences between the rights of the shareholders of Simtek before and after the

reincorporation, as a result of the differences among the CBCA and the DGCL, and the differences between the Amended and Restated Articles of Incorporation of Simtek (the "Colorado Articles of Incorporation") and the Bylaws of Simtek (the "Colorado Bylaws") and the Delaware Certificate of Incorporation and the Delaware Bylaws. The summary below is not an exhaustive list of all differences or a complete description of the differences described, and is qualified in its entirety by reference to the CBCA, the DGCL, the Colorado Articles of Incorporation, the Colorado Bylaws, the Delaware Certificate of Incorporation, and the Delaware Bylaws.

	Simtek as a Colorado Corporation	Simtek as a Delawa
Authorized Shares	Under the Colorado Articles of Incorporation, the Company is authorized to issue a total of 300,000,000 shares of common stock, par value $.01 per share, and 2,000,000 shares of preferred stock, par value $1.00 per share.	Under the Delaware Cert Incorporation, Delaware Simtek is authorized to shares of common stock, per share, and 2,000,00 preferred stock, par va share. If the reincorp incident to the reverse 3), then the number of common and preferred st proportionately reduced the ratio for the rever
Classification of Directors	The Colorado Articles of Incorporation and the Colorado Bylaws provide for a classified board of directors if there are 6 or more directors, with each director to serve for three-year terms.	All directors of Delawa Simtek will be elected regardless of the numbe
Removal of Directors	The Colorado Articles of Incorporation and the Colorado Bylaws provide that directors may be removed at any time, with or without cause, by the affirmative vote of at least 75% of all shares entitled to vote.	The DGCL provides that removed at any time, wi by a majority vote of a to vote.
Vacancies on the Board of Directors	For vacancies when the Board size is increased beyond the number of authorized directors, the Colorado Bylaws provide that the Board or the shareholders may fill such vacancies. For all other vacancies, the Colorado Bylaws provide that the Board fills the vacancies.	For vacancies when the increased beyond the nu directors, the Delaware that the board or the s fill such vacancies. F vacancies, the Delaware that the board fills th

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Number of Directors	The Colorado Bylaws state that the Board is to have between three and nine members, with the exact number to be set	Under the Delaware Cert Incorporation and the D the board of directors

	by the Board. The CBCA, like the DGCL, provides that shareholders may amend a corporation's bylaws without the approval of the board of directors. Accordingly, under the CBCA, shareholders of the Company have the ability to determine the size of the Board.	Delaware-incorporated S between five and nine m exact number to be set directors. Because the shareholders to amend t Bylaws, shareholders of Delaware-incorporated S ability to determine th board of directors.
Shareholders' Power to Call Special Meetings	In accordance with the CBCA, the Colorado Bylaws provide that a special meeting of shareholders must be called by the President at the request of holders of not less than 10% of the outstanding shares of the Company.	Under the DGCL, special meetings may be called the extent authorized b certificate of incorpor The Delaware Bylaws pro special meeting of shar called by the board of president or the chairm
Notice of Shareholder Nominations for Directors and Business to be Brought Before Meetings	For annual meetings, the Colorado Bylaws provide that shareholders must give notice no later than 30 days prior to the first anniversary of the initial notice of the past year's annual meeting, provided that such notice need not be given more than 50 days prior to the annual meeting. For special meetings, the Colorado Bylaws provide that shareholders must give notice within 10 days of the initial notice of the meeting given by the Company.	The Delaware Bylaws req to give notice between prior to the first anni previous year's annual however, that if the cu annual meeting varies b days from the one year previous year's annual meeting is a special me must be provided within announcement of the mee

Indemnification--General	Under the Colorado Articles of Incorporation, the Company is required to indemnify, to the fullest extent permitted by the CBCA, former and current directors and officers of the Company against liability incurred in any action brought against those persons as a result of their role with the Company. The CBCA generally requires a person seeking indemnification to have acted in good faith and, in the case of conduct in an official capacity with the corporation, in a manner that he or she reasonably believed was in the corporation's best interests, and in all other cases, in a manner that he or she reasonably believed was at least not opposed to the corporation's best interests. In addition, in a criminal proceeding, the person must also have had no reasonable cause to believe the person's conduct was unlawful. Regardless of standards of conduct, indemnification of expenses for directors and officers is mandatory under the CBCA to the extent they are wholly successful on the merits in defending a proceeding. Under the CBCA, in derivative suits (i.e., suits by or in the right of the corporation), indemnification is only available for expenses and attorneys' fees incurred in defending or settling a suit and only in circumstances where there has been no adjudication of liability to the corporation.	Under the Delaware Cert Incorporation, the Dela the DGCL, Delaware-inco required to indemnify f directors and officers, employees and agents, b person seeking indemnif satisfied the statutory conduct. To satisfy th standard of conduct, a acted in good faith and person reasonably belie not opposed to the best corporation. In additi criminal action or proc must also have had no r believe the person's co unlawful. Regardless o conduct, indemnificatio directors and officers the DBCL to the extent successful on the merit proceeding. Under the derivative suits (i.e., the right of the corpor indemnification is only expenses and attorneys' defending or settling a circumstances where the adjudication of monetar corporation.
Indemnification--Advancing Expenses	Under the Colorado Articles of Incorporation and the CBCA, the Company is required to advance expenses to current or former directors and officers (but only to directors upon an undertaking to repay such expenses if it is ultimately determined the director is not entitled to indemnification) in connection with actions brought against those persons as a result of their role with the Company.	The Delaware Bylaws pr Delaware-incorporated S advance expenses incurr former director or offi an action upon receipt by or on behalf of such officer to repay such a ultimately be determine is not entitled to be i Delaware Bylaws provide Delaware-incorporated S expenses incurred by a employee or agent in de such terms and conditio company deems appropria

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Amendment to the Articles (Certificate) of Incorporation	Pursuant to the CBCA, amendments to the Colorado Articles of Incorporation must be submitted to a shareholder vote if proposed either by the Board or by the holders of shares representing at least 10% of all of the votes entitled to be cast on the amendment. The Board is generally required to recommend the amendment to the shareholders, except if the amendment is proposed by the shareholders or if the Board determines that because of a conflict of interest or other special circumstances it should make no recommendation. Among other consequences, this aspect of the CBCA may limit the effectiveness of any anti-takeover provisions contained in a corporation's articles of incorporation. The Colorado Articles of Incorporation do not impose any supermajority voting requirements upon proposed amendments to the articles, although the sections of the Colorado Articles of Incorporation relating to directors (i.e., removal, indemnification) can only be amended by 75% of the shares entitled to vote. To approve all other amendments, the Colorado Bylaws and the CBCA provide that the affirmative vote of a majority of the shares resented at a meeting (at which a quorum is present) is necessary.	Under the DGCL, a propo corporation's certifica incorporation may not b vote of shareholders wi of the board of directo the Delaware Certificat includes provisions tha hostile takeover of Del Simtek more difficult, DGCL would prevent thos being amended or remove consent of the board of may therefore have anti effects. The DGCL prov Delaware Certificate of be amended with the app majority of the shares to vote thereon.

Business Combination Statute	The CBCA does not contain any business combination provisions.	Section 203 of the DGCL three-year moratorium on combination transaction stockholders" (generally own 15% or more of the c voting stock). Delaware specifically opted to be of the DGCL in the Delaw Incorporation. The Compa 203 of the DGCL will enc acquirer to negotiate wi directors. Section 203 a limiting the ability of a two-tiered bid for the stockholders would not b Shareholders should note application of Section 2 Delaware-incorporated Si the power to reject a pr in certain circumstances acquirer may be offering company's common stock o price. Section 203 would potential acquirers who with its provisions.

Franchise Tax	There is no franchise tax in Colorado.	The DGCL requires corpo franchise tax annually maximum is $165,000 a y payable by Delaware-inc is estimated to be appr based on the assumed pa method for 2006.

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Dissenters' (Appraisal) Rights	Under the CBCA, shareholders are entitled to exercise dissenters' rights in the event of certain mergers, share exchanges, sales, leases, exchanges, or other dispositions of all or substantially all of a corporation's assets. Shareholders also may dissent in the case of a reverse stock split that reduces the number of shares owned to a fraction of a share or to scrip if such sc00%">	The DGCL provides appra in the case of a stockh certain mergers or cons stockholders have no ap a sale, lease, or excha substantially all of a assets. Appraisal righ available to record hol

Increase gross margin from our Utility revenues by continuing to reduce the cost of manufacturing our Utility products, while at the same time m

Manage the manufacturing transition to reduced-cost Utility products; and

Manage our operating expenses to a reasonable percentage of revenues.

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.

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 continuing economic slowdown and the uncertainty over its breadth, depth and duration continue to put pressure on the global economy and have 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.

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 will 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. If we were not able to obtain additional financing when needed, 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.

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 Utility and Commercial revenues. 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 continued 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 further 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 Utility 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.

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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 copper, silver, 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. For example, as a result of the recent earthquake and tsunami in Japan, we may experience shortages of supply for components that we source from companies located in Japan. To help address these issues, we may decide to purchase quantities of these items that are in excess of our estimated requirements. As a result, we could be forced to increase our excess and obsolete inventory reserves to provide for these excess quantities, which could harm our operating results. 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.

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, 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. 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.

We are exposed to credit risk and payment delinquencies on our accounts receivable, and this risk has been heightened during the current 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.

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, 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. In addition, 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, including those used in our Utility 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 by two providers, Toshiba and Cypress Semiconductor. Toshiba has declined to renew its Neuron Chip agreement with us, which expired in January 2010. However, we have agreed with Toshiba that Toshiba will continue to accept orders for Neuron Chips from its customers through September 2011 for deliveries through December 2012. In the meantime, we are implementing a plan to allow for a smooth migration path for Toshiba s customers to our new Neuron 5000 processor, which we purchase from Open-Silicon. Another semiconductor supplier, STMicroelectronics, manufactures our power line smart transceiver products, for which we have no alternative source. 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.

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 Utility 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;

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- 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.

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. 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 Commercial 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 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. 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.

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. In each of our 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 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;

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- 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 Utility products include Aclara, Elster, Enel, GE, IBM, Iskraemeco, Itron, Kamstrup, Landis+Gyr, 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 Utility offerings.

For our Commercial 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, 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.

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

We market our Utility products directly, as well as through selected VARs and integration partners. We believe that a significant portion of our Utility 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 Utility products with other companies in other geographic areas, revenues from sales of our Utility products may not meet our financial targets, which will harm our operating results and financial condition.

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Currently, significant portions of our Commercial revenues are derived from sales to distributors, including EBV, the primary independent distributor of our products to OEMs in Europe. Historically, sales to EBV, as well as sales to our other distributor partners, have accounted for a substantial portion of our total Commercial revenues. Agreements with our 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 they significantly reduce their inventory levels for our products, service levels to our end-use customers could decrease.

Voluntary 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 standards organizations around the world in order to help prevent the adoption of exclusionary standards as well as to promote voluntary standards for our products. However, we do not have the resources to participate in all voluntary standards processes that may affect our markets 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 Utility and Commercial 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 adoption for our Open Smart Grid Protocol, which is used by smart meters and other devices within our NES 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 Utility and Commercial 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 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.

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 our technical personnel. In November 2009, we announced that our Chairman and CEO would step down as CEO for health reasons. At the same time, we announced that one of our existing directors would become our CEO on an interim basis, while we conducted a search for a new CEO. Our search was completed and our new CEO joined Echelon in August 2010. Our future success will depend on our ability to attract, integrate, motivate and retain qualified 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.

We face financial and operational 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 78.1%, 74.9%, and 76.8% of our total revenues for the years ended December 31, 2010, 2009, and 2008, respectively. We expect that international sales will continue to constitute a significant portion of our total net revenues.

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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. As 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 Utility products in the utility s local currency, which will increase our exposure to foreign currency risk. In addition, we have agreed with EBV, our European distributor, that upon notice from EBV, we will sell our products to EBV in European Euros rather than U.S. dollars. If EBV were to exercise this right, our revenue exposure to foreign currency fluctuations would increase.

For our cost of goods sold, our products are generally assembled by CEMs in China. Although our transactions with these vendors have historically been 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, any future increase 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.

Additional 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.

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 Commercial 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.

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In addition, many of our Commercial 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 Commercial product line competitors, which would have a material adverse affect on our revenues, results of operations, and 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. We believe that similar new product introduction delays in the future could also increase our costs and delay our revenues.

Because we may incur penalties and/or be liable for damages with respect to sales of our Utility products, we could incur unanticipated liabilities that would negatively affect our operating results.

The agreements governing the sales of our NES system products may expose us to penalties, damages 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. Any such liabilities would have an adverse effect on our financial condition and operating results.

If we sell our NES system products directly to a utility, we will face additional risks.

When we sell our NES system products to a utility directly, we may be required to assume responsibility for installing the NES system in the utility s territory, integrating the NES system into the utility s operating and billing system, overseeing management of the combined system, 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 system installations, and could also negatively affect the timing of our revenues and cash flows related to these transactions.

The sales cycle for our Commercial products is lengthy and unpredictable.

The sales cycle between initial Commercial 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.

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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:

- 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 Utility product offerings to meet a utility s requirements, which could delay delivery and/or acceptance of our products;
- the complex revenue recognition rules relating to products such as our NES System could require us to defer some or all of the revenue associated with Utility 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 contract electronic manufacturers 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 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 2011. 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 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 other companies, products, or technologies that are complementary to our business. Lastly, our combined cash, cash equivalents, and short-term investments 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.

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.

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.

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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 affect on our revenues, results of operations, and financial condition.

We have limited ability to protect our intellectual property rights.

Our success depends significantly upon our intellectual property rights. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements and other contractual provisions to establish, maintain and protect these intellectual property rights, all of which afford only limited protection. If any of our patents fail to protect our technology, or if we do not obtain patents in certain countries, our competitors may find it easier to offer equivalent or superior technology.

We have 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 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.

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

As of February 28, 2011, our directors and executive officers, together with certain entities affiliated with them (including, for this purpose, Enel, which has the right to nominate a director to our board of directors), beneficially owned 26.3% of our outstanding stock.

When we sold 3.0 million newly issued shares of our common stock to Enel on September 11, 2000, we granted Enel the right to nominate a director to our board of directors, although a nominee of Enel does not currently sit on our board. In connection with the stock sale, our directors and our Chief Financial Officer agreed to enter into a voting agreement with Enel in which each of them agreed to vote in favor of Enel s nominee to our board of directors. In addition, Enel agreed to vote for our board s recommendations for the election of directors, approval of accountants, approval of Echelon s equity compensation plans, and certain other matters. As a result, our directors and executive officers, together with certain entities affiliated with them, may be able to control substantially all matters requiring approval by our stockholders, including the election of all directors and approval of certain other corporate matters.

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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 affect on our business, financial condition and 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, India, Italy, Japan, the Netherlands, Singapore, South Korea, 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, 2010, the future minimum rental payments for all of our leased office space, including those for our corporate headquarters facilities, totaled approximately $40.6 million. For the year ended December 31, 2010, the aggregate rental expense for all leased office space was approximately $1.8 million.

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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. RESERVED

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

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, 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
Year Ended December 31, 2009	**High**	**Low**
Fourth quarter	$ 15.38	$ 10.69
Third quarter	15.09	7.00
Second quarter	8.89	6.87
First quarter	8.94	5.13

As of February 28, 2011, there were approximately 409 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, 2010.

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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, 2005 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 2005	December 2006	December 2007	December 2008	December 2009	December 2010
Echelon Corporation	$ 100.00	$ 102.17	$ 263.60	$ 104.09	$ 147.64	$ 130.14
S&P 500 Composite Index	$ 100.00	$ 115.79	$ 122.16	$ 76.96	$ 97.33	$ 111.99
S&P 500 Information Technology Index	$ 100.00	$ 108.42	$ 126.10	$ 71.70	$ 115.95	$ 127.77

Repurchase of Equity Securities by the Company

In April 2008, the Company s board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company s common stock. During the year ended December 31, 2010, no shares were repurchased under the repurchase program. Since inception, we have repurchased a total of 750,000 shares under the program at a cost of $8.9 million. As of December 31, 2010, 2,250,000 shares were available for repurchase. The stock repurchase program will expire in April 2011. The following table provides information about the repurchase of our common stock during the quarter ended December 31, 2010:

	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	75,021	$ 8.52		2,250,000
November 1- November 30	912,382	$ 8.93		2,250,000
December 1- December 31	229,073	$ 10.23		2,250,000
Total	1,216,476	$ 9.15		2,250,000

(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.

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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,				
	2010	2009	2008	2007	2006
	(in thousands, except per share data)				
Consolidated Statement of Operations Data:					
Net revenues:					
Product	$ 107,441	$ 100,187	$ 131,073	$ 135,405	$ 56,515
Service	3,596	3,151	2,974	2,172	761
Total revenues	111,037	103,338	134,047	137,577	57,276
Cost of revenues:					
Cost of product	59,722	56,813	79,984	85,035	22,039
Cost of service	2,464	2,418	2,587	2,360	1,877
Total cost of revenues	62,186	59,231	82,571	87,395	23,916
Gross profit	48,851	44,107	51,476	50,182	33,360
Operating expenses:					
Product development	34,762	35,435	37,753	32,644	28,221
Sales and marketing	25,062	23,525	23,635	21,181	20,408
General and administrative	17,647	15,742	17,143	16,083	13,949
Restructuring charges	1,212				
Total operating expenses	78,683	74,702	78,531	69,908	62,578
Operating loss	(29,832)	(30,595)	(27,055)	(19,726)	(29,218)
Interest and other income (expense), net	393	(28)	2,925	5,717	5,817
Interest expense on lease financing obligations	(1,572)	(1,668)	(1,404)	(1,211)	(1,379)
Loss before provision for income taxes	(31,011)	(32,291)	(25,534)	(15,220)	(24,780)
Income tax expense (benefit)	301	(257)	297	452	350
Net loss	$ (31,312)	$ (32,034)	$ (25,831)	$ (15,672)	$ (25,130)
Loss per share [1]:					
Basic	$ (0.76)	$ (0.79)	$ (0.64)	$ (0.39)	$ (0.64)
Diluted	$ (0.76)	$ (0.79)	$ (0.64)	$ (0.39)	$ (0.64)
Shares used in per share calculation [1]:					
Basic	41,365	40,724	40,636	39,891	39,487
Diluted	41,365	40,724	40,636	39,891	39,487

Cash dividends declared per common share	$	$	$	$	$
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$ 64,632	$ 80,116	$ 87,316	$ 107,190	$ 124,157
Working capital	77,259	96,357	108,811	126,711	129,521
Total assets	145,570	164,437	185,517	204,707	211,272
Total liabilities	51,581	48,539	52,946	51,496	57,609
Total stockholders equity	93,989	115,898	132,571	153,211	153,663

[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.

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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. We offer our products and related services to OEMs and systems integrators in the building, industrial, transportation, utility/home, and other automation markets.

For the last several years, we have been investing heavily in the development of hardware and software products for use in the smart grid. These hardware devices and associated software are used by electric utilities in their distribution and metering systems. To date, we have generated revenues of approximately $245.0 million from these investments. We refer to this revenue as Utility revenue. We also sell certain of our products to Enel and certain suppliers of Enel for use in Enel s Contatore Elettronico electricity meter management project in Italy. We refer to Echelon s revenue derived from sales to Enel and Enel s designated manufacturers as Enel Project revenue. We refer to all other revenue as Commercial revenue. We also provide a variety of technical training courses related to our products and the underlying technology. Some of our customers also rely on us to provide customer support on a per-incident or term contract basis.

Our financial performance during 2010 reflects modest improvement in revenues from both our Utility and Commercial products, which were partially offset by an anticipated decrease in Enel Project revenues. Overall, our net revenues increased by 7.5% over amounts generated in 2009. This led to a slight reduction in our net loss for the year. The following table provides an overview of key financial metrics for the years ended December 31, 2010 and 2009 that our management team focuses on in evaluating our financial condition and operating performance (in thousands, except per share amounts and percentages).

	2010	2009	$ Change	% Change
Net revenues	$ 111,037	$ 103,338	$ 7,699	7.5%
Gross margin	44.0%	42.7%		1.3 ppt
Operating expenses	$ 78,683	$ 74 ,702	$ 3,981	5.3%
Net loss	$ (31,312)	$ (32,034)	$ 722	2.3%
Cash, cash equivalents, and short-term investments	$ 64,632	$ 80,116	$ (15,484)	(19.3%)

Net revenues: As noted above, our net revenues increased in both our Utility and Commercial product lines during 2010. As compared to 2009, net revenues from our Utility and Commercial product lines increased by 18.6% and 10.3%, respectively. However, we continue to believe that our revenue levels from these products have been adversely affected by the severe economic downturn that began in late 2008 and has continued since then. Utilities are the ultimate customer for our Utility products. We believe that utilities have limited their capital expenditures in response to reduced cash flow arising from the worldwide recession. In addition, in the United States we believe that utilities further delayed decisions pending the distribution of stimulus awards from the United States Department of Energy as well as regulatory obstacles they have faced in moving forward with their smart grid roll-outs. With respect to our Commercial product line, many of our customers produce products used in commercial or industrial buildings. The markets for these products were adversely affected by the recession. However, we have seen strength in energy saving markets such as demand response. The reduction in our Enel Project revenues during 2010 was primarily due to an anticipated decrease in the level of orders placed by Enel s meter manufacturers for metering kits under the 2006 development and supply agreement.

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Gross margin: Our gross margin improved by 1.3 percentage points in 2010 as compared to 2009. Excluding the impact of non-cash stock-based compensation charges, gross margins improved by 0.9%, from 44.3% in 2009 to 45.2% in 2010. The year-over-year improvement in gross margin was primarily due to the fact that we continued to experience higher gross margins in our Utility product line during 2010 as compared to 2009. Utility gross margin improvement was the direct result of both continued investments we have made in engineering to develop products that cost less to build, as well as work we have done with our third party contract electronic manufacturers to reduce their costs. In addition, higher overall revenue levels also contributed to the improved gross margins as indirect costs as a percentage of revenues decreased. Partially offsetting these improvements was the negative impact resulting from the mix of products sold in 2010 as compared to 2009.

Operating expenses: Our operating expenses increased by 5.3% in 2010 as compared to 2009. Excluding the impact of restructuring costs and non-cash stock-compensation charges, operating expenses increased by 7.1%, from $62.0 million in 2009 to $66.4 million in 2010. Part of this increase in operating expenses was due to the restoration of full salaries in May 2010 for our U.S. based personnel. In May 2009, in light of worsening economic conditions, we implemented a structured salary reduction program in an effort to reduce our operating costs. Also contributing to the year-over-year increase were increased product development costs associated with new products for our Utility customers, increased commissions for our sales personnel, increased compensation for our interim and current Chief Executive Officers, increased fees paid to third party service providers, and charges associated with a restructuring program we commenced in December 2010. Partially offsetting these increases were payments of $4.5 million received from a third party that were used to reduce product development expenditures.

Net loss: Our net loss decreased by $722,000 in 2010 as compared to 2009. The $722,000 decrease in our loss was directly attributable to the $7.7 million year-over-year increase in net revenues and improved gross margins, and was partially offset by increased operating expenses. Excluding the impact of restructuring costs of $1.2 million and non-cash stock-compensation charges of $12.3 million, our net loss remained relatively unchanged in 2010.

Cash, cash equivalents, and short-term investments: During 2010, our cash, cash equivalent, and short-term investment balance decreased by 19.3%, from $80.1 million at December 31, 2009 to $64.6 million at December 31, 2010. This $15.5 million reduction was primarily the result of $9.2 million of cash used in operating activities, and to a lesser extent by cash used to pay taxes on behalf of our employees associated with equity compensation awards and principal payments on our lease financing obligations.

We believe that during 2011, we will continue to experience revenue growth in our Utility and Commercial product lines, as well as increased revenues from the Enel Project. This belief is dependent on many macro-economic factors, including continued market improvement for the products our Commercial customers sell that incorporate our technology, continued easing of world-wide credit markets our Utility customers rely on to fund their projects, and timely resolution of regulatory processes. Our management team remains focused on working to ensure that our company is properly positioned to capitalize on existing customer relationships, as well as new opportunities as they become available. For example, we continue to invest strategically in the development of new technologies and products to increase our share of the network infrastructure market, including technologies and products specifically aimed at the smart grid and other green initiatives. We also continue to enhance our sales and marketing efforts in a variety of ways, including hiring new employees to cover critical areas, adding to our existing base of third party value added resellers, and initiating new sales channel programs.

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.

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We recognize revenue when persuasive evidence of an arrangement exists, delivery (and acceptance, as applicable) has occurred, the sales price is fixed or determinable, collectability is probable, and there are no post-delivery obligations. For non-distributor hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For sales made to our distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer. Service revenue is recognized as the training services are performed, or ratably over the term of the support period.

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.

In most instances involving large-scale deployments, our Utility products are sold as part of multiple element arrangements. These arrangements may require us to deliver our Utility products and services over an extended period of time. In October 2009, the FASB amended the accounting standards for multiple deliverable revenue arrangements to:

- provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
- require an entity to allocate revenue in an arrangement using its best estimated selling price (BESP) of deliverables if a vendor does not have vendor-specific objective evidence (VSOE) of selling price or third-party evidence (TPE) of selling price; and
- eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

We elected to early adopt this accounting guidance January 1, 2010 on a prospective basis for applicable transactions originating or materially modified after December 31, 2009.

As noted above, our multiple deliverable revenue arrangements are primarily related to sales of Utility products, which may include, within a single arrangement, electricity meters and data concentrators (collectively, the Hardware); NES system software; Element Manager software; post-contract customer support (PCS) for the NES system and Element Manager software; extended warranties for the Hardware; and, occasionally, specified enhancements or upgrades to software used in the NES system. For arrangements originating or materially modified after December 31, 2009, with the exception of the NES system software, each of these deliverables is considered a separate unit of accounting. The NES system software functions together with an electricity meter to deliver its essential functionality and any related software license fee is charged for on a per meter basis. Therefore, the NES system software and an electricity meter are combined and considered a single unit of accounting. The Element Manager software is not considered to be part of an electricity meter s essential functionality and, therefore, Element Manager software and any related PCS continues to be accounted for under industry specific software revenue recognition guidance. However, all other NES system deliverables are no longer within the scope of industry specific software revenue recognition guidance.

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 VSOE of selling price or TPE of selling price, if it exists. If neither VSOE nor TPE of selling price exists for a deliverable, we use our BESP for that deliverable. Since the use of the residual method has been 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.

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.

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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, 2010 resulting from changes in VSOE, TPE, or BESP, nor do we expect a material impact from such changes in the near term.

Total net revenues as reported and unaudited pro forma total net revenues that would have been reported during the year ended December 31, 2010, if the transactions entered into or materially modified after December 31, 2009 were subject to previous accounting guidance, are shown in the following table (in thousands):

	As Reported	Pro Forma Basis as if the Previous Accounting Guidance Were in Effect
Total net revenues for the year ended December 31, 2010	$ 111,037	$ 107,965

The $3.1 million impact to total net revenues during the year ended December 31, 2010 resulting from the adoption of the new accounting guidance was to net product revenues, and related solely to sales of our Utility products. The impact was related primarily to the fact that, under the new accounting guidance, we recorded revenue on certain transactions for which the previous accounting guidance would have required deferral. Approximately $1.8 million of the $3.1 million impact was attributable to transactions involving multiple element arrangements where software upgrades had not yet been delivered as of December 31, 2010. Under the new accounting guidance, we determined the BESP for the software upgrades and deferred the relative selling price of these items. Under the previous accounting guidance, all revenue related to these transactions would have been deferred as we did not have VSOE of fair value for the undelivered items. The remaining $1.3 million of the $3.1 million impact was primarily attributable to transactions involving multiple element arrangements in which we shipped data concentrators to a customer but had not yet shipped all of the meters associated with that arrangement. As described below, since the meters and data concentrators were not shipped in proportion to the overall expected ratio for that arrangement, under the previous accounting guidance we would have been required to defer the revenue on the excess data concentrators until the corresponding meters were shipped in a future period. Under the new accounting guidance, however, we determined the BESP for both the data concentrators and the meters and recognized revenue for the relative value of each based on the quantity that were delivered to and accepted by our customers.

As it relates to the timing and pattern of revenue recognition for Utility product sales in the future, the new accounting guidance has had a significant effect on total net revenues for transactions entered into or materially modified after December 31, 2009, and we expect this trend to continue. This expectation is primarily due to the fact that we do not currently have VSOE of fair value for most of our Utility product offerings, which often resulted in deferral of revenue as discussed below. For Utility arrangements subject to the new revenue recognition guidance, revenue allocated to meters and data concentrators will be recognized as those units are delivered to and accepted by our customers, while revenue allocated to PCS and extended warranties will be recognized ratably over the service period.

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 Utility 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.

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As of December 31, 2010 and December 31, 2009, approximately $3.7 million and $5.2 million, respectively, of our Utility product revenue was deferred. Of the $3.7 million of deferred revenue at December 31, 2010, approximately $1.5 million of it relates to revenue that will be accounted for under previous revenue recognition guidance while the remaining $2.2 million relates to revenue that will be accounted for under the new revenue recognition guidance.

Stock-Based Compensation. Under generally accepted accounting principles in the United States, stock-based compensation cost is measured at the grant date based on the estimated fair value of the award and is recognized as expense ratably over the requisite service period, which is the vesting period.

We currently use the Black-Scholes-Merton (BSM) option-pricing model to estimate the fair value of stock options and stock appreciation rights (SARs). The estimation of fair value of share-based payment awards on the date of grant using the BSM option-pricing model is affected by the fair market value of our stock on the date of grant, as well as a number of highly complex and subjective variables. These variables include the expected term of the option, the expected volatility of our stock price over the expected term of the option, risk-free interest rates, and expected dividends.

For options SARs granted prior to January 1, 2008, the expected term was calculated using the simplified method as permitted under the Securities and Exchange Commission Staff Accounting Bulletin No. 107. Under the simplified method, the expected term was calculated by taking the average of the vesting term and the contractual term of the option. For options and SARs granted subsequent to December 31, 2007, the expected term has been estimated by applying a Monte Carlo simulation model that incorporates Echelon s historical data on post-vest exercise activity and employee termination behavior. The expected volatility is based on both the historical volatility of the our 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 our company s stock. We base the risk-free interest rate that we use in the BSM option-pricing model on U.S. Treasury issues in effect at the time of equity compensation grant that have remaining terms similar to the expected term of the option. We have never paid cash dividends on our common stock, and do not anticipate paying cash dividends in the foreseeable future. Therefore, we use an expected dividend yield of zero in the BSM option-pricing model.

Current accounting rules also require us to record compensation expense for stock-based compensation net of estimated forfeitures, and to revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All share-based payment awards are amortized using the accelerated multiple option method over their requisite service period, which is generally the vesting period.

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 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. 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. 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.

There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and may materially affect the estimated fair value of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods, and assumptions. The BSM option-pricing model was developed for use in estimating the fair value of traded options that have no vesting or hedging restrictions and that are fully transferable, characteristics that are not present in our equity compensation grants.

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods, or if we decide to use a different option-pricing model, stock-based compensation expense in those future periods may differ significantly from what we have recorded in the current period and could materially affect our operating results.

Allowance for Doubtful Accounts. We typically sell our products and services to customers with net 30-day payment terms. In certain instances, payment terms may extend to as much as approximately net 90 days. For a customer whose credit worthiness does not meet our minimum criteria, we may require partial or full payment prior to shipment. Alternatively, customers may be required to provide us with an irrevocable letter of credit prior to shipment.

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We evaluate the collectability of our accounts receivable based on a combination of factors. In circumstances where we are aware of a specific customer s inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected. These determinations are made based on several sources of information, including, but not limited to, a specific customer s payment history, recent discussions we have had with the customer, updated financial information for the customer, and publicly available news related to that customer. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, the current business environment, the credit worthiness of our overall customer base, changes in our customers payment patterns, and our historical experience. If the financial condition of our customers were to deteriorate, or if general economic conditions worsen, additional allowances may be required in the future, which could materially impact our results of operations and financial condition. Our allowance for doubtful accounts was $361,000 as of December 31, 2010, and $350,000 as of December 31, 2009.

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. Inventories on hand in excess of one year s forecasted demand are generally deemed to be excess.

In performing the excess inventory analysis, management considers factors that are unique to each of our Utility and Commercial product lines. For our Utility products, the analysis requires us to consider that Utility 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 Commercial products, our customers generally buy from a portfolio of off-the-shelf or standard products. In addition, whereas for our Utility customers our revenues are attributable to a relatively few customers buying substantial quantities of any given product, our Commercial revenues are composed of a larger volume of smaller dollar transactions. Accordingly, while any single Commercial customer s demand for a given product may fluctuate from quarter to quarter, the fact that there are so many Commercial 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 Commercial 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 $904,000 as of December 31, 2010, and $1.0 million as of December 31, 2009.

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Results of Operations

The following table reflects the percentage of total revenues represented by each item in our Consolidated Statements of Operations for the years ended December 31, 2010, 2009, and 2008:

	Year Ended December 31,		
	2010	2009	2008
Revenues:			
Product	96.8%	97.0%	97.8%
Service	3.2	3.0	2.2
Total revenues	100.0	100.0	100.0
Cost of revenues:			
Cost of product	53.8	55.0	59.7
Cost of service	2.2	2.3	1.9
Total cost of revenues	56.0	57.3	61.6
Gross profit	44.0	42.7	38.4
Operating expenses:			
Product development	31.3	34.3	28.2
Sales and marketing	22.6	22.8	17.6
General and administrative	15.9	15.2	12.8
Restructuring charges	1.1		
Total operating expenses	70.9	72.3	58.6
Loss from operations	(26.9)	(29.6)	(20.2)
Interest and other income, net	0.4		2.2
Interest expense on lease financing obligations	(1.4)	(1.6)	(1.1)
Loss before provision for income taxes	(27.9)	(31.2)	(19.1)
Income tax expense (benefit)	0.3	(0.2)	0.2
Net loss	(28.2)%	(31.0)%	(19.3)%

Revenues

Total revenues

	Year Ended December 31,			2010 over 2009	2009 over 2008	2010 over 2009	2009 over 2008
(Dollars in thousands)	2010	2009	2008	$ Change	$ Change	% Change	% Change
Total revenues	$ 111,037	$ 103,338	$ 134,047	$ 7,699	($ 30,709)	7.5%	(22.9%)

The $7.7 million increase in total revenues in 2010 as compared to 2009 was primarily attributable to a $9.0 million increase in Utility revenues and a $4.6 million increase in Commercial revenues, partially offset by a $5.9 million decrease in Enel Project revenues. The $30.7 million decrease in total revenues in 2009 as compared to 2008 was primarily attributable to an $18.8 million decrease in Utility revenues, a $9.5 million decrease in Commercial revenues, and a $2.4 million decrease in Enel Project revenues.

Utility revenues

	Year Ended December 31,			2010 over 2009 $ Change	2009 over 2008 $ Change	2010 over 2009 % Change	2009 over 2008 % Change
(Dollars in thousands)	2010	2009	2008				
Utility Revenues	$ 57,257	$ 48,271	$ 67,118	$ 8,986	($ 18,847)	18.6%	(28.1%)

During 2010, 2009, and 2008, our Utility 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 Utility revenues.

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The $9.0 million increase in Utility revenues during 2010 as compared to 2009 was 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 Russia and Denmark. In addition, as discussed more fully in the section titled Critical Accounting Policies and Estimates earlier in this section, due to our January 1, 2010 adoption of new accounting guidance for multiple element arrangements our Utility 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.

During 2009, our Utility revenues decreased by approximately 28.1% as compared to 2008. We believe this reduction was due, at least in part, to the sudden and severe worldwide economic slowdown that began in late 2008 and continued through 2009. As a result of the recession, utilities experienced reduced cash flows, which we believe caused them to limit their capital expenditures. In addition, the economic downturn has had a particularly detrimental effect on the credit markets, both in the United States and abroad, which play a key role in a utility s decision to move forward with a large-scale deployment, as such efforts frequently require the utility to secure financing for the project. We also believe that the American Recovery and Reinvestment Act of 2009, which was enacted in early 2009, caused many U.S. utilities to postpone their plans to move forward with their large-scale smart grid deployments. This was due to the fact that, once the stimulus program was announced, utilities throughout the United States applied for stimulus funds in order to offset a portion of their project s expected costs.

Our ability to recognize revenue on shipments of our Utility 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 certain contractual provisions, such as customer acceptance. In addition, the complex revenue recognition rules relating to products such as our NES System may require us to defer some or all of the revenue associated with shipments of these products until certain conditions are met in a future period.

Our Utility revenues have historically been concentrated with a relatively few customers. During the years ended December 31, 2010, 2009, and 2008, approximately 86.4%, 85.4%, and 93.1%, respectively, of our Utility revenues were attributable to five customers. While our Utility customers will change over time, given the nature of the Utility market, we expect our future Utility revenues will continue to be concentrated among a limited number of customers.

During the third quarter of 2010, we announced the Echelon Control System (ECoS), a new open software platform for intelligent distributed control of the smart grid. ECoS will run throughout the edge of the grid on a new Echelon product, the Edge Control Node (ECN) 7000 series of open and extensible hardware solutions. We also announced that Duke Energy will be the first customer for ECoS and the ECN. While both ECoS and the ECN currently remain under development, we expect to begin shipping final versions of the new products during the latter part of 2011, at which point revenues associated with the new products will commence.

We currently expect that our 2011 NES system revenues will increase over 2010 levels, in large part due to our expectation that world-wide macro-economic conditions and associated credit markets, which were severely impacted by the world-wide recession that began in late 2008 and continued through 2009 and much of 2010, will continue to improve.

Commercial revenues

	Year Ended December 31,			2010 over 2009	2009 over 2008	2010 over 2009	2009 over 2008
(Dollars in thousands)	2010	2009	2008	$ Change	$ Change	% Change	% Change
Commercial Revenues	$ 49,135	$ 44,549	$ 54,040	$ 4,586	($ 9,491)	10.3%	(17.6%)

Our Commercial 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.

The $4.6 million increase in Commercial revenues in 2010 as compared to 2009 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 Commercial family of products, the year-over-year increase was driven primarily from increases in our control and connectivity as well as SmartServer products.

The $9.5 million decrease in Commercial revenues in 2009 as compared to 2008 was primarily due to significant decreases in revenues in the EMEA and Americas regions. During 2009, the recession was particularly hard on many of our Commercial customers, including those in the utility, building automation, industrial automation, and transportation markets. Partially offsetting these decreases was a slight increase in sales in the APJ region. Within the Commercial family of products, the year-over-year decrease was primarily attributable to a decrease in our control and connectivity products, in particular our power line transceiver and control module products, which are used extensively by customers in the negatively impacted markets listed above.

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Our future Commercial 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 our Commercial 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 Commercial revenues conducted in currencies other than the United States dollar, principally the Japanese Yen, was about 7.3% in 2010, 6.9% in 2009, and 5.9% in 2008. To date, we have not hedged any of these foreign currency risks. We do not currently expect that, during 2011, the amount of our Commercial 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.

We currently expect our 2011 Commercial revenues will continue to increase over amounts generated in 2010, due primarily to our expectation of ongoing improvements in world-wide macro-economic conditions.

Enel Project revenues

	Year Ended December 31,			2010 over 2009	2009 over 2008	2010 over 2009	2009 over 2008
(Dollars in thousands)	2010	2009	2008	$ Change	$ Change	% Change	% Change
Enel Project Revenues	$ 4,645	$ 10,518	$ 12,889	($ 5,873)	($ 2,371)	(55.8%)	(18.4%)

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 $4.6 million, $10.5 million, and $12.9 million of Enel project revenue recognized during 2010, 2009, and 2008, respectively, related primarily to shipments under the development and supply agreement, and to a lesser extent, from revenues attributable to the software enhancement agreement. Both the development and supply agreement and the software enhancement agreements expire in December 2011, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances. We currently expect that revenues from the Enel project during 2011 will be moderately higher than those generated in 2010 as we expect Enel to order higher quantities of metering kit products in 2011.

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,			2010 over 2009	2009 over 2008	2010 over 2009	2009 over 2008
(Dollars in thousands)	2010	2009	2008	$ Change	$ Change	% Change	% Change
Gross Profit	$ 48,851	$ 44,107	$ 51,476	$ 4,744	($ 7,369)	10.8%	(14.3%)
Gross Margin	44.0%	42.7%	38.4%			1.3	4.3

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.

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 Utility product line, which resulted from a higher percentage of our Utility revenues being generated from sales of the more recent and cost reduced versions of our Utility 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 51.6% of our revenues were attributable to sales of our Utility products and services, 44.3% of our revenues were attributable to sales of our Commercial products and services, and the remaining 4.1% were attributable to the Enel project. During 2009, approximately 46.7% of our revenues were attributable to sales of our Utility products and services, 43.1% of our revenues were attributable to sales of our Commercial products and services, and the remaining 10.2% were attributable to the Enel project. In general, gross margins generated from sales of our Utility products are lower than those generated from both sales of our Commercial products and services as well as sales made under the Enel Project. As a result, when Utility revenues are higher as a percentage of overall revenues, as they were during 2010, overall gross margins will be negatively impacted. Conversely, when Utility revenues comprise a lower percentage of overall revenues, overall gross margins will be favorably impacted.

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2009 gross margins of 42.7% improved by 4.3 percentage points as compared to those generated in 2008. This improvement was primarily due to the mix of revenues reported. As noted above, during 2009, approximately 46.7% of our revenues were attributable to sales of our Utility products and services, 43.1% of our revenues were attributable to sales of our Commercial products and services, and the remaining 10.2% were attributable to the Enel project. During 2008, approximately 50.1% of our revenues were attributable to sales of our Utility products and services, 40.3% of our revenues were attributable to sales of our Commercial products and services, and the remaining 9.6% were attributable to the Enel project. As such, the lower proportion of lower margin Utility sales in 2009 as compared to 2008 caused 2009 margins to increase. Also contributing to the year-over-year fluctuations in gross margins was the impact of improved gross margins in our Utility product line. As a percentage of 2009 revenues, indirect costs were relatively unchanged from those recorded in 2008.

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 Utility and Commercial 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, or to the extent the 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 Utility products, contain significant amounts of certain commodities, such as copper, silver, 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,			2010 over 2009	2009 over 2008	2010 over 2009	2009 over 2008
(Dollars in thousands)	2010	2009	2008	$ Change	$ Change	% Change	% Change
Product Development	$ 34,762	$ 35,435	$ 37,753	($ 673)	($ 2,318)	(1.9%)	(6.1%)

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.

The $673,000 decrease in product development expenses during 2010 as compared to 2009 was primarily due to the fact that product development expenses of $4.5 million during 2010 were offset by contractually guaranteed payments (as such term is defined by generally accepted accounting principles) by a third party (also discussed in Note 1(n) Accrued Liabilities in the accompanying consolidated financial statements included in Part IV of this report). Excluding the impact of the $4.5 million in offsetting project payments, our product development expenses increased $3.8 million during 2010. This increase was primarily due to the incremental expenses we incurred associated with this project. We currently anticipate this arrangement will continue into 2011, although we expect the amount of the third party customer funding we use to reduce our product development expenses will decrease from $4.5 million in 2010 to $1.5 million in 2011. During this time, we expect our product development expenses will fluctuate from quarter to quarter. These fluctuations will be driven by both the amount of contractually guaranteed payments earned by us during the respective quarter, since the payments are used to offset current period product development expenses incurred, and any incremental expenses associated with this project that we incur in the respective period. Therefore, while the arrangement is in effect, our future quarterly product development expenses could be higher or lower than levels reported for the corresponding periods in 2010.

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.

The $2.3 million decrease in product development expenses during 2009 as compared to 2008 was primarily due to a $649,000 decrease in compensation expenses for our product development personnel, which was primarily the result of a structured salary reduction program we implemented in May 2009 for our U.S. based personnel, as well as a reduction of $381,000 in equity compensation expense. Also contributing to the year-over-year decrease were reductions in equipment and supplies used in the development process in the amount of $541,000, lower facility costs of $439,000 resulting primarily from the June 2008 amendments to the lease agreements for our San Jose, California headquarters facility, reduced fees paid to third party service providers of $215,000, and other miscellaneous spending reductions of $93,000.

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In April 2010, we announced that our Board of Directors had approved a restoration of salary for all of our employees who had been affected by the structured salary reduction we implemented in 2009. The salary restoration took effect on May 1, 2010, and as a result, compensation expense for product development personnel would be expected to increase for the full year 2011. However, in December 2010, we initiated a restructuring program which is expected to reduce our product development headcount by approximately 10% in 2011. When coupled with the reduction in offsetting third party payments as discussed above, we expect our overall product development expenses will increase slightly in 2011 as compared to 2010.

Sales and marketing

(Dollars in thousands)	Year Ended December 31, 2010	2009	2008	2010 over 2009 $ Change	2009 over 2008 $ Change	2010 over 2009 % Change	2009 over 2008 % Change
Sales and Marketing	$ 25,062	$ 23,525	$ 23,635	$ 1,537	($ 110)	6.5%	(0.5%)

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 $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.

The $110,000 decrease in sales and marketing expenses in 2009 as compared to 2008 was primarily due to $431,000 reduction in advertising and product promotion costs, a $233,000 reduction in facility costs resulting primarily from the June 2008 amendments to the lease agreements for our San Jose, California headquarters facility, a $229,000 reduction in travel and entertainment expenses, a $158,000 reduction in fees paid to third party service providers, and other miscellaneous spending reductions of $177,000, partially offset by a $1.1 million increase in compensation and other employee related expenses, including a $435,000 increase in stock-based compensation expenses. Also contributing to the year-over-year decrease was approximately $289,000 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 0.7% between the two years.

Our sales personnel were not affected by the structured salary reduction program we implemented in May 2009, although our U.S. based marketing personnel were. Therefore, our full year 2011 compensation costs for our marketing personnel will increase due to the May 2010 salary restoration discussed above. We also intend to invest more heavily in our sales and marketing efforts during 2011, including the hiring of additional personnel in our sales and marketing organization. This will also likely increase our sales and marketing expenses over historical levels.

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

(Dollars in thousands)	Year Ended December 31, 2010	2009	2008	2010 over 2009 $	2009 over 2008 $	2010 over 2009 %	2009 over 2008 %

				Change	Change	Change	Change
General and Administrative	$ 17,647	$ 15,742	$ 17,143	$ 1,905	($ 1,401)	12.1%	(8.2%)

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.

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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 the May 2010 salary restoration discussed above, 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.

The $1.4 million decrease in general and administrative expenses in 2009 as compared to 2008 was primarily due to a $691,000 reduction in expenses related to our independent accountants and other third party service providers, a $467,000 reduction in facility costs resulting primarily from the June 2008 amendments to the lease agreements for our San Jose, California headquarters facility, a $221,000 reduction in travel and entertainment expenses, and a $151,000 reduction in compensation and other employee related expenses, partially offset by miscellaneous other spending increases of $129,000.

We currently expect our 2011 general and administrative expenses will increase slightly over 2010 levels.

Restructuring Charges

	Year Ended December 31,			2010 over 2009	2009 over 2008	2010 over 2009	2009 over 2008
(Dollars in thousands)	2010	2009	2008	$ Change	$ Change	% Change	% Change
Restructuring charges	$ 1,212	$	$	$ 1,212	$	N/A	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.

Accrued restructuring charges of approximately $1.2 million as of December 31, 2010 are reflected in accrued liabilities on our Consolidated Balance Sheets. We expect to pay these accrued termination benefits through the first two quarter of 2011. We do not currently expect to incur any additional material restructuring charges during 2011.

Interest and Other Income (Expense), Net

	Year Ended December 31,			2010 over 2009	2009 over 2008	2010 over 2009	2009 over 2008
(Dollars in thousands)	2010	2009	2008	$ Change	$ Change	% Change	% Change
Interest and Other Income (Expense), Net	$ 393	($ 28)	$ 2,925	$ 421	($ 2,953)	1,503.6%	(101.0%)

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 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, which was partially offset by a $233,000 decrease in interest income. The increase 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 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 2009, interest and other income (expense), net decreased by approximately $3.0 million as compared to 2008. This decrease was primarily due to a $1.9 million decrease in interest income, and to a lesser extent, by a $1.0 million increase in foreign currency translation losses on our short-term intercompany balances. As was the case in 2010, 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 2011 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.

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Interest Expense on Lease Financing Obligations

(Dollars in thousands)	Year Ended December 31, 2010	2009	2008	2010 over 2009 $ Change	2009 over 2008 $ Change	2010 over 2009 % Change	2009 over 2008 % Change
Interest Expense on Lease Financing Obligations	$ 1,572	$ 1,668	$ 1,404	($ 96)	$ 264	(5.8%)	18.8%

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.

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. As a result of the lease extension, our 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). This had the effect of increasing the amount of our monthly payment attributable 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 2011 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, 2010	2009	2008	2010 over 2009 $ Change	2009 over 2008 $ Change	2010 over 2009 % Change	2009 over 2008 % Change
Income Tax Expense (Benefit)	$ 301	($ 257)	$ 297	$ 558	($ 554)	217.1%	(186.5%)

The provision for income taxes for 2010, 2009, and 2008 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 $301,000 in 2010, income tax benefit of $257,000 in 2009, and income tax expense of $297,000 in 2008, 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.

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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.

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 $616,000 during 2010, $450,000 during 2009, and $513,000 during 2008.

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, 2010, 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, 2010, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

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As of December 31, 2010, 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	$ 31,766	$ 3,174	$ 6,468	$ 6,738	$ 15,386
Operating leases	9,061	1,606	2,296	1,736	3,423
Purchase commitments	32,165	32,165			
Total	$ 72,992	$ 36,945	$ 8,764	$ 8,474	$ 18,809

The amounts in the table above exclude $993,000 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, 2010, we raised $294.1 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 authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. There were no repurchases under this stock repurchase program during the year ended December 31, 2010. Since inception, we have repurchased a total of 750,000 shares under this program at a cost of $8.9 million. As of December 31, 2010, 2,250,000 shares were available for repurchase. This stock repurchase program will expire in April 2011.

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

	As of December 31,		
	2010	2009	2008
Cash, cash equivalents, and short-term investments	$ 64,632	$ 80,116	$ 87,316
Trade accounts receivable, net	25,102	21,496	23,480
Working capital	77,259	96,357	108,811
Stockholder s equity	93,989	115,898	132,571

As of December 31, 2010, we had $64.6 million in cash, cash equivalents, and short-term investments, a decrease of $15.5 million as compared to December 31, 2009. 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 $9.2 million in 2010, a $3.4 million increase from

2009. During 2010, net cash used in operating activities 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.

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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.

During 2008, net cash used in operating activities of $3.5 million was primarily the result of our net loss of $25.8 million and a net increase in our operating assets and liabilities of $242,000, all of which was partially offset by non-cash charges for stock-based compensation expenses of $14.5 million, depreciation and amortization expenses of $7.4 million, and a decrease in accrued investment income of $721,000. The primary components of the $242,000 increase in our operating assets and liabilities were a $7.7 million decrease in deferred revenues, a $2.6 million increase in other current assets, a $2.4 million increase in inventories, and a $2.4 million increase in accounts payable, partially offset by a $10.1 million decrease in accounts receivable and a $4.2 million decrease in deferred cost of goods sold. Deferred revenues decreased due primarily to lower overall revenue levels in the fourth quarter of 2008, which was in part due to the sudden world-wide economic slowdown that occurred during that time. Other current assets increased primarily due to non-trade receivable amounts due our company from one of our contract manufacturers for materials they purchased from us. Inventories increased due in part to the sudden world-wide economic slowdown that occurred during the fourth quarter of 2008, as well as to our transition between CEMs during 2008. During this transition, we were required to purchase significant amounts of raw material inventory, much of which remained on our balance sheet as of December 31, 2008. Accounts payable increased due to the timing of expenditures during the fourth quarter of 2008. Accounts receivable decreased primarily due to a $10.1 million reduction in revenues during the fourth quarter of 2008 as compared to the same period in 2007. Deferred cost of goods sold decreased due to a corresponding reduction in deferred revenues.

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 $4.0 million for 2010, an $18.2 million increase in cash inflows compared to 2009. Net cash provided by investing activities 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.

Net cash used in investing activities of $23.8 million in 2008 was primarily the result of net purchases of available-for-sale short-term investments of $19.2 million and by capital expenditures of $4.6 million.

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 $3.9 million for 2010, a $3.2 million increase in cash outflows compared to 2009. Net cash used in financing activities 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.

Net cash used in financing activities of $10.1 million in 2008 was primarily attributable to $8.9 million of open-market repurchases of our common stock under our stock repurchase program, $1.8 million of principal payments on our lease financing obligations, and $1.6 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 $2.1 million from issuance of common stock upon exercise of options by our employees.

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, 2011. 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, 2010, we were in compliance with these covenants. As of December 31, 2010, our primary bank has issued, against the line of credit, two standby letters of credit totaling $146,000. 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 2011. 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, 2010, 2009, and 2008, 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 Executive Chairman, M. Kenneth Oshman, uses his private plane or charter aircraft for Company business for himself and any employees that accompany him. In August 2008, our Board of Directors approved a reimbursement arrangement whereby our company will reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. Our Compensation Committee reaffirmed this arrangement in February 2011. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. During 2010, we recognized a total of approximately $96,000 in expenses pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the Consolidated Statements of Operations. The Audit Committee of our board of directors regularly reviews these reimbursements.

In November 2009, our Board of Directors approved a similar reimbursement arrangement for our then President and Chief Executive Officer, Robert R. Maxfield, whereby our company would reimburse Mr. Maxfield for 50% of the costs incurred for charter aircraft used while on company business. Alternatively, if Mr. Maxfield used his private plane while on company business, we would have reimbursed him for the cost of an equivalent first class ticket on a commercial flight. During 2010, we recognized a total of approximately $1,000 in expense pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the Consolidated Statements of Operations.

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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. Both the development and supply agreement and the software enhancement agreement expire in December 2011, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

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, $6.1 million of which was included in accounts receivable at December 31, 2009. During 2008, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $12.9 million.

On October 29, 2001, we loaned Russell Harris, our Senior Vice President of Operations, $1,000,000 in connection with his principal residence. Mr. Harris issued to us a promissory note secured by residential real estate. The note bore interest at the rate of 4.5% per annum, compounded monthly. The interest that accrued under the note was due and payable in monthly installments over the nine year term of the note, and the principal was due and payable on October 29, 2010. The principal was paid in full by Mr. Harris in June 2009. During the years ended December 31, 2009 and 2008, interest paid by Mr. Harris was $22,000 and $45,000, respectively. While it was outstanding, the terms of this loan were never amended.

Recently Issued Accounting Standards

With the exception of a change in how we record revenue for multiple element arrangements as discussed in the section titled *Critical Accounting Policies and Estimates* above, there have been no new recent accounting pronouncements or changes in accounting pronouncements during the year ended December 31, 2010, 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, 2010, 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, 2010, 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.

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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, 2010.

(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, 2010. 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, 2010. 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, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Echelon is scheduled to hold its 2011 annual meeting of stockholders on May 24, 2011. 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 31, 2011.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE MATTERS

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 2011 Annual Meeting of Stockholders (the 2011 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, 2010.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference from our 2011 Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item is incorporated herein by reference from our 2011 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 2011 Proxy Statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated herein by reference from our 2011 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.

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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
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.

+ 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.

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(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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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 as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders equity, comprehensive loss, and cash flows for each of the years in the three-year period ended December 31, 2010. We also have audited Echelon Corporation s internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Echelon Corporation 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 Annual Report on Internal Control over Financial Reporting appearing under Item 9A(b). Our responsibility is to express an opinion on these consolidated financial statements and 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, 2010 and 2009, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles. Also in our opinion, Echelon Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

As discussed in Note 1(e) to the consolidated financial statements, 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

Mountain View, California

March 15, 2011

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ECHELON CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

	December 31, 2010	December 31, 2009
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 7,675	$ 17,206
Short-term investments	56,957	62,910
Accounts receivable, net of allowances of $945 in 2010 and $1,177 in 2009 [1]	25,102	21,496
Inventories	8,993	10,949
Deferred cost of goods sold	2,588	3,154
Other current assets	3,962	3,622
Total current assets	105,277	119,337
Property and equipment, net	31,020	35,595
Goodwill	8,316	8,496
Other long-term assets	957	1,009
TOTAL ASSETS	$ 145,570	$ 164,437
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 10,399	$ 7,255
Accrued liabilities	6,713	4,850
Current portion lease financing obligations	1,731	1,588
Deferred revenues	9,175	9,287
Total current liabilities	28,018	22,980
Long-Term Liabilities:		
Lease financing obligations, excluding current portion	22,062	23,794
Other long-term liabilities	1,501	1,765
Total long-term liabilities	23,563	25,559
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 45,211,460 shares in 2010 and 44,224,926 shares in 2009		
Outstanding 41,992,276 shares in 2010 and 41,005,742 shares in 2009	452	442
Additional paid-in capital	338,521	328,643
Treasury stock, at cost (3,219,184 shares in 2010 and 2009)	(28,130)	(28,130)
Accumulated other comprehensive income	561	1,046
Accumulated deficit	(217,415)	(186,103)

Total stockholders equity	93,989	115,898
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 145,570	$ 164,437

[1] Includes related party amounts of $0 in 2010 and $6,056 in 2009. See Note 11 for additional information on related party transactions.

See accompanying notes to the consolidated financial statements.

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ECHELON CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Year Ended December 31,		
	2010	2009	2008
REVENUES:			
Product	$ 107,441	$ 100,187	$ 131,073
Service	3,596	3,151	2,974
Total revenues [1]	111,037	103,338	134,047
COST OF REVENUES:			
Cost of product	59,722	56,813	79,984
Cost of service	2,464	2,418	2,587
Total cost of revenues	62,186	59,231	82,571
Gross profit	48,851	44,107	51,476
OPERATING EXPENSES:			
Product development	34,762	35,435	37,753
Sales and marketing	25,062	23,525	23,635
General and administrative	17,647	15,742	17,143
Restructuring charges	1,212		
Total operating expenses	78,683	74,702	78,531
Loss from operations	(29,832)	(30,595)	(27,055)
Interest and other income (expense), net	393	(28)	2,925
Interest expense on lease financing obligations	(1,572)	(1,668)	(1,404)
Loss before income taxes	(31,011)	(32,291)	(25,534)
Income tax expense (benefit)	301	(257)	297
NET LOSS	$ (31,312)	$ (32,034)	$ (25,831)
Loss per share:			
Basic	$ (0.76)	$ (0.79)	$ (0.64)
Diluted	$ (0.76)	$ (0.79)	$ (0.64)
Shares used in per share calculation:			
Basic	41,365	40,724	40,636
Diluted	41,365	40,724	40,636

[1] Includes related party amounts of $4,645 in 2010, $10,518 in 2009, and $12,889 in 2008. See Note 11 for additional information on related party transactions.

See accompanying notes to the consolidated financial statements.

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ECHELON CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands)

	Common Stock		Treasury Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount				
BALANCE AT DECEMBER 31, 2007	43,206	$ 432	(2,469)	$ (19,259)	$ 298,556	$ 1,718	$ (128,236)	$ 153,211
Exercise of stock options	405	4			3,913			3,917
Release of performance shares	322	3			(3)			
Stock received for payment of option exercise price	(130)	(1)			(1,799)			(1,800)
Stock received for payment of employee taxes on vesting of performance shares and upon exercise of stock options	(124)	(1)			(1,540)		(2)	(1,543)
Repurchase of stock			(750)	(8,871)				(8,871)
Repurchase of employee shares	(3)				(36)			(36)
Stock-based compensation					14,458			14,458
Foreign currency translation adjustment						(967)		(967)
Unrealized holding gain on available-for-sale securities						33		33
Net loss							(25,831)	(25,831)
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

See accompanying notes to the consolidated financial statements.

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ECHELON CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended December 31,		
	2010	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	$ (31,312)	$ (32,034)	$ (25,831)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	6,721	6,468	7,406
Increase in (reduction of) allowance for doubtful accounts	28	27	(29)
Loss on disposal of fixed assets	5	37	10
Reduction of (increase in) accrued investment income	(31)	43	721
Stock-based compensation	12,328	14,403	14,458
Change in operating assets and liabilities:			
Accounts receivable	(3,580)	1,943	10,079
Inventories	2,006	5,553	(2,428)
Other current assets	(402)	1,148	(2,647)
Accounts payable	2,999	(3,076)	(2,382)
Deferred cost of goods sold	608	(732)	4,177
Accrued liabilities	1,795	(492)	654
Deferred revenues	(275)	920	(7,669)
Deferred rent	(75)	(26)	(26)
Net cash used in operating activities	(9,185)	(5,818)	(3,507)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of available-for-sale short-term investments	(62,848)	(137,715)	(91,239)
Proceeds from sales and maturities of available-for-sale short-term investments	68,847	124,335	72,033
Changes in other long-term assets	27	1,082	(42)
Capital expenditures	(1,995)	(1,824)	(4,570)
Net cash provided by (used in) investing activities	4,031	(14,122)	(23,818)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net proceeds from exercise of stock options	615	2,004	2,117
Principal payments of lease financing obligations	(1,588)	(1,452)	(1,789)
Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options	(2,945)	(1,309)	(1,574)
Repurchase of common stock under stock repurchase program			(8,871)
Net cash used in financing activities	(3,918)	(757)	(10,117)
EFFECT OF EXCHANGE RATES ON CASH	(459)	234	(951)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(9,531)	(20,463)	(38,393)
CASH AND CASH EQUIVALENTS:			
Beginning of year	17,206	37,669	76,062
End of year	$ 7,675	$ 17,206	$ 37,669

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid for interest on lease financing obligations	$ 1,564	$ 1,659	$ 1,454
Cash paid for income taxes	$	$ 122	$ 562
Noncash investing and financing information Increase in property and equipment and related lease financing obligation due to lease extension (see Note 3)	$	$	$ 12,526

See accompanying notes to the consolidated financial statements.

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ECHELON CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(in thousands)

	Year Ended December 31,		
	2010	2009	2008
Net loss	$ (31,312)	$ (32,034)	$ (25,831)
Other comprehensive income (loss), net of tax:			
Foreign currency translation adjustment	(500)	335	(967)
Unrealized holding gain (loss) on available-for-sale securities	15	(73)	33
Comprehensive loss	$ (31,797)	$ (31,772)	$ (26,765)

See accompanying notes to the consolidated financial statements.

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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 develops, markets, and supports a wide range of hardware and software products and services that enable OEMs and systems integrators to design and implement open, interoperable, distributed control networks. 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. For the electric utility industry, the Company has developed a smart grid solution called the Networked Energy Services (NES) system. The NES system provides a two-way information and control path between the utility and its customer, which enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. The Company sells its products and services 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 58% of net revenues for the year ended December 31, 2010 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 Utility customers generally procure products that have been customized to meet their requirements, the Company has limited visibility into ultimate product demand, which makes sales forecasting more difficult. As a result, anticipated demand may not materialize, which could subject the Company to increased levels of excess and obsolete inventories.

The Company has historically experienced shortages or interruptions in supply for certain products or components used in the manufacture of the Company s products that have been or will be discontinued. In order to ensure an adequate supply of these items, the Company has occasionally purchased quantities of these items that are in excess of the Company s then current estimate of short-term requirements. If the long-term requirements do not materialize as originally expected, and the Company is not otherwise able to dispose of these excess products or components, it could subject the Company to increased levels of excess and obsolete inventories. For example, to ensure supply, the Company procured a substantial quantity of a certain component used in one of its Utility products. If the long-term requirements do not materialize as originally expected, or if the Company develops alternative solutions that no longer employ these items and the Company is not able to dispose of these excess products or components, it could subject the Company to increased levels of excess and obsolete inventories.

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(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, stock-based compensation, allowance for doubtful accounts, 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 (and acceptance, as applicable) has occurred, the sales price is fixed or determinable, collectability is probable, and there are no post-delivery obligations. For non-distributor hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For sales made to the Company s distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer. Service revenue is recognized as the training services are performed, or ratably over the term of the support period.

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

In October 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of industry specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple deliverable revenue arrangements to:

- provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

- require an entity to allocate revenue in an arrangement using its best estimated selling price (BESP) of deliverables if a vendor does not have vendor-specific objective evidence (VSOE) of selling price or third-party evidence (TPE) of selling price; and

- eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

The Company elected to early adopt this accounting guidance at the beginning of its first quarter of fiscal year 2010 on a prospective basis for applicable transactions originating or materially modified after December 31, 2009.

Multiple Element Arrangements

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

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

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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 VSOE of selling price or TPE of selling price, if it exists. If neither VSOE nor TPE of selling price exists for a deliverable, the Company uses its 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, 2010 resulting from changes in VSOE, TPE, or BESP, nor does the Company expect a material impact from such changes in the near term.

Total net revenues as reported and unaudited pro forma total net revenues that would have been reported during the year ended December 31, 2010, if the transactions entered into or materially modified after December 31, 2009 were subject to previous accounting guidance, are shown in the following table (in thousands):

	As Reported	**Pro Forma Basis as if the Previous Accounting Guidance Were in Effect**
Total net revenues for the year ended December 31, 2010	$ 111,037	$ 107,965

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The $3.1 million impact to total net revenues during the year ended December 31, 2010 resulting from the adoption of the new accounting guidance was to net product revenues, and related solely to sales of the Company s Utility products. The impact was related primarily to the fact that, under the new accounting guidance, the Company recorded revenue on certain transactions for which the previous accounting guidance would have required deferral. Approximately $1.8 million of the $3.1 million impact was attributable to transactions involving multiple element arrangements where software upgrades had not yet been delivered as of December 31, 2010. Under the new accounting guidance, the Company determined the BESP for the software upgrades and deferred the relative selling price of these items accordingly. Under the previous accounting guidance, all revenue related to these transactions would have been deferred as the Company did not have VSOE of fair value for the undelivered items. The remaining $1.3 million of the $3.1 million impact was primarily attributable to transactions involving multiple element arrangements in which the Company shipped data concentrators to a customer but had not yet shipped all of the meters associated with that arrangement. As described below, since the meters and data concentrators were not shipped in proportion to the overall expected ratio for that arrangement, under the previous accounting guidance the Company would have been required to defer the revenue on the excess data concentrators until the corresponding meters were shipped in a future period. Under the new accounting guidance, however, the Company determined the BESP for both the data concentrators and the meters and recognized revenue for the relative value of each based on the quantity that were delivered to and accepted by customers.

As it relates to the timing and pattern of revenue recognition for Utility product sales in the future, the new accounting guidance has had a significant effect on total net revenues for transactions entered into or materially modified after December 31, 2009, and the Company expects this trend to continue. This expectation is primarily due to the fact that the Company does not currently have VSOE of fair value for most of its Utility product offerings, which often resulted in deferral of revenue as discussed below. For Utility arrangements subject to the new revenue recognition guidance, revenue allocated to meters and data concentrators will be recognized as those units are delivered to and accepted by the Company s customers, while revenue allocated to PCS and extended warranties will be recognized ratably over the service period.

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

As of December 31, 2010 and December 31, 2009, approximately $3.7 million and $5.2 million, respectively, of the Company s Utility product revenue was deferred. Of the $3.7 million of deferred revenue at December 31, 2010, approximately $1.5 million of it relates to revenue that will be accounted for under previous revenue recognition guidance while the remaining $2.2 million relates to revenue that will be accounted for under the new revenue recognition guidance.

(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) 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 stock options and stock appreciation rights (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).

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(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, 2010, 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, 2010.

(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,	
	2010	2009
Purchased materials	$ 4,306	$ 3,882
Work-in-process	48	176
Finished goods	4,639	6,891
	$ 8,993	$ 10,949

(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, 2010, 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, 2010, 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.

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(n) Accrued Liabilities

Accrued liabilities consisted of the following (in thousands):

	December 31,	
	2010	2009
Accrued payroll and related costs	$ 3,727	$ 3,329
Restructuring charges	1,158	
Warranty reserve	877	1,004
Accrued taxes	167	185
Payments received toward design and development expenses	300	
Customer deposits	197	
Other accrued liabilities	287	332
	$ 6,713	$ 4,850

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

(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 to mitigate the risk of uncollectibility, such as a bank guarantee. Additionally, the Company establishes an allowance for doubtful accounts and sales return allowances based upon factors surrounding the credit risk of specific customers, historical trends, and other available information.

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. For the years ended December 31, 2010 and 2009, 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):

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	December 31, 2010	December 31, 2009
Eltel Networks A/S	39.3%	30.3%
Enel (and its contract manufacturers)	0.0%	28.2%
Duke Energy Corporation	16.3%	15.5%
Total	55.6%	74.0%

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 Utility products. The Neuron Chip, which is an important component that the Company and its customers use in control network devices, is currently manufactured and distributed by two providers, Toshiba and Cypress Semiconductor. Toshiba has informed the Company that it does not intend to renew its Neuron Chip agreement with Echelon, which expired in January 2010. 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 Utility 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 alternative 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 and Pro Forma Basic 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, 2010, 2009, and 2008 (in thousands, except per share amounts):

	Year Ended December 31, 2010	2009	2008
Net loss (Numerator):			
Net loss, basic and diluted	$ (31,312)	$ (32,034)	$ (25,831)
Shares (Denominator):			
Weighted average shares used in basic computation	41,365	40,724	40,636
Weighted average shares used in diluted computation	41,365	40,724	40,636
Net loss per share:			
Basic	$ (0.76)	$ (0.79)	$ (0.64)
Diluted	$ (0.76)	$ (0.79)	$ (0.64)

For the years ended December 31, 2010, 2009, and 2008, 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 2010, 2009, and 2008 were 6,476,817, 7,392,866, and 6,860,098, 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.

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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.

(t) Recent Accounting Pronouncements

With the exception of item *(e) Revenue Recognition* discussed above, there have been no new recent accounting pronouncements or changes in accounting pronouncements during the year ended December 31, 2010, that are of significance, or potential significance, to the Company.

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, 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	$

There have been no transfers between fair value measurement levels during the year ended December 31, 2010.

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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, 2009 (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]	$ 1,655	$ 1,655	$	$
Fixed income available-for-sale securities: [2]				
U.S. corporate commercial paper	14,991		14,991	
U.S. government securities	52,919		52,919	
Total fixed income available-for-sale securities	67,910		67,910	
Total	$ 69,565	$ 1,655	$ 67,910	$

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

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

All of the $57.0 million of fixed income available-for-sale securities at December 31, 2010 are classified as short-term investments. Of the $67.9 million of fixed income available-for-sale securities at December 31, 2009, approximately $5.0 million are classified as cash equivalents, while the remaining $62.9 million 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, 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	$

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, 2009 (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. corporate commercial paper	$ 9,991	$ 9,991	$	$
U.S. government securities	52,917	52,919	15	13
Total investments in debt securities	$ 62,908	$ 62,910	$ 15	$ 13

As of December 31, 2010 and 2009, the Company s available-for-sale securities had original contractual maturities of between three to twelve months. As of December 31, 2010 and 2009, the average remaining term to maturity for the Company s available-for-sale securities was five and six months, respectively.

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As of December 31, 2010, there were no investments that were in an unrealized loss position. The following table show the gross unrealized losses and fair value for those investments that were in an unrealized loss position as of December 31, 2009, aggregated by investment category and the length of time that individual securities have been in a continuous loss position (in thousands):

	December 31, 2009					
	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	$ 16,941	$ (13)	$	$	$ 16,941	$ (13)
Total	$ 16,941	$ (13)	$	$	$ 16,941	$ (13)

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, 2010, 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, 2010 and December 31, 2009 is as follows (in thousands):

	December 31, 2010	December 31, 2009
Buildings and improvements	$ 37,356	$ 37,356
Computer and other equipment	23,496	23,313
Software	4,933	4,791
Furniture and fixtures	2,729	2,787
Leasehold improvements	3,978	3,950
	72,492	72,197
Less: Accumulated depreciation and amortization	(41,472)	(36,602)
Property and equipment, net	$ 31,020	$ 35,595

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.

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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 the years ended December 31, 2010, 2009, and 2008, the Company has recorded depreciation expense associated with the building assets of $2.0 million, $2.0 million, and $2.3 million, respectively. As of December 31, 2010 and December 31, 2009, the net book value of the building assets was $18.6 million and $20.7 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 the years ended December 31, 2010, 2009, and 2008, land lease expense was $741,000, $741,000, and $604,000, respectively; principal reductions on the lease financing obligations were $1.6 million, $1.4 million and $1.8 million, respectively; and interest expense was $1.6 million, $1.7 million, and $1.4 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, 2010, 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, 2010, the Company was authorized to issue 100,000,000 shares of $0.01 par value common stock, of which 41,992,276 were outstanding.

In March and August 2004, March 2006, and February 2007, the Company s board of directors approved a stock repurchase program, which authorized the Company to repurchase up to 3.0 million shares of the Company s common stock. Since inception, the Company repurchased a total of 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, the Company s board of directors approved a new stock repurchase program, which authorizes 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, 2010. Since inception, the Company has repurchased a total of 750,000 shares under the program at a cost of $8.9 million. As of

December 31, 2010, 2,250,000 shares were available for repurchase. The new stock repurchase program will expire in April 2011.

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(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, and directors for their long-term contribution to the Company, to align their interest with those of the Company s stockholders in creating stockholder value, and to provide incentives for them to remain with the Company. The number and frequency of equity compensation grants is based on competitive practices, operating results of the Company, and accounting regulations. Since the inception of the 1997 Plan, the Company has granted options to all of its employees.

Historically, the Company has issued new shares upon the exercise of stock options. However, treasury shares are also available for issuance, although the Company does not currently intend to use treasury shares for this purpose.

1997 Stock Plan

During 1997, the Company adopted the 1997 Stock Plan (the 1997 Plan) for employees, officers and directors, which was amended and restated in May 2004. As of December 31, 2010, a total of 15,511,170 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.

1998 Directors Option Plan

The 1998 Director Option Plan (the Director Plan) was adopted by the Board of Directors in May 1998 and became effective upon the closing of the initial public offering of the Company s stock in July 1998. It provided for stock option grants to non-employee directors. The Director Plan expired in July 2008. Future grants made to members of our Board of Directors will be made from the 1997 Plan. Prior to its expiration, options granted under the Director Plan were generally fully vested on the date of grant and had exercise prices equal to the per share fair market value of the Company s common stock on the date of grant. During 2008, options to purchase an aggregate of 75,000 shares were granted under the Director Plan. The weighted average exercise price for the options granted in 2008 was $13.12.

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In the event of a merger of the Company with or into another corporation or the sale of substantially all of the assets of the Company, each outstanding option granted under the Director Plan shall be assumed or an equivalent option may be substituted by the successor corporation. Following such assumption or substitution, if the optionee s status as a director of the successor corporation terminates other than upon a voluntary resignation by the optionee, the option shall become fully exercisable, including as to shares as to which it would not otherwise be exercisable. If the outstanding options are not assumed or substituted, the options shall become fully vested and exercisable. Options granted must be exercised within three months of the end of the optionee s tenure as a director of the Company, or within twelve months after such director s termination by death or disability, but in no event later than the expiration of the option s five year term; provided, however, that shares subject to an option granted to a director who has served as a director with the Company for at least five years shall become fully vested and exercisable for the remainder of the option s five year term upon such director s termination. No option granted under the Director Plan is transferable by the optionee other than by will or the laws of descent and distribution, and each option is exercisable, during the lifetime of the optionee, only by such optionee.

(d) Employee Stock Option Exchange Program

On November 19, 2008, the Company announced a voluntary employee stock option exchange program (the Exchange Program) whereby eligible employees were given an opportunity to exchange some or all of their outstanding stock options and SARs, collectively the Surrendered Awards , for a predetermined number of new SARs. Under the Exchange Program, participating eligible employees would receive one new SAR for each Surrendered Award with an exercise price less than $12.00 per share. For exchanged options with an exercise price equal to or greater than $12.00 per share, participants would receive between 0.33 and 0.67 new SARs for each Surrendered Award exchanged, depending on the exercise price of the Surrendered Award. The Company s board of directors and Compensation Committee approved the Exchange Program to restore the retention and incentive benefits of the Company s equity awards. Non-employee members of the Company s board of directors were not eligible to participate in the Exchange Program.

On December 17, 2008, in accordance with the Exchange Program, the Company accepted and cancelled options and SARs to purchase 4,659,926 shares of its common stock. On the same day, the Company granted new SARs totaling 3,240,890 shares. The new SARs were granted at an exercise price of $7.69, the closing price of the Company s stock on December 17, 2008. The new SARs granted under the Exchange Program have vesting schedules and maximum terms as follows:

Percentage of Surrendered Award Vested as of December 17, 2008	**Vesting Schedule of New SARs**	**Maximum Term of New SARs**
Fully vested	100% of the new SARs will be scheduled to vest on the first anniversary of the new grant date	two (2) years
75% vested	50% of the new SARs will be scheduled to vest on each of the first and second anniversaries of the new grant date	three (3) years
50% vested	33.33% of the new SARs will be scheduled to vest on each of the first three (3) anniversaries of the new grant date	four (4) years
25% or less vested	25% of the new SARs will be scheduled to vest on each of the first four (4) anniversaries of the new grant date	five (5) years

See Note 5 for a discussion of the accounting for the Exchange Program.

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(e) Stock Award Activity

The following table summarizes stock award activity under all plans for the years ended December 31, 2010, 2009, and 2008:

	Shares Available for Grant	Options Outstanding Number Outstanding	Options Outstanding Weighted-Average Exercise Price Per Share
BALANCE AT DECEMBER 31, 2007	8,527,059	7,032,823	$ 13.26
Options and stock appreciation rights granted	(4,297,547)	4,297,547	8.98
RSUs granted	(777,732)		
Options and stock appreciation rights cancelled	5,266,484	(5,266,484)	14.96
RSUs cancelled	128,109		
Options exercised		(405,561)	9.66
Unissued shares returned to plan	6,510		
1998 Directors Plan shares expired	(855,000)		
Additional shares reserved	1,729,454		
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

The total intrinsic value of options and SARs exercised during the years ended December 31, 2010, 2009, and 2008 was approximately $2.8 million, $1.0 million, and $1.6 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.

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The following table provides additional information regarding RSU and RSA activity for the years ended December 31, 2010, 2009, and 2008:

	Number Nonvested and Outstanding	Weighted-Average Grant Date Fair-Value
BALANCE AT DECEMBER 31, 2007	874,879	$ 15.05
RSUs granted	777,732	10.88
RSUs vested and released	(322,729)	12.93
RSUs cancelled	(128,109)	13.22
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

The fair value of each RSU and RSA grant 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 vested and released during the years ended December 31, 2010, 2009, and 2008 was approximately $6.2 million, $3.9 million, and $3.9 million, respectively. The intrinsic value of vested and released RSUs 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, 2010, the number of RSUs and RSAs outstanding and expected to vest was 2,069,833, with a total intrinsic value of $21.1 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 $10.19 as of December 31, 2010, the last market trading day of 2010.

The following table provides additional information for significant ranges of outstanding and exercisable stock options and stock appreciation rights as of December 31, 2010:

	Exercise Price Range	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price per Share	Aggregate Intrinsic Value
	$5.99-6.35	434,236	1.28	$ 6.14	$ 1,757,853
	7.35-7.47	1,086,944	4.13	7.46	2,963,626
	7.69	1,638,679	2.12	7.69	4,096,695
	7.82-10.00	499,240	1.87	8.82	685,312
	10.04-13.74	466,800	2.47	12.63	1,351
	$13.85-$28.65	149,749	1.26	19.07	
Outstanding		4,275,648	2.52	$ 8.55	$ 9,504,837
Vested and expected to vest		4,191,294	2.52	$ 8.55	$ 9,301,350

Exercisable	2,645,017	1.83	$ 8.80	$ 5,588,751

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company s closing stock price of $10.19 as of December 31, 2010, which would have been received by the option holders had all option holders exercised their options as of that date.

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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. Excluding SARs granted in December 2008 as part of the Exchange Program, which is discussed further below, the weighted average fair value of options and SARs granted during the years ended December 31, 2010, 2009, and 2008, was $3.94, $4.48, and $6.33, respectively, and was determined using the following weighted average assumptions:

	Year Ended December 31,		
	2010	2009	2008
Expected dividend yield	0.0%	0.0%	0.0%
Risk-free interest rate	1.2%	1.8%	2.7%
Expected volatility	67.5%	71.9%	61.1%
Expected term (in years)	4.2	4.3	4.1

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. For options and SARs granted prior to January 1, 2008, the expected term was calculated using the simplified method. Under the simplified method, the expected term was calculated by taking the average of the vesting term and the contractual term of the option. For options and SARs granted subsequent to December 31, 2007, 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 2008, the Company issued a limited number of performance shares to a consultant. The fair value 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.

(b) Accounting for Employee Stock Option Exchange Program

As discussed in Note 4, the Company completed a stock option exchange program for eligible employees on December 17, 2008. As a result of its terms, the Exchange Program is considered a modification to the Surrendered Awards, which requires the calculation of incremental compensation cost. The incremental compensation cost is calculated by comparing the fair value of each newly issued SAR to the fair value of the corresponding Surrendered Award, each of which was calculated as of December 17, 2008 using the BSM option-pricing model. To the extent the fair value of the newly issued SARs exceeds the fair value of the Surrendered Awards, there is incremental compensation cost. The total incremental compensation cost resulting from the Exchange Program was $2.3 million, and was calculated using the following weighted average assumptions.

	Surrendered Awards	Newly Issued SARs
Expected dividend yield	0.0%	0.0%
Risk-free interest rate	0.8%	1.0%
Expected volatility	77.1%	73.7%
Expected term (in years)	2.5	2.9

The Company must also continue to amortize previously unrecognized compensation expense related to the original grant date fair value of the Surrendered Awards. The Company has elected to combine both the incremental value and the unamortized original grant date fair value of the Surrendered Awards, the total of which will be recognized as compensation expense over the vesting term of the new SARs.

(c) Expense Allocation

Compensation expense for all share-based payment awards, including those granted prior to January 1, 2006, has been recognized using the accelerated multiple-option approach. As stock-based compensation expense recognized in the Consolidated Statement of Operations for the years ended December 31, 2010, 2009, and 2008 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.

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As of December 31, 2010, there were 481,189 non-vested RSUs and RSAs (with a grant date fair value of approximately $3.6 million) that were subject to certain financial-based performance requirements that must be achieved before vesting can occur. Of these 481,189 non-vested RSUs and RSAs, 116,189 (that were issued in May 2009 with a grant date fair value of approximately $859,000) contain financial-based performance conditions that must be achieved by May 2014, and the remaining 365,000 RSUs and RSAs (that were issued in August 2010 with a grant date fair value of approximately $2.7 million) contain financial-based performance conditions that must be achieved by April 2015.

Through December 31, 2010, cumulative compensation expense of $1.0 million associated with the 116,189 RSUs granted in May 2009 and the 365,000 RSUs and RSAs granted in August 2010 has been recognized because the Company believes it is probable that the associated financial performance requirements will be achieved. If such requirements are not met, no compensation cost will be recognized and any recognized compensation cost will be reversed. For these 481,189 awards that are considered probable of achievement, the unearned compensation expense of $2.6 million is expected to be recognized over estimated service periods ranging from 1.5 years to 3.0 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.

As of December 31, 2010, total compensation cost related to non-vested stock options and other equity based awards not yet recognized was $13.9 million, which is expected to be recognized over the next 20 months on a weighted-average basis, and of which $2.6 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, 2010, 2009, and 2008, which was allocated as follows (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Cost of sales product	$ 1,172	$ 1,534	$ 1,628
Cost of sales service	125	183	209
Stock-based compensation expense included in cost of sales	1,297	1,717	1,837
Product development	4,185	5,651	6,032
Sales and marketing	2,939	3,421	2,986
General and administrative	3,907	3,614	3,603
Stock-based compensation expense included in operating expenses	11,031	12,686	12,621
Total stock-based compensation expense related to stock options and share awards	12,328	14,403	14,458
Tax benefit			
Stock-based compensation expense related to stock options and share awards, net of tax	$ 12,328	$ 14,403	$ 14,458

Of the $12.3 million of compensation expense recorded for the year ended December 31, 2010, approximately $4.5 million related to equity compensation awards granted during 2010, while the remaining $7.8 million related to equity compensation awards granted on or before December 31, 2009. Of the $14.4 million of compensation expense recorded for the year ended December 31, 2009, approximately $4.3 million related to equity compensation awards granted during 2009, while the remaining $10.1 million related to equity compensation awards granted on or before December 31, 2008. Of the $14.5 million of compensation expense recorded for the year ended December 31, 2008, approximately $4.3 million related to equity compensation awards granted during 2008, while the remaining $10.2 million related to equity compensation awards granted on or before December 31, 2007.

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. As of December 31, 2009, approximately $99,000 and $29,000 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, 2010, the Company had four customers that accounted for a significant portion of its revenues: EBV Electronik GmbH (EBV), the Company s primary distributor of its Commercial products in Europe; Duke Energy Corporation (Duke), a U.S. utility company; and Eltel Networks A/S (Eltel) and ES Elektrosandberg AB (ES), value added resellers of the Company s Utility products. For the years ended December 31, 2010, 2009, and 2008, the percentages of the Company s revenues attributable to sales made to these customers were as follows:

	Year Ended December 31,		
	2010	2009	2008
Eltel	28.5%	25.3%	4.2%
EBV	12.8%	13.6%	15.3%
Duke	6.3%	10.7%	10.3%
ES	0.5%	1.4%	14.9%
Total	48.1%	51.0%	44.7%

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Of the percentage of sales made to EBV, approximately 0.5% for the year ended December 31, 2009, related to sales of components we 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. The Company s contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2011.

7. GOODWILL:

The carrying amount of goodwill as of December 31, 2010, 2009, and 2008 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, 2010 and 2009 are as follows (in thousands):

	Amount
Balance as of December 31, 2008	$ 8,417
Unrealized foreign currency translation gain	79
Balance as of December 31, 2009	8,496
Unrealized foreign currency translation loss	(180)
Balance as of December 31, 2010	$ 8,316

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, 2010, the future minimum lease payments for the lease financing obligations were as follows (in thousands):

2011	$ 3,174
2012	3,214
2013	3,254
2014	3,328
2015	3,410
2016 and thereafter	15,386
Total payments	$ 31,766
Amount representing interest	(7,989)
Present value of future minimum lease payments	$ 23,777
Lease financing obligations classified as current	$ 1,716
Lease financing obligations classified as long-term	$ 22,061

The Company also leases facilities under operating leases for its 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 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, 2010, future minimum lease payments under all operating leases, including $7.1 million related to the land lease associated with the Company s corporate headquarters facilities (see Note 3), were as follows (in thousands):

2011	$ 1,606
2012	1,244
2013	1,052
2014	869
2015	867
2016 and thereafter	3,423
Total	$ 9,061

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Rent expense for all operating leases was approximately $2.1 million for 2010, $2.0 million for 2009, and $1.9 million for 2008. 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, 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. As of December 31, 2009, the Company has accrued approximately $409,000 of deferred rent related to these agreements, of which approximately $48,000 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 $616,000, $450,000, and $513,000 for the years ended December 31, 2010, 2009, and 2008, 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, 2010, 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.

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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, 2010, 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, 2011. The letter of credit contains certain financial covenants requiring the Company to maintain an overall minimum tangible net worth level and to maintain a minimum level of liquid assets. As of December 31, 2010, the Company was in compliance with these covenants. As of December 31, 2010, the Company s primary bank has issued, against the line of credit, two standby letters of credit totaling $146,000. 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,		
	2010	2009	2008
Domestic	$ (31,730)	$ (32,793)	$ (25,842)
Foreign	719	502	308
	$ (31,011)	$ (32,291)	$ (25,534)

The provision for income taxes consists of the following (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Federal:			
Current	$	$ (392)	$ (195)
Deferred			
Total federal provision		(392)	(195)
State:			
Current	4	4	5
Deferred			
Total state provision	4	4	5
Foreign:			
Current	297	131	487
Deferred			
Total foreign provision	297	131	487

Total income tax expense (benefit)	$ 301	$ (257)	$ 297

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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,		
	2010	2009	2008
Federal tax at statutory rate of 35%	$ (10,854)	$ (11,302)	$ (8,937)
State taxes, net of federal benefit	2	2	5
U.S.-Foreign rate differential	42	140	155
Change in Valuation Allowance	11,136	11,052	9,766
Others	(25)	(149)	(692)
Total income tax expense (benefit)	$ 301	$ (257)	$ 297

As of December 31, 2010 and 2009, 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, 2010 and 2009, the Company had no significant deferred tax liabilities. The components of the net deferred income tax asset are as follows (in thousands):

	December 31,	
	2010	2009
Net operating loss carry forwards	$ 59,724	$ 53,443
Tax credit carry forwards	18,274	17,098
Fixed and intangible assets	7,349	7,040
Capitalized research and development costs	37	41
Reserves and other cumulative temporary differences	24,924	16,017
Gross deferred income tax assets	110,308	93,639
Valuation allowance	(110,308)	(93,639)
Net deferred income tax assets	$	$

As of December 31, 2010, part of our 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, 2010, the Company had net operating loss carryforwards of $188.7 million for federal income tax reporting purposes and $73.8 million for state income tax reporting purposes, which expire at various dates through 2030. 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, 2010, the Company had approximately $10.4 million and $11.9 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 2030 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 $8.2 million. It is not practicable to determine the income tax liability that might be incurred if these earnings were to be distributed.

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The following is a rollforward of the Company s uncertain tax positions for the years ended December 31, 2010 and 2009 (in thousands):

	Year Ended December 31, 2010	2009
Balance as of the beginning of the year	$ 4,629	$ 4,662
Tax positions related to current year:		
Additions	340	353
Reductions		
Tax positions related to prior years:		
Additions	575	1
Reductions	(1)	(190)
Settlements		
Lapses in statute of limitations	(1,006)	(197)
Balance as of the end of the year	$ 4,537	$ 4,629

Included in the balance of total unrecognized tax benefits at December 31, 2010 are potential benefits of $773,000, which if recognized, would affect the effective rate on income from continuing operations.

On January 1, 2009, the Company had accrued interest and penalties related to the uncertain tax benefits of approximately $310,000. During 2009, the Company decreased the prior year balance by $149,000 and accrued $63,000 of additional penalties and interest. During 2010, the Company decreased the prior year balance by $82,000 and accrued $65,000 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 2010, it will forego the bonus depreciation in its U.S. tax filings for the year ended December 31, 2010.

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 $904,000 as of December 31, 2010 and $1.0 million as of December 31, 2009.

11. RELATED PARTIES:

During the years ended December 31, 2010, 2009, and 2008, 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.

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From time to time, our Executive Chairman, M. Kenneth Oshman, uses his private plane or charter aircraft for Company business for himself and any employees that accompany him. In August 2008, our Board of Directors approved a reimbursement arrangement whereby our company will reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. Our Compensation Committee reaffirmed this arrangement in February 2011. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. During 2010, we recognized a total of approximately $96,000 in expenses pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the Consolidated Statements of Operations. The Audit Committee of our board of directors regularly reviews these reimbursements.

In November 2009, our Board of Directors approved a similar reimbursement arrangement for our then President and Chief Executive Officer, Robert R. Maxfield, whereby our company would reimburse Mr. Maxfield for 50% of the costs incurred for charter aircraft used while on company business. Alternatively, if Mr. Maxfield used his private plane while on company business, we would have reimbursed him for the cost of an equivalent first class ticket on a commercial flight. During 2010, we recognized a total of approximately $1,000 in expense pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the Consolidated Statements of Operations.

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.

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. Both the development and supply agreement and the software enhancement agreement expire in December 2011, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

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 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, $6.1 million of which was included in accounts receivable at December 31, 2009. During 2008, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $12.9 million.

On October 29, 2001, the Company loaned Russell Harris, its Senior Vice President of Operations, $1,000,000 in connection with his principal residence. Mr. Harris issued the Company a promissory note secured by residential real estate. The note bore interest at the rate of 4.5% per annum, compounded monthly. The interest that accrued under the note was due and payable in monthly installments over the nine year term of the note, and the principal was due and payable on October 29, 2010. The principal was paid in full by Mr. Harris in June 2009. As of December 31, 2008, the outstanding principal balance was $1,000,000. During the years ended December 31, 2009 and 2008, interest paid by Mr. Harris was $22,000 and $45,000, respectively. While it was outstanding, the terms of this loan were never amended.

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.

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

	Costs Incurred	Cash Payments	December 31, 2010
Termination benefits	$ 1,212	$ (54)	$ 1,158

Accrued restructuring charges of approximately $1.2 million as of December 31, 2010 comprise the remaining liability balance and are reflected in accrued liabilities on our Consolidated Balance Sheets. We expect to pay these accrued termination benefits through the first two quarter of 2011.

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, 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
Year Ended December 31, 2008:				
Allowance for Doubtful Accounts	$ 330	$ (5)	$ 2	$ 323
Allowance for Customer Returns and Sales Credits	$ 1,098	$ 7,058	$ 7,469	$ 687

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

The Company operates in three main geographic areas: the Americas; Europe, Middle East and Africa (EMEA); and Asia Pacific / Japan (APJ). Each geographic area provides products and services to the Company s customers located in the respective region. The Company s long-lived assets include property and equipment, goodwill, purchased technology, and deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of December 31, 2010 and 2009, long-lived assets of approximately $37.0 million and $41.6 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements.

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The Company has three primary product lines: Utility, Commercial, and products and services sold to Enel. Summary revenue information by product line for the years ended December 31, 2010, 2009, and 2008 is as follows (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Utility	$ 57,257	$ 48,271	$ 67,118
Commercial	49,135	44,549	54,040
Enel	4,645	10,518	12,889
Total	$ 111,037	$ 103,338	$ 134,047

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, 2010, 2009, and 2008 is as follows (in thousands):

	Year Ended December 31,		
	2010	**2009**	**2008**
Americas:			
United States	$ 24,275	$ 25,930	$ 31,090
Other Americas	2,494	1,816	2,358
Total Americas	26,769	27,746	33,448
EMEA:			
Denmark	31,680	26,234	5,729
Germany	19,637	18,259	25,564
Sweden	3,040	4,516	34,079
Other EMEA	19,186	16,647	22,940
Total EMEA	73,543	65,656	88,312
APJ	10,725	9,936	12,287
Total	$ 111,037	$ 103,338	$ 134,047

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 2010 and 2009. 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.

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	Three Months Ended							
	Dec. 2010	Sep. 2010	June 2010	March 2010	Dec. 2009	Sep. 2009	June 2009	March 2009
	(in thousands, except per share data)							
Selected Quarterly Financial Data								
Consolidated Statement of Operations Data:								
Revenues:								
Product	$ 37,897	$ 26,441	$ 25,784	$ 17,319	$ 37,997	$ 22,965	$ 21,836	$ 17,389
Service	913	683	1,173	827	837	710	810	794
Total revenues	38,810	27,124	26,957	18,146	38,834	23,675	22,646	18,183
Cost of revenues:								
Cost of product	21,325	14,083	15,147	9,167	22,076	12,838	12,259	9,640
Cost of service	594	567	706	597	622	547	601	648
Total cost of revenues	21,919	14,650	15,853	9,764	22,698	13,385	12,860	10,288
Gross profit	16,891	12,474	11,104	8,382	16,136	10,290	9,786	7,895
Operating expenses:								
Product development	10,164	8,438	7,857	8,303	8,852	8,850	8,642	9,091
Sales and marketing	6,599	6,003	5,963	6,497	6,869	5,279	5,655	5,722
General and administrative	4,532	4,756	4,129	4,230	4,152	3,717	4,086	3,787
Restructuring charges	1,212							
Total operating expenses	22,507	19,197	17,949	19,030	19,873	17,846	18,383	18,600
Loss from operations	(5,616)	(6,723)	(6,845)	(10,648)	(3,737)	(7,556)	(8,597)	(10,705)
Interest and other income (expense), net	13	(559)	504	435	130	(91)	(377)	310
Interest expense on lease financing obligations	(384)	(390)	(396)	(402)	(409)	(415)	(419)	(425)
Loss before provision for income taxes	(5,987)	(7,672)	(6,737)	(10,615)	(4,016)	(8,062)	(9,393)	(10,820)
Income tax expense (benefit)	49	170	136	(54)	(288)	155	131	(255)
Net loss	$ (6,036)	$ (7,842)	$ (6,873)	$ (10,561)	$ (3,728)	$ (8,217)	$ (9,524)	$ (10,565)
Loss per share:								
Basic	$ (0.14)	$ (0.19)	$ (0.17)	$ (0.26)	$ (0.09)	$ (0.20)	$ (0.23)	$ (0.26)
Diluted	$ (0.14)	$ (0.19)	$ (0.17)	$ (0.26)	$ (0.09)	$ (0.20)	$ (0.23)	$ (0.26)
Shares used in net loss per share calculation:								
Basic	41,639	41,560	41,298	41,072	40,967	40,759	40,658	40,508
Diluted	41,639	41,560	41,298	41,072	40,967	40,759	40,658	40,508

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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 15, 2011

ECHELON CORPORATION

By: /s/ Oliver R. Stanfield
Oliver R. Stanfield
Executive Vice President and Chief Financial Officer
(Duly Authorized Officer and Principal Financial and Accounting Officer)

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Ronald Sege and Oliver R. Stanfield 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	President and Chief Executive Officer and Director (Principal Executive Officer)	March 15, 2011
/s/ Oliver R. Stanfield Oliver R. Stanfield	Executive Vice President and Chief Financial Officer (Principal Financial and Principal Accounting Officer)	March 15, 2011
/s/ M. Kenneth Oshman M. Kenneth Oshman	Executive Chairman	March 3, 2011
/s/ Armas Clifford Markkula, Jr. Armas Clifford Markkula, Jr.	Vice Chairman	March 3, 2011
/s/ Robyn M. Denholm	Director	March 14, 2011

Robyn M. Denholm		
/s/ ROBERT J. FINOCCHIO, JR.	Director	March 3, 2011
Robert J. Finocchio, Jr.		
/s/ ROBERT R. MAXFIELD	Director	March 5, 2011
Robert R. Maxfield		
/s/ RICHARD M. MOLEY	Director	March 3, 2011
Richard M. Moley		
/s/ BETSY RAFAEL	Director	March 14, 2011
Betsy Rafael		
/s/ LARRY W. SONSINI	Director	March 4, 2011
Larry W. Sonsini		

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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
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.

+ 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