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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q/A

AMENDMENT NO. 1

(Mark one)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2007

OR

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

000-29748

(Commission file number)

ECHELON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**77-0203595**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification Number)**

550 Meridian Avenue

San Jose, CA 95126

(Address of principal executive office and zip code)

(408) 938-5200

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to filing requirements for the past 90 days.

Yes x No ¨

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

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

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

Yes ¨ No x

As of April 30, 2007, 39,432,584 shares of the registrant s common stock were outstanding.

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ECHELON CORPORATION

FORM 10-Q/A

AMENDMENT NO. 1

FOR THE QUARTER ENDED MARCH 31, 2007

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EXPLANATORY NOTE

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

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

	March 31,	December 31,	
	2007	2007	2006
Increase in total assets	$ 14.3 million	$ 12.3 million	$ 15.0 million
Increase in total liabilities	$ 17.2 million	$ 15.2 million	$ 17.9 million
Increase in additional paid-in-capital	$ 1.0 million	$ 2.0 million	$ 0.8 million
Increase in accumulated deficit	$ 3.9 million	$ 4.9 million	$ 3.7 million

The effects of all restatement adjustments on our condensed consolidated statements of operations for the quarters ended March 31, 2007 and 2006 are as follows:

	Quarter Ended March 31,	
	2007	2006
Decrease in rent expense	$ 1.0 million	$ 1.0 million
Increase in depreciation expense	$ 0.7 million	$ 0.7 million
Increase in stock-based compensation expense	$ 0.2 million	$ 0.1 million
Increase in interest expense	$ 0.3 million	$ 0.4 million
Increase in net loss	$ 0.2 million	$ 0.2 million

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

Restatement of stock-based compensation expense: During the preparation of our financial results for the quarter ended March 31, 2008, we identified an error in our previously reported stock-based compensation expense for the years ended December 31, 2007, 2006 and 2005, and each of the quarterly periods in 2007 and 2006. The error was isolated to share awards and does not affect the other forms of our equity compensation awards, namely stock options and stock-settled stock appreciation rights. While the grant date fair value of the share awards was determined correctly in accordance with Statement of Financial Accounting Standard (SFAS) No. 123R (revised 2004), *Share-Based Payment*, the amount of expense associated with these awards that was recognized in 2007, 2006 and 2005 was not correct. The error was caused by a misapplication of the widely-used equity compensation software application we use to manage and account for our equity compensation awards. This misapplication caused the expense associated with these share awards to be calculated using the straight-line, single-option method rather than the accelerated, multiple-option method, which we had elected to use for all of our equity compensation awards. Use of the straight-line, single-option method resulted in understatements of stock-based compensation expense in 2007, 2006 and 2005 of $1.2 million, $535,000 and $263,000, respectively. For the quarters ended March 31, 2007 and 2006, stock-based compensation expense was understated by $153,000 and $145,000, respectively.

Restatement related to the leases of our San Jose, California headquarters facilities: In connection with the restatement of stock-based compensation expense, KPMG LLP, our independent registered public accounting firm, brought to our attention that we had inappropriately accounted for the leases of our corporate headquarters facilities that were entered into in 1999 and 2001. Under the guidance in Emerging Issues Task Force Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction* (EITF 97-10), and SFAS No. 98, *Accounting for Leases: Sale-Leaseback transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; Initial Direct Costs of Direct Financing Leases; an amendment of FASB Statements No. 13, 66, and 91*

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

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

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

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

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

FORWARD-LOOKING INFORMATION

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

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

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PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ECHELON CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

	March 31, 2007 (As Restated)[1]	December 31, 2006 (As Restated)[1]
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 35,870	$ 37,412
Short-term investments	85,684	86,745
Accounts receivable, net	17,520	13,918
Inventories	11,075	11,359
Deferred cost of goods sold	6,432	19,060
Other current assets	2,011	2,138
Total current assets	158,592	170,632
Property and equipment, net	29,611	30,405
Goodwill	8,312	8,278
Other long-term assets	1,956	1,957
Total assets	$ 198,471	$ 211,272
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 6,420	$ 6,893
Accrued liabilities	8,502	4,796
Current portion lease financing obligations	2,657	2,579
Deferred revenues	15,066	26,843
Total current liabilities	32,645	41,111
LONG-TERM LIABILITIES:		
Lease financing obligations, net of current portion	15,361	16,052
Deferred rent, net of current portion	429	446
Total long-term liabilities	15,790	16,498
STOCKHOLDERS EQUITY:		
Common stock	418	416
Additional paid-in capital	285,526	283,728
Treasury stock	(19,259)	(19,259)

Accumulated other comprehensive income	1,121	997
Accumulated deficit	(117,770)	(112,219)
Total stockholders equity	150,036	153,663
Total liabilities and stockholders equity	$ 198,471	$ 211,272

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

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended March 31,	
	2007 (As Restated)[1]	2006 (As Restated)[1]
REVENUES:		
Product	$ 39,077	$ 10,574
Service	192	171
Total revenues	39,269	10,745
COST OF REVENUES:		
Cost of product [2]	28,634	4,565
Cost of service [2]	483	436
Total cost of revenues	29,117	5,001
Gross profit	10,152	5,744
OPERATING EXPENSES:		
Product development [2]	7,778	6,959
Sales and marketing [2]	5,427	5,162
General and administrative [2]	3,568	3,265
Total operating expenses	16,773	15,386
Loss from operations	(6,621)	(9,642)
Interest and other income, net	1,497	1,394
Interest expense on lease financing obligations	(319)	(360)
Loss before provision for income taxes	(5,443)	(8,608)
Provision for income taxes	108	80
NET LOSS	$ (5,551)	$ (8,688)
Net loss per share:		
Basic	$ (0.14)	$ (0.22)
Diluted	$ (0.14)	$ (0.22)
Shares used in computing net loss per share:		
Basic	39,227	39,767
Diluted	39,227	39,767

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

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

Cost of product	$ 147	$ 127
Cost of service	16	16
Product development	482	669
Sales and marketing	316	398
General and administrative	372	341

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended March 31,	
	2007 (As Restated)[1]	**2006 (As Restated)[1]**
CASH FLOWS USED IN OPERATING ACTIVITIES:		
Net loss	$ (5,551)	$ (8,688)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,778	1,713
Loss on disposal of fixed assets	2	
Increase in (reduction of) allowance for doubtful accounts	7	(94)
Reduction of (increase in) accrued investment income	114	(3)
Stock-based compensation	1,333	1,551
Change in operating assets and liabilities:		
Accounts receivable	(3,607)	4,945
Inventories	290	(204)
Deferred cost of goods sold	12,627	(1,078)
Other current assets	136	(646)
Accounts payable	(479)	361
Accrued liabilities	3,713	(2,872)
Deferred revenues	(11,779)	4,495
Deferred rent	(32)	(25)
Net cash used in operating activities	(1,448)	(545)
CASH FLOWS PROVIDED BY INVESTING ACTIVITIES:		
Purchases of available-for-sale short-term investments	(31,783)	(12,842)
Proceeds from maturities and sales of available-for-sale short-term investments	32,768	22,195
Change in other long-term assets	6	17
Capital expenditures	(983)	(1,031)
Net cash provided by investing activities	8	8,339
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Principal payments of lease financing obligations	(613)	(544)
Proceeds from exercise of stock options	845	
Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options	(377)	
Repurchase of common stock under stock repurchase program		(977)
Net cash used in financing activities	(145)	(1,521)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	43	84
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(1,542)	6,357
CASH AND CASH EQUIVALENTS:		

Beginning of period	37,412	59,080
End of period	$ 35,870	$ 65,437
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for income taxes	$ 163	$ 81
Cash paid for interest on lease financing obligations	$ 316	$ 356

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

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation:

The condensed consolidated financial statements include the accounts of Echelon Corporation (the Company), a Delaware corporation, and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Company s consolidated financial statements (as restated) for the year ended December 31, 2007 included in its Annual Report on Form 10-K/A filed concurrently with this Quarterly Report on Form 10-Q/A.

2. Restatement of Condensed Consolidated Financial Statements:

During the preparation of its financial results for the quarter ended March 31, 2008, the Company identified an error in its previously reported equity compensation expense and determined it had inappropriately accounted for the 1999 and 2001 leases of its San Jose, California corporate headquarters facilities.

Restatement of stock-based compensation expense: The Company identified an error in its previously reported stock-based compensation expense for the years ended December 31, 2007, 2006 and 2005 and each of the quarterly periods in 2007 and 2006. The error was isolated to share awards and does not affect the other forms of our equity compensation awards, namely stock options and stock-settled stock appreciation rights. While the grant date fair value of the share awards was determined correctly in accordance with Statement of Financial Accounting Standard (SFAS) No. 123R (revised 2004), *Share-Based Payment* (SFAS 123R), the amount of expense associated with these awards that was recognized in 2007, 2006 and 2005 was not correct. The error was caused by a misapplication of the widely-used equity compensation software application the Company uses to manage and account for its equity compensation awards. This misapplication caused the expense associated with these share awards to be calculated using the straight-line, single-option method rather than the accelerated, multiple-option method, which the Company had elected to use for all of its equity compensation awards. Use of the straight-line, single-option method resulted in understatements of stock-based compensation expense in the quarters ended March 31, 2007 and 2006, of $153,000 and $145,000, respectively.

Restatement related to the leases of our San Jose, California headquarters facilities: The Company inappropriately accounted for the leases of its corporate headquarters facilities that were entered into in 1999 and 2001. Under the guidance in Emerging Issues Task Force Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction* (EITF 97-10), and SFAS No. 98, *Accounting for Leases: Sale-Leaseback transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; Initial Direct Costs of Direct Financing Leases; an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11* (SFAS 98), the Company should have reflected an asset on its balance sheet for the costs paid by the lessor to construct its headquarters facilities, as well as a corresponding liability, because the Company was the deemed owner of the headquarters facilities for accounting purposes during the construction periods. Upon completion of construction, the Company did not meet the sale-leaseback criteria under SFAS 98 and therefore should have treated the leases as financing obligations and the assets and corresponding liabilities would not be derecognized. The Company has historically accounted for these leases as operating leases under SFAS No. 13, *Accounting for Leases* (SFAS 13), whereby the total minimum lease payment obligations under the leases was recognized as monthly rent expense on a straight-line basis over the terms of the leases. The restatement adjustments do not affect the total cash payments the Company has made or is obligated to make under the lease agreements, nor do they change the total expense to be recognized over the lease terms. However, the timing and nature of expenses in the statement of operations is different under this treatment as compared to operating lease treatment. Specifically, the Company should have recognized land lease expense, depreciation expense on the assets it is deemed to own and interest expense on the associated lease financing obligations.

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Therefore the Company has restated its consolidated balance sheets as of December 31, 2007 and 2006, and its consolidated statements of operations, stockholders equity, cash flows and comprehensive income (loss) for each of the years in the three-year period ended December 31, 2007 and each of the quarters in 2007 and 2006, to reflect the restatement adjustments applicable to those periods.

The following table presents the effects of the adjustments made to the Company s previously reported condensed consolidated balance sheets as of March 31, 2007 and December 31, 2006 (in thousands):

	March 31, 2007			December 31, 2006		
	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated
ASSETS						
Current Assets:						
Cash and cash equivalents	$ 35,870	$	$ 35,870	$ 37,412	$	$ 37,412
Short-term investments	85,684		85,684	86,745		86,745
Accounts receivable, net	17,520		17,520	13,918		13,918
Inventories	11,075		11,075	11,359		11,359
Deferred cost of goods sold	6,432		6,432	19,060		19,060
Other current assets	2,236	(225)	2,011	2,359	(221)	2,138
Total current assets	158,817	(225)	158,592	170,853	(221)	170,632
Property and Equipment, net	15,075	14,536	29,611	15,188	15,217	30,405
Goodwill	8,312		8,312	8,278		8,278
Other long-term assets	1,956		1,956	1,957		1,957
TOTAL ASSETS	$ 184,160	$ 14,311	$ 198,471	$ 196,276	$ 14,996	$ 211,272
LIABILITIES AND STOCKHOLDERS EQUITY						
Current Liabilities:						
Accounts payable	$ 6,420	$	$ 6,420	$ 6,893	$	$ 6,893
Accrued liabilities	8,417	85	8,502	4,697	99	4,796
Current portion lease financing obligations		2,657	2,657		2,579	2,579
Deferred revenues	15,066		15,066	26,843		26,843
Total current liabilities	29,903	2,742	32,645	38,433	2,678	41,111
Long-Term Liabilities:						
Lease financing obligations, net of current portion		15,361	15,361		16,052	16,052
Deferred rent, net of current portion	1,296	(867)	429	1,268	(822)	446
Total long-term liabilities	1,296	14,494	15,790	1,268	15,230	16,498
Stockholders Equity:						
Common stock	418		418	416		416
Additional paid-in capital	284,575	951	285,526	282,930	798	283,728
Treasury stock	(19,259)		(19,259)	(19,259)		(19,259)
Accumulated other comprehensive income	1,121		1,121	997		997
Accumulated deficit	(113,894)	(3,876)	(117,770)	(108,509)	(3,710)	(112,219)
Total stockholders equity	152,961	(2,925)	150,036	156,575	(2,912)	153,663
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 184,160	$ 14,311	$ 198,471	$ 196,276	$ 14,996	$ 211,272

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The following table presents the effects of the adjustments made to the Company s previously reported condensed consolidated statements of operations for each of the three-month periods ended March 31, 2007 and 2006 (in thousands, except per share data):

	Three Months Ended March 31, 2007			2006		
	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated
REVENUES:						
Product	$ 39,077	$	$ 39,077	$ 10,574	$	$ 10,574
Service	192		192	171		171
Total revenues	39,269		39,269	10,745		10,745
COST OF REVENUES:						
Cost of product	28,627	7	28,634	4,563	2	4,565
Cost of service	492	(9)	483	445	(9)	436
Total cost of revenues	29,119	(2)	29,117	5,008	(7)	5,001
Gross profit	10,150	2	10,152	5,737	7	5,744
OPERATING EXPENSES:						
Product development	7,801	(23)	7,778	6,991	(32)	6,959
Sales and marketing	5,415	12	5,427	5,147	15	5,162
General and administrative	3,708	(140)	3,568	3,402	(137)	3,265
Total operating expenses	16,924	(151)	16,773	15,540	(154)	15,386
Loss from operations	(6,774)	153	(6,621)	(9,803)	161	(9,642)
Interest and other income, net	1,497		1,497	1,394		1,394
Interest expense on lease financing obligations		(319)	(319)		(360)	(360)
Loss before provision for income taxes	(5,277)	(166)	(5,443)	(8,409)	(199)	(8,608)
Provision for income taxes	108		108	80		80
NET LOSS	$ (5,385)	$ (166)	$ (5,551)	$ (8,489)	$ (199)	$ (8,688)
Loss per share:						
Basic	$ (0.14)	$	$ (0.14)	$ (0.21)	$ (0.01)	$ (0.22)
Diluted	$ (0.14)	$	$ (0.14)	$ (0.21)	$ (0.01)	$ (0.22)
Shares used in per share calculation:						
Basic	39,227		39,227	39,767		39,767
Diluted	39,227		39,227	39,767		39,767

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The following table presents the effects of the adjustments made to the Company s previously reported condensed consolidated statements of cash flows for each of the three-month periods ended March 31, 2007 and 2006 (in thousands):

	Three Months Ended March 31,					
	2007			2006		
	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated
Net cash used in operating activities	$ (2,061)	$ 613	$ (1,448)	$ (1,089)	$ 544	$ (545)
Net cash provided by investing activities	8		8	8,339		8,339
Net cash provided by (used in) financing activities	468	(613)	(145)	(977)	(544)	(1,521)
Effect of exchange rate changes on cash	43		43	84		84
Net increase (decrease) in cash and cash equivalents	(1,542)		(1,542)	6,357		6,357
CASH AND CASH EQUIVALENTS:						
Beginning of period	37,412		37,412	59,080		59,080
End of period	$ 35,870	$	$ 35,870	$ 65,437	$	$ 65,437
SUPPLEMENTAL DISCLOSURES:						
Cash paid for taxes	$ 163	$	$ 163	$ 81	$	$ 81
Cash paid for interest	$	$ 316	$ 316	$	$ 356	$ 356

3. Summary of Significant Accounting Policies (As Restated):

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated.

Foreign Currency Translation

For foreign subsidiaries using the local currency as their functional currency, assets and liabilities are translated at exchange rates in effect at the balance sheet date and income and expenses are translated at average exchange rates. The effects of these translation adjustments are reported as a separate component of stockholders equity. Remeasurement adjustments for non-functional currency monetary assets and liabilities are included in other income (expense) in the accompanying condensed consolidated statements of operations.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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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 customer 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 has occurred, the sales price is fixed or determinable, collectibility is probable, and there are no post-delivery obligations. For hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For sales 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. For software licenses, these criteria are generally met upon shipment to the final end-user. Service revenue is recognized as the training services are performed, or ratably over the term of the support period. In the case of custom software development services, revenue is recognized when the customer accepts the software.

In accordance with AICPA Statement of Position 97-2 (SOP 97-2), *Software Revenue Recognition*, as amended, revenue earned on software arrangements involving multiple elements is allocated to each element based upon the relative fair values of the elements. The Company uses the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date. In these instances, the amount of revenue deferred at the time of sale is based on vendor specific objective evidence (VSOE) of the fair value for each undelivered element. If VSOE of fair value does not exist for each undelivered element, all revenue attributable to the multi-element arrangement is deferred until sufficient VSOE of fair value exists for each undelivered element or all elements have been delivered.

The Company currently sells a limited number of its LonWorks® Infrastructure products that are considered multiple element arrangements under SOP 97-2. Revenue for the software license element is recognized at the time of delivery of the applicable product to the end-user. The only undelivered element at the time of sale consists of post-contract customer support (PCS). The VSOE for this PCS is based on prices paid by the Company s customers for stand-alone purchases of PCS. Revenue for the PCS element is deferred and recognized ratably over the PCS service period. The costs of providing these PCS services are expensed when incurred.

In certain instances, the Company s Networked Energy Services (NES) System products are sold as part of multiple element arrangements, which may include electricity meters and data concentrators (collectively, the Hardware); NES System software, for which a royalty is charged on a per-meter basis; PCS for the NES System software; and extended warranties for the Hardware. These arrangements may require the Company to deliver Hardware over an extended period of time. In accordance with SOP 97-2, when the multiple element arrangement includes NES System 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 NES System 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. The Company has established VSOE for the PCS on the NES System software, as well as for the warranties on its NES Hardware products. These revenues 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.

The Company accounts for the rights of return, price protection, rebates, and other sales incentives offered to its distributors in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, *Revenue Recognition When Right of Return Exists,* and EITF 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products).* During the first and second quarters of 2006, the Company modified its revenue recognition method for sales made to its distributor partners. Under the revised method, revenue on sales made to distributors is deferred until the distributor sells the products through to its end-use customers. The impact of these revenue recognition methodology revisions were one-time reductions in revenues of approximately $2.9 million during the quarter ended March 31, 2006.

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Deferred Revenue and Deferred Cost of Goods Sold

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

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 as cash and cash equivalents.

Short-Term Investments

The Company classifies its investments in marketable debt securities as available-for-sale in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. As of March 31, 2007, the Company s available-for-sale short-term investment securities had contractual maturities from four to twenty-four months and an average remaining term to maturity of eight months. The fair value of available-for-sale securities was determined based on quoted market prices at the reporting date for those instruments. As of March 31, 2007, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses by major security type were as follows (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains / (Losses)
U.S. corporate securities:			
Commercial paper	$ 41,522	$ 41,527	$ 5
Corporate notes and bonds	19,127	19,122	(5)
	60,649	60,649	
U.S. government securities	25,026	25,035	9
Total investments in debt and equity securities	$ 85,675	$ 85,684	$ 9

Computation of Net Loss Per Share (As Restated)

Net loss per share has been calculated under SFAS No. 128 (SFAS 128), *Earnings per Share*. SFAS 128 requires companies to compute earnings per share under two different methods (basic and diluted). Basic net loss per share is calculated by dividing net 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 loss per share computations for the three months ended March 31, 2007 and 2006 (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2007 (As Restated)[1]	2006 (As Restated)[1]
Net income (Numerator):		
Net loss, basic & diluted	$ (5,551)	$ (8,688)
Shares (Denominator):		

Weighted average common shares outstanding	39,227	39,767
Shares used in basic computation	39,227	39,767
Common shares issuable upon exercise of stock options (treasury stock method)		
Shares used in diluted computation	39,227	39,767
Net income (loss) per share:		
Basic	$ (0.14)	$ (0.22)
Diluted	$ (0.14)	$ (0.22)

(1) See Note 2 of these Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

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In accordance with SFAS 128, for the three months ended March 31, 2007 and 2006, the diluted net loss per share calculation is equivalent to the basic net loss per share calculation as there were no potentially dilutive stock options due to the Company s net loss position. The number of stock options and stock appreciation rights excluded from this calculation for the three months ended March 31, 2007 and 2006 was 9,707,886 and 8,005,244, respectively.

Impairment of Long-Lived Assets Including Goodwill

The Company reviews property, plant, and equipment and certain identifiable intangibles, excluding goodwill, 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 property, plant, and equipment and certain identifiable intangibles are considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the asset exceeds its fair market value. For the quarters ended March 31, 2007 and 2006, the Company has made no material adjustments to its long-lived assets.

Costs in excess of the fair value of tangible and other intangible assets acquired and liabilities assumed in a purchase business combination are recorded as goodwill. SFAS No. 142 (SFAS 142), *Goodwill and Other Intangible Assets,* requires that companies no longer amortize goodwill, but instead test for impairment at least annually 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. 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 as a result of its required tests.

SFAS 142 also requires that intangible assets with finite lives be amortized over their estimated useful lives and reviewed for impairment in accordance with SFAS No. 144, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. As of March 31, 2007, the Company s acquired intangible assets with a finite life, which consisted of purchased technology, have been fully amortized.

Recently Issued Accounting Standards

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*. SFAS 157 defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and expands disclosure related to the use of fair value measures in financial statements. SFAS 157 does not expand the use of fair value measures in financial statements, but standardizes its definition and guidance in GAAP. SFAS 157 emphasizes that fair value is a market-based measurement and not an entity-specific measurement based on an exchange transaction in which the entity sells an asset or transfers a liability (exit price). SFAS 157 establishes a fair value hierarchy from observable market data as the highest level to fair value based on an entity s own fair value assumptions as the lowest level. SFAS 157 is to be effective for the Company s financial statements issued in 2008; however, earlier application is encouraged. The Company believes that the adoption of SFAS 157 will not have a material impact on its consolidated financial statements.

4. Property and Equipment (As Restated):

Property and equipment are stated at cost. The cost of buildings and improvements for our leased San Jose, California headquarters facilities, for which we are 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).

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. This agreement requires minimum rental payments for ten years totaling approximately $20.6 million and also required that the Company provide a $3.0 million security deposit, which requirement has since been reduced to $1.2 million. The Company satisfied the security deposit requirement by causing to have issued a standby letter of credit (LOC) in July 2000. The LOC is subject to annual renewals and is currently secured by a $10.0 million line of credit at the bank that issued the LOC. The line of credit is maintained primarily for the purpose of providing standby letters of credit as required under the Company s lease agreements, as well as for providing standby letters of credit that arise from time to time in the general course of business. As of March 31, 2007 and December 31, 2006, no amounts had been drawn against the line of credit or the letters of credit.

In October 2000, the Company entered into another lease agreement with the same real estate developer for an additional building at its headquarters site. Construction on the second building was completed in May 2003, at which time monthly rental payments commenced. This second lease agreement also requires minimum rental payments for ten years totaling approximately $23.4 million. In addition, this second lease agreement also required a security deposit of $5.0 million. The Company satisfied this security deposit requirement by causing to have issued another LOC in October 2001. This LOC is also subject to annual renewals and is currently secured by a line of credit at the bank that issued it.

Both the December 1999 and October 2000 leases permit the Company to exercise an option to extend the respective lease for two sequential five-year terms.

As discussed in Note 2, the Company has accounted for the two buildings at its San Jose, California headquarters site under EITF 97-10 and SFAS 98. EITF 97-10 applies to entities involved with the construction of an asset that will be leased when the construction project is completed. During construction, the Company paid for certain tenant improvements, including structural elements of the buildings and, in accordance with EITF 97-10, is therefore the deemed owner for accounting purposes of the two buildings at its San Jose, California headquarters site. Accordingly, the Company recorded assets for the total costs of the buildings and improvements, including the costs paid by the lessor (the legal owner of the buildings that the Company leases), with corresponding liabilities for the costs paid by the lessor. Upon completion of construction of each building, the Company did not meet the sale-leaseback criteria in SFAS 98 for derecognition of the building assets and liabilities. Therefore, the leases are accounted for as financing obligations.

For the December 1999 and October 2000 lease agreements, the Company initially recorded assets and corresponding lease financing obligations for the building and improvement costs paid by the lessor in the amount of $12.0 million and $15.2 million, respectively. The Company has recorded depreciation expense associated with the building and improvement costs paid by the lessor of $681,000 in each of the quarters ended March 31, 2007 and 2006. As of March 31, 2007 and December 31, 2006, the net book value of the buildings and improvements paid for by the lessor was $14.5 million and $15.2 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 which includes the construction period. The remaining lease payments are considered to be payments of principal and interest on the lease financing obligations. For the quarters ended March 31, 2007 and 2006, land lease expense was $113,000 for each quarter, principal reductions on the lease financing obligations were $613,000 and $544,000, respectively, and interest expense was $319,000 and $360,000, respectively.

5. Stockholders Equity and Employee Stock Option Plans (As Restated):

Preferred Stock

With the closing of the Company s initial public offering (IPO) in July 1998, all of the then outstanding preferred stock automatically converted into 7,887,381 shares of common stock. Upon conversion of the outstanding preferred stock to common stock, such preferred stock was retired. As of March 31, 2007, the Company was authorized to issue 5,000,000 shares of new $0.01 par value preferred stock, of which none was outstanding as of March 31, 2007.

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Common Stock

As of March 31, 2007, the Company was authorized to issue 100,000,000 shares of $0.01 par value common stock, of which 39,313,944 were outstanding.

In March and August 2004, March 2006, and February 2007, the Company s board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company s common stock. During the quarter ended March 31, 2007, the Company did not repurchase any shares under the program. As of March 31, 2007, 795,816 shares were available for repurchase. The stock repurchase program will expire in March 2008.

Comprehensive Loss (As Restated)

Comprehensive loss for the Company consists of net loss plus the effect of unrealized holding gains or losses on investments classified as available-for-sale and foreign currency translation adjustments. Comprehensive loss for the three months ended March 31, 2007 and 2006 is as follows (in thousands):

	Three Months Ended March 31,	
	2007 (As Restated)[1]	2006 (As Restated)[1]
Net loss	$ (5,551)	$ (8,688)
Other comprehensive income, net of tax:		
Foreign currency translation adjustment	83	140
Unrealized holding gains on available-for-sale securities	40	35
Comprehensive loss	$ (5,428)	$ (8,513)

(1) See Note 2 of these Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

Stock Option Program Description

The Company has two plans under which it grants options: the 1997 Stock Plan (the 1997 Plan) and the 1998 Director Option Plan (the Director Option Plan). A more detailed description of each plan can be found below and in the Company s Annual Report on Form 10-K.

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

The 1997 Stock Plan (the 1997 Plan) is a stockholder approved plan that provides for broad-based grants to employees, including executive officers. Based on the terms of individual option grants, options granted under the 1997 Plan generally expire five years after the date of grant, although options granted from June 15, 2000 through May 5, 2003, generally have a term of ten years. Options granted under the 1997 Plan generally vest at a rate of 25% per year over four years. In addition to incentive and nonstatutory stock options, the 1997 Plan also permits the granting of stock purchase rights, stock appreciation rights, performance units, and performance shares. To date, other than stock options, the Company has granted performance shares and stock appreciation rights under the 1997 Plan. Performance shares issued by the Company generally vest in equal, annual installments over four years, although certain of these performance shares issued to management vest 100% after two years while others have additional financial based performance requirements that must be met before vesting can occur. Stock appreciation rights issued by the Company generally vest in equal, annual installments over four years.

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1998 Directors Option Plan

Non-employee directors are entitled to participate in the stockholder approved 1998 Director Option Plan (the Director Plan). The Director Plan provides for the automatic grant of 25,000 shares of common stock (the First Option) to each non-employee director on the date he or she first becomes a director. Each non-employee director is also automatically granted an option to purchase 10,000 shares (a Subsequent Option) on the date of the Company s Annual Stockholder Meeting, provided that he or she is re-elected to the Board or otherwise remains on the Board, and provided that on such date, he or she shall have served on the Board for at least the preceding six months. Each First Option and each Subsequent Option have a term of five years and vest immediately upon grant.

Stock Award Activity

The following table summarizes stock award activity, including stock options and performance shares, and related information for the three-month periods ended March 31, 2007 and 2006:

		Options Outstanding	
	Shares Available for Grant	Number Outstanding	Weighted-Average Exercise Price Per Share
BALANCE AT DECEMBER 31, 2005	6,949,420	8,089,473	$ 11.24
Options granted	(8,075)	8,075	8.16
Performance shares granted	(106,017)		
Options exercised			
Options forfeited or expired	92,304	(92,304)	7.50
Performance shares forfeited or expired	4,867		
Additional shares reserved	1,692,020		
BALANCE AT MARCH 31, 2006	8,624,519	8,005,244	$ 11.28
BALANCE AT DECEMBER 31, 2006	7,961,595	8,282,680	$ 10.91
Options and stock appreciation rights granted	(43,825)	43,825	9.20
Performance shares granted	(117,953)		
Options exercised		(177,426)	6.21
Options and stock appreciation rights forfeited or expired	212,883	(212,883)	10.80
Performance shares forfeited or expired	30,885		
Additional shares reserved	1,664,301		
BALANCE AT MARCH 31, 2007	9,707,886	7,936,196	$ 11.01

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The total intrinsic value of options exercised during the three months ended March 31, 2007 was approximately $538,000. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the shares.

The following table provides additional information for significant ranges of outstanding and exercisable stock options as of March 31, 2007:

Exercise Price Range	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price per Share	Aggregate Intrinsic Value
$6.11	1,351,543	2.79	$ 6.11	$ 5,987,335
6.26-8.17	281,605	3.35	7.23	931,031
8.19	906,993	3.38	8.19	2,131,434
8.24-8.52	1,049,905	3.73	8.46	2,188,380
8.58-10.65	353,725	4.60	9.91	224,578
10.89	798,820	1.96	10.89	
11.14-12.91	1,271,002	2.36	12.39	
13.00-16.06	305,200	3.73	14.12	
16.35	812,437	4.90	16.35	
$16.36-$30.76	804,966	3.83	18.91	
Outstanding	7,936,196	3.29	$ 11.01	$ 11,462,758
Vested and expected to vest	7,813,752	3.28	$ 11.05	$ 11,186,558
Exercisable	6,281,374	3.14	$ 11.77	$ 7,451,329

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company s closing stock price of $10.54 as of March 30, 2007, the last market trading day during the first quarter of 2007, which would have been received by the option holders had all option holders exercised their options as of that date.

The following table provides additional information regarding performance share activity for the three-month periods ended March 31, 2007 and 2006:

	Number Nonvested and Outstanding	Weighted-Average Grant Date Fair-Value
BALANCE AT DECEMBER 31, 2005	412,968	$ 7.82
Performance shares granted	106,017	9.00
Performance shares forfeited	(4,867)	8.19
BALANCE AT MARCH 31, 2006	514,118	$ 8.06
BALANCE AT DECEMBER 31, 2006	703,036	$ 8.20
Performance shares granted	117,953	8.89
Performance shares vested and released	(104,636)	6.78
Performance shares forfeited	(30,885)	8.47
BALANCE AT MARCH 31, 2007	685,468	$ 8.52

No performance shares vested during the three-month periods ended March 31, 2006. The total fair value of performance shares vested and released during the quarter ended March 31, 2007 was approximately $831,000. The fair value is calculated by multiplying the fair market value of the Company s stock on the vesting date by the number of shares vested.

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6. Stock-Based Compensation (As Restated):

Valuation of Options Granted

SFAS No. 123R requires the use of a valuation model to calculate the fair-value of stock-based awards. The Company has elected to use the BSM option-pricing model, which incorporates various assumptions including volatility, expected term of the option from the date of grant to the time of exercise, risk-free interest rates, and dividend yields. The BSM option-pricing model was developed for use in estimating the fair-value of traded options having no vesting or hedging restrictions and that are fully transferable. As the Company s employee stock options and stock appreciation rights have certain characteristics that differ significantly from traded options, and because changes in the subjective assumptions used in the BSM option-pricing model can materially affect the estimated fair-value, in management s opinion, the Company s estimate of fair-value for its options based on the BSM option-pricing model may not provide an accurate measure of the fair-value an independent third-party would assign in an arms-length transaction.

The weighted average calculated fair value of options and stock appreciation rights granted during the three months ended March 31, 2007 and 2006, was $3.76 and $3.61, respectively, and was determined using the following weighted average assumptions:

	Three Months Ended March 31,	
	2007	**2006**
Expected dividend yield	0.0%	0.0%
Risk-free interest rate	4.7%	4.4%
Expected volatility	47.9%	53.7%
Expected life (in years)	3.8	3.8

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 life of the option. The expected volatility is based on the historical volatility of the Company s common stock over the most recent period commensurate with the expected life of the option, and does not include any implied volatility as there currently are no market traded options on the Company s stock that meet the criteria required for reliance on implied volatility in accordance with SAB 107. The expected life of the option has been calculated using the simplified method as permitted under SAB 107. Under the simplified method, the expected term is calculated by taking the average of the vesting term and the contractual term of the option. The simplified method was chosen due to the fact that there has been only limited exercise activity for options granted over the last several years, and thus, management has concluded that such exercise data does not provide a reasonable basis upon which to estimate expected term.

Expense Allocation (As Restated)

Compensation expense for all share-based payment awards, including those granted prior to January 1, 2006, has been recognized in accordance with SFAS 123R using the accelerated multiple-option approach. As stock-based compensation expense recognized in the Consolidated Statement of Operations for the three months ended March 31, 2007 and 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures have been estimated based on historical experience. As of March 31, 2007, total compensation cost related to non-vested stock options and other equity based awards not yet recognized was $7.5 million (as restated), which is expected to be recognized over the next 21 months (as restated) on a weighted-average basis.

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The following table summarizes the stock-based compensation expense related to employee stock options, stock appreciation rights, and performance shares under SFAS 123R for the three months ended March 31, 2007 and 2006, which was allocated as follows (in thousands):

	Three Months Ended March 31,	
	2007 (As Restated) [1]	2006 (As Restated) [1]
Cost of sales - product	$ 147	$ 127
Cost of sales - service	16	16
Stock-based compensation expense included in cost of sales	163	143
Product development	482	669
Sales and marketing	316	398
General and administrative	372	341
Stock-based compensation expense included in operating expenses	1,170	1,408
Stock-based compensation expense related to stock options and performance shares	1,333	1,551
Tax benefit		
Stock-based compensation expense related to stock options and performance shares, net of tax	$ 1,333	$ 1,551

(1) See Note 2 of these Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

Of the $1.3 million (as restated) of compensation expense recorded for the quarter ended March 31, 2007, approximately $50,000 (as restated) related to equity compensation awards granted during 2007, while the remaining $1.3 million (as restated) related to equity compensation awards granted on or before December 31, 2006. Of the $1.6 million (as restated) of compensation expense recorded for the quarter ended March 31, 2006, approximately $75,000 (as restated) related to equity compensation awards granted during 2006, while the remaining $1.5 million (as restated) related to equity compensation awards granted on or before December 31, 2005.

7. 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. For the last several years, the Company has had two customers that represented a majority of the Company s revenues: Enel S.p.A. (Enel), an Italian utility company (including Enel s third party meter manufacturers) and EBV Electronik GmbH (EBV), the Company s primary distributor of its LONWORKS® infrastructure products in Europe. During the quarter ended March 31, 2007, significant revenues were recognized from two additional customers, Telvent Energia y Medioambiente SA (Telvent) and ES Elektrosandberg AB (ES). These customers are value added resellers (VARs) of the Company s NES products. For the quarters ended March 31, 2007 and 2006, the percentage of the Company s revenues attributable to sales made to these customers was as follows:

	Three Months Ended March 31,	
	2007	2006
Telvent	54.7%	0.0%
EBV	11.8%	22.7%
ES	6.5%	0.0%
Enel	2.9%	1.9%
Total	75.9%	24.6%

The Company s contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2007.

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The Company s original contract with Enel expired in June 2005, and shipments under that contract were completed in 2005. During 2006, the Company supplied Enel and its third party meter manufacturers with limited spare parts for Enel s Contatore Elettronico system. In October 2006, the Company entered into a new development and supply agreement and a new software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers will purchase additional electronic components and finished goods from Echelon, assuming certain initial acceptance tests are completed successfully. Under the software enhancement agreement, the Company will provide software enhancements to Enel for use in its Contatore Elettronico system. Both the new development and supply agreement and the software enhancement agreement expire in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

8. Commitments and Contingencies (As Restated):

Lease Commitments (As Restated)

As discussed in Note 4, the December 1999 and October 2000 leases of our corporate headquarters facilities are accounted for under EITF 97-10 and SFAS 98.

In addition, the Company leases facilities under operating leases for its sales, marketing, and product development personnel located elsewhere within the United States and in nine 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 2018, 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.

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 operations, was approximately $149,000 and $108,000 for the quarters ended March 31, 2007 and 2006, 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.

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.

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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 generally accepted accounting principles, 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 March 31, 2007, 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.

Legal Actions

From time to time, in the ordinary course of business, the Company is 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, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While the Company believes it has adequately provided for such contingencies as of March 31, 2007, 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.

9. Inventories:

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

	March 31, 2007	December 31, 2006
Purchased materials	$ 4,665	$ 3,378
Work-in-process	70	107
Finished goods	6,340	7,874
	$ 11,075	$ 11,359

9. Accrued Liabilities (As Restated):

Accrued liabilities consist of the following (in thousands):

	March 31, 2007 (As Restated) [1]	December 31, 2006 (As Restated) [1]
Accrued payroll and related costs	$ 2,916	$ 2,776
Accrued taxes	1,320	1,307
Customer deposits	3,675	
Other accrued liabilities	591	713
	$ 8,502	$ 4,796

(1) See Note 2 of these Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

Customer deposits of $3.7 million as of March 31, 2007 represent amounts received from one customer for products expected to be shipped during the second quarter of 2007.

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11. Segment Disclosure (As Restated):

In 1998, the Company adopted SFAS No. 131 (SFAS 131), *Disclosures about Segments of an Enterprise and Related Information*. 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, the Chief Operating Officer, and their direct reports. SFAS 131 also requires disclosures about products and services, geographic areas and major customers.

The Company operates in one principal industry 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 are marketed under the LonWorks brand name, which provides the infrastructure and support required to implement and deploy open, interoperable, control network solutions. All of the Company s products either incorporate or operate with the Neuron® Chip and/or the LonWorks protocol. The Company also provides a range of services to its customers that consist of technical support, training courses covering its LonWorks network technology and products, and custom software development. In total, the Company offers a wide ranging set of products and services that together constitute the LonWorks system. Any given customer purchases a small subset of such products and services that are appropriate for that customer s application.

The Company manages its business primarily on a geographic basis. The Company s geographic areas are comprised of three main groups: the Americas; Europe, Middle East and Africa (EMEA); and Asia Pacific / Japan (APJ). Each geographic area provides products and services as further described in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations. The Company evaluates the performance of its geographic areas based on profit or loss from operations. Profit or loss for each geographic area includes sales and marketing expenses and other charges directly attributable to the geographic area and excludes certain expenses that are managed outside the geographic area. Costs excluded from geographic area profit or loss consist primarily of unallocated corporate expenses, which are comprised of product development costs, corporate marketing costs, and other general and administrative expenses, which are separately managed. The Company s long-lived assets include property and equipment, goodwill, loans to certain key employees, purchased technology, and deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of March 31, 2007 and December 31, 2006, long-lived assets of about $36.6 million (as restated) and $37.4 million (as restated), respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements. Assets and the related depreciation and amortization are not reported by geography because that information is not reviewed by the executive staff when making decisions about resource allocation to the geographic areas based on their performance.

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In North America, the Company sells its products 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 customer is domiciled. Summary information by geography for the quarters ended March 31, 2007 and 2006 is as follows (in thousands):

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Revenues from customers:		
Americas	$ 4,255	$ 4,800
EMEA	31,362	3,984
APJ	3,652	1,961
Unallocated		
Total	$ 39,269	$ 10,745
Gross profit:		
Americas (As Restated) [1]	$ 2,769	$ 2,656
EMEA	5,143	2,184
APJ	2,240	904
Unallocated		
Total	$ 10,152	$ 5,744
Income/(Loss) from operations:		
Americas (As Restated) [1]	$ 1,683	$ 1,561
EMEA	3,584	728
APJ	1,045	(223)
Unallocated	(12,933)	(11,708)
Total	$ (6,621)	$ (9,642)

(1) See Note 2 of these Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

EBV, the primary independent distributor of the Company s LonWorks infrastructure products in Europe, accounted for 11.8% of total revenues for the quarter ended March 31, 2007 and 22.7% for the same period in 2006.

Products sold to Enel and its designated manufacturers accounted for $1.2 million, or 2.9% of total revenues for the quarter ended March 31, 2007, and $200,000, or 1.9% of total revenues for the same period in 2006. During the quarter ended March 31, 2007, 93.2% of the revenues shipped under the Enel program were shipped to customers in APJ, while the remaining 6.8% were shipped to customers in EMEA. During the quarter ended March 31, 2006, 100.0% of the revenues shipped under the Enel program were shipped to customers in APJ.

12. Income Taxes:

We adopted FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109*, on January 1, 2007. This interpretation prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken on a tax return. FIN 48 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, and disclosure and transition.

As a result of the implementation of FIN 48, the Company recognized no material adjustment in the liability for unrecognized income tax benefits. The Company has unrecognized tax benefits of approximately $1.2 million as of January 1, 2007, all of which, if recognized, would result in a reduction of the Company s effective tax rate.

In connection with the adoption of FIN 48, the Company will continue to include interest and penalties related to uncertain tax positions as a component of income tax, which was immaterial for the three months ended March 31, 2007. We do not believe it is reasonably possible that the Company s unrecognized tax benefits will change significantly within the next twelve months.

The Company is subject to taxation in the US and various state and foreign jurisdictions. The tax years 1992-2006 remain open to examination by the federal and most state tax authorities due to certain net operating loss and credit carryforward positions.

The provision for income taxes for the quarters ended March 31, 2007 and 2006 includes a provision for Federal, state and foreign taxes based on the annual estimated effective tax rate applied to the Company and its subsidiaries for the year. The difference between the statutory rate and the Company s effective tax rate is primarily due to the impact of foreign taxes.

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13. Related Party:

During the quarter ended March 31, 2007, and the years ended December 31, 2006, 2005, and 2004, 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.

In June 2000, the Company entered into a stock purchase agreement with Enel. At the same time, the Company also entered into a Research and Development and Technological Cooperation Agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, the Company cooperated with Enel to integrate LonWorks technology into Enel s remote metering management project in Italy. For the quarters ended March 31, 2007 and 2006, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $1.2 million and $200,000, respectively. As of March 31, 2007, $79,000 of the Company s total accounts receivable balance related to amounts owed by Enel and its designated manufacturers. As of March 31, 2006, there were no amounts owed the Company by Enel or its designated manufacturers.

In October 2006, Enel and the Company entered into a new development and supply agreement as well as a software enhancement agreement. Under the development and supply agreement, Enel will purchase additional metering kit and data concentrator products from the Company, assuming initial acceptance tests are completed successfully. Under the software enhancement agreement, the Company will provide software enhancements to Enel for use in its Contatore Elettronico system. Both the new development and supply agreement and the software enhancement agreement expire on December 31, 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

14. 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 recorded at the time of shipment. 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 $288,000 as of March 31, 2007 and $224,000 as of December 31, 2006.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business. These statements may be identified by the use of words such as we believe, expect, anticipate, intend, plan, goal, continues, may, and similar expressions. In addition, forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the Factors That May Affect Future Results Of Operations section. Our actual results may differ materially.

RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS

During the preparation of our financial results for the quarter ended March 31, 2008, we identified an error in our previously reported equity compensation expense and determined we had inappropriately accounted for the 1999 and 2001 leases of our San Jose, California corporate headquarters facilities.

Restatement of stock-based compensation expense: We identified an error in our previously reported stock-based compensation expense for the years ended December 31, 2007, 2006 and 2005 and each of the quarterly periods in 2007 and 2006. The error was isolated to share awards and does not affect the other forms of our equity compensation awards, namely stock options and stock-settled stock appreciation rights. While the grant date fair value of the share awards was determined correctly in accordance with Statement of Financial Accounting Standard (SFAS) No. 123R (revised 2004), *Share-Based Payment* (SFAS 123R), the amount of expense associated with these awards that was recognized in 2007, 2006 and 2005 was not correct. The error was caused by a misapplication of the widely-used equity compensation software application we use to manage and account for our equity compensation awards. This misapplication caused the expense associated with these share awards to be calculated using the straight-line, single-option method rather than the accelerated, multiple-option method, which we had elected to use for all of our equity compensation awards. Use of the straight-line, single-option method resulted in understatements of stock-based compensation expense in 2007, 2006 and 2005 of $1.2 million, $535,000 and $263,000, respectively. For the quarters ended March 31, 2007 and 2006, stock-based compensation expense was understated by $153,000 and $145,000, respectively.

Restatement related to the leases of our San Jose, California headquarters facilities: In connection with the restatement of stock-based compensation expense, KPMG LLP, our independent registered public accounting firm, brought to our attention that we had inappropriately accounted for the leases of our corporate headquarters facilities that were entered into in 1999 and 2001. Under the guidance in Emerging Issues Task Force Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction* (EITF 97-10), and SFAS No. 98, *Accounting for Leases: Sale-Leaseback transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; Initial Direct Costs of Direct Financing Leases; an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11* (SFAS 98), we should have reflected an asset on our balance sheet for the costs paid by the lessor to construct our headquarters facilities, as well as a corresponding liability, because we were the deemed owner of the headquarters facilities for accounting purposes during the construction periods. Upon completion of construction, we did not meet the sale-leaseback criteria under SFAS 98 and therefore should have treated the leases as financing obligations and the assets and corresponding liabilities would not be derecognized. We had historically accounted for these leases as operating leases under SFAS No. 13, *Accounting for Leases* (SFAS 13), whereby the total minimum lease payment obligations under the leases were recognized as monthly rent expense on a straight-line basis over the terms of the leases. The restatement adjustments do not affect the total cash payments we have made or are obligated to make under the lease agreements, nor do they change the total expense to be recognized over the lease terms. However, the timing and nature of expenses in the statement of operations is different under this treatment as compared to operating lease treatment. Specifically, we should have recognized land lease expense, depreciation expense on the assets we are deemed to own and interest expense on the associated lease financing obligations.

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Our management and the Audit Committee of our Board of Directors have concluded that these errors in our consolidated financial statements were unintentional, and no misdeed or fraud was involved in any respect. The Audit Committee also determined that the error in stock-based compensation expense was in no way caused by any backdating of or similar improper activity involving stock option grants.

Therefore we have restated our condensed consolidated balance sheets as of March 31, 2007, and December 31, 2006, and our condensed consolidated statements of operations and cash flows for the quarters ended March 31, 2007 and 2006, to reflect the restatement adjustments applicable to those periods. We will also file amendments to our 2007 Form 10-K and Forms 10-Q for each of the quarters ended June 30 and September 30, 2007. The amended 2007 filings will include restated information for the periods affected by these restatements.

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

	March 31, 2007	December 31, 2007	December 31, 2006
Increase in total assets	$ 14.3 million	$ 12.3 million	$ 15.0 million
Increase in total liabilities	$ 17.2 million	$ 15.2 million	$ 17.9 million
Increase in additional paid-in-capital	$ 1.0 million	$ 2.0 million	$ 0.8 million
Increase in accumulated deficit	$ 3.9 million	$ 4.9 million	$ 3.7 million

The effects of all restatement adjustments on our condensed consolidated statements of operations for the quarters ended March 31, 2007 and 2006 are as follows:

	Quarter Ended March 31, 2007	Quarter Ended March 31, 2006
Decrease in rent expense	$ 1.0 million	$ 1.0 million
Increase in depreciation expense	$ 0.7 million	$ 0.7 million
Increase in stock-based compensation expense	$ 0.2 million	$ 0.1 million
Increase in interest expense	$ 0.3 million	$ 0.4 million
Increase in net loss	$ 0.2 million	$ 0.2 million

The correction of the accounting for our San Jose, California headquarters facilities leases required us to calculate the adjustments by year beginning with the year ended December 31, 2000. The cumulative effect of the restatement adjustments related to the lease accounting errors for the years 2000 through 2004 is reported as a $2.5 million increase to the 2005 beginning accumulated deficit balance. The financial statement effects of all restatement adjustments by year are summarized in the following table (in thousands):

		Adjustments related to errors in lease accounting			
Fiscal Year	Increase in stock-based compensation expense	Net increase (decrease) in rent expense	Increase in depreciation expense	Increase in interest expense	Net increase in expense
2000	$	$ 281	$	$	$ 281
2001		31	301	199	531
2002		(1,606)	1,204	945	543
2003		(3,173)	2,344	1,483	654
2004		(3,948)	2,724	1,666	442
Cumulative effect of restatement on prior periods		(8,415)	6,573	4,293	2,451
2005	263	(3,947)	2,723	1,530	569
2006	535	(3,948)	2,724	1,379	690
2007	1,173	(3,948)	2,724	1,211	1,160

$ 1,971	$ (20,258)	$ 14,744	$ 8,413	$ 4,870

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Included in Note 2 of Notes to Condensed Consolidated Financial Statements in this Report are tables that present the effects of all restatement adjustments on the condensed consolidated financial statements reconciling the previously reported data to the as restated data for the Condensed Consolidated Balance Sheets as of March 31, 2007 and December 31, 2006, and the Condensed Consolidated Statements of Operations and Cash Flows for each of the quarters ended March 31, 2007 and 2006.

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 nine foreign countries throughout Europe and Asia. We develop, market, and sell system and network infrastructure products that enable everyday devices such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves to be made smart and inter-connected. Working together, products and systems equipped with our technology can monitor and save energy, lower costs, improve productivity and enhance service, quality, safety and convenience. We offer these hardware and software products and related services to OEMs and systems integrators in the building, industrial, transportation, utility/home, and other automation markets.

We have been investing in products for use by electricity utilities for use in management of electricity distribution. We refer to these products (and related services) as our networked energy services, or NES, offerings. We began to receive modest amounts of NES revenue in 2004, which increased to approximately $883,000 in 2005 and decreased slightly to $791,000 in 2006. During the first quarter of 2007, NES revenue increased significantly to $24.9 million. We 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 LonWorks Infrastructure, or LWI, 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.

During the first and second quarters of 2006, we revised our revenue recognition methodology for sales made to the distributors of our LWI products. Under the revised methodology, we now defer revenue, as well as cost of goods sold, on items shipped to these distributors that remain in their inventories at quarter-end. The revision significantly reduced our first and second quarter 2006 revenues, but did not have an impact on cash flows from operations or require any changes to our historical financial statements. A more thorough explanation of this revision can be found later in this report in the LonWorks Infrastructure revenues and EBV revenues sections of our discussion on Results of Operations.

We have a history of losses and, although we achieved profitability in past fiscal periods, we incurred a loss for the quarter ended March 31, 2007 and expect to incur an operating loss for the full year ending December 31, 2007. This expectation is due primarily to two factors. First, as we expected in both 2005 and 2006, revenues from the Enel Project decreased significantly as compared to prior periods as the deployment phase of the Contatore Elettronico project came to an end. We expect that during 2007, Enel Project revenues attributable to the two recently signed agreements with Enel will rise only slightly from 2006 levels. While we expect our NES revenues to increase substantially during 2007, we do not currently believe they will increase rapidly enough to return us to an operating profit for the full year ending December 31, 2007.

The second factor contributing to our expectation for losses in 2007 relates to the fact that, effective January 1, 2006, we began recording compensation expense associated with stock options and other forms of equity compensation as required under SFAS 123R. For the year ended December 31, 2006, the adoption of this new accounting standard resulted in an increase in equity compensation expenses of approximately $4.6 million (as restated) as compared to the same period in 2005. We expect equity compensation expense in 2007 will be moderately higher than that charged in 2006.

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CRITICAL ACCOUNTING ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our revenues, allowance for doubtful accounts, inventories, commitments and contingencies, income taxes, and asset impairments. 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 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.

Stock-Based Compensation. Effective January 1, 2006, we adopted the provisions of and account for stock-based compensation in accordance with SFAS 123R. We elected the modified-prospective method, under which prior periods are not revised for comparative purposes. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the calculated 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 determine the calculated fair value of stock options. The determination of the calculated fair value of stock-based payment awards on the date of grant using the BSM option-pricing model is affected by our stock price on the date of grant, as well as a number of highly complex and subjective variables. These variables include the expected volatility of our stock price over the expected term of the option, actual and projected employee stock option exercise behaviors, risk-free interest rates, and expected dividends.

We estimate the expected term of options granted using the simplified method as illustrated in SEC Staff Accounting Bulletin No. 107 (SAB 107). Under the simplified method, the expected term is calculated by taking the average of the vesting term and the contractual term of the option. The expected volatility is based on the historical volatility of our common stock over the most recent period commensurate with the expected life of the option, and does not include any implied volatility as there are currently no market traded options on our stock that meet the criteria required for reliance on implied volatility in accordance with SAB 107. 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 option 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.

SFAS 123R also requires 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 multiple option method over their requisite service period, which is generally the vesting period.

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 calculated fair value estimate 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 calculated fair value of traded options that have no vesting or hedging restrictions and that are fully transferable, characteristics that are not present in our option grants.

Existing valuation models, including the BSM and lattice binomial models, may not provide reliable measures of fair values of our stock-based compensation. Consequently, there is a risk that our estimates of the calculated fair values of our stock-based compensation awards on the grant dates may be significantly different from the actual values realized, if any, upon the exercise,

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expiration, early termination, or forfeiture of those stock-based payments in the future. For example, our employee stock options may expire worthless or otherwise result in zero intrinsic value as compared to the calculated fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that is significantly higher than the calculated fair values originally estimated on the grant date and reported in our financial statements. There is currently no market-based mechanism or other practical application to verify the reliability and accuracy of the estimated fair values resulting from these valuation models, nor is there a means to compare and adjust the estimates to actual values.

If factors change and we employ different assumptions for estimated 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 and earnings per share.

Information regarding the restatement of our financial statements related to an error in stock-based compensation expense can be found in Note 2 of Notes to Condensed Consolidated Financial Statements and further information regarding stock-based compensation can be found in Note 6 (As Restated) of Notes to Condensed Consolidated Financial Statements contained in this Report.

Sales Returns and Allowances. We sell our products and services to OEMs, systems integrators, and our other customers directly through our sales force and indirectly through distributors located in the geographic markets that we serve. Sales to certain distributors are made under terms allowing limited rights of return. Sales to EBV, our largest distributor, accounted for 11.8% of total net revenues for the quarter ended March 31, 2007, and 22.7% for the same period in 2006. Worldwide sales to distributors, including those to EBV, accounted for approximately 17.4% of total net revenues for the quarter ended March 31, 2007, and 36.1% for the same period in 2006.

Net revenues consist of product and service revenues reduced by estimated sales returns and allowances. Provisions for estimated sales returns and allowances are recorded at the time of sale, and are based on management s estimates of potential future product returns and allowances related to product revenues in the current period. In evaluating the adequacy of our sales returns and other allowances, management analyzes historical returns, current and historical economic trends, contractual terms, and changes in customer demand and acceptance of our products.

Other than standard warranty repair work, Enel and its designated contract meter manufacturers do not have rights to return products we ship to them. However, our agreement with Enel contains an acceptance provision, whereby Enel is entitled to inspect products we ship to them to ensure the products conform, in all material respects, to the product s specifications. Once the product has been inspected and approved by Enel, or if the acceptance period lapses before Enel inspects or approves the products, the goods are considered accepted. Prior to shipping our products to Enel, we perform detailed reviews and tests to ensure the products will meet Enel s acceptance criteria. We do not ship products unless they have passed these reviews and tests. As a result, we record revenue for these products upon shipment to Enel. If Enel were to subsequently properly reject any material portion of a shipment for not meeting the agreed upon specifications, we would defer the revenue on that portion of the transaction until such time as Enel and we were able to resolve the discrepancy. Such a deferral could have a material impact on the amount and timing of our Enel related revenues.

Our allowances for sales returns and other sales-related reserves were approximately $819,000 as of March 31, 2007, and $791,000 million as of December 31, 2006.

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 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 collectibility 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 worsened, 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 $250,000 as of March 31, 2007 and December 31, 2006.

Inventory Valuation. At each balance sheet date, we evaluate our ending inventories for excess quantities and obsolescence. This evaluation includes analyses of sales levels by product and projections of future demand. Inventories on hand, in excess of one year s forecasted demand, are not valued. In addition, we write off 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 $288,000 as of March 31, 2007, and $224,000 as of December 31, 2006.

Deferred Income Taxes. We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. Based on our historical net operating losses, and the uncertainty of our future operating results, we have recorded a valuation allowance that fully reserves our deferred tax assets. If we later determine that, more likely than not, some or all of the net deferred tax assets will be realized, we would then need to reverse some or all of the previously provided valuation allowance. Our deferred tax asset valuation allowance was $61.2 million as of December 31, 2006.

Valuation of Goodwill and Other Intangible Assets. We assess the impairment of goodwill and identifiable intangible assets on an annual basis and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner or use of the acquired assets or the strategy for our overall business;
- significant negative industry or economic trends; and
- significant changes in the composition of the intangible assets acquired.

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When we determine that the carrying value of goodwill and other intangible assets may not be recoverable based upon the existence of one or more of the above indicators, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. Net goodwill and other intangible assets amounted to $8.3 million as of December 31, 2006.

When we adopted SFAS 142, *Goodwill and Other Intangible Assets,* in 2002, we ceased amortizing goodwill, which had a net unamortized balance of $1.7 million as of December 31, 2001. Since then, primarily as a result of acquisitions in 2002 and 2003, the net balance of goodwill has grown to $8.3 million as of March 31, 2007. We review goodwill for impairment annually during the quarter ending March 31. Our review during the quarter ended March 31, 2007 indicated no impairment. If, as a result of an annual or any other impairment review that we perform in the future, we determine that there has been an impairment of our goodwill or other intangible assets, we would be required to take an impairment charge. Such a charge could have a material adverse impact on our financial position and/or operating results.

Results of Operations

The following table reflects the percentage of total revenues represented by each item in our Consolidated Statements of Operations for the three months ended March 31, 2007 and March 31, 2006:

	Three Months Ended March 31,	
	2007 (As Restated)[1]	2006 (As Restated)[1]
Revenues:		
Product	99.5%	98.4%
Service	0.5	1.6
Total revenues	100.0	100.0
Cost of revenues:		
Cost of product	72.9	42.5
Cost of service	1.2	4.0
Total cost of revenues	74.1	46.5
Gross profit	25.9	53.5
Operating expenses:		
Product development	19.8	64.8
Sales and marketing	13.8	48.0
General and administrative	9.1	30.4
Total operating expenses	42.7	143.2
Loss from operations	(16.8)	(89.7)
Interest and other income, net	3.8	13.0
Interest expense on lease financing obligations	(0.8)	(3.4)
Loss before provision for income taxes	(13.8)	(80.1)
Provision for income taxes	0.3	0.7
Net loss	(14.1)%	(80.8)%

(1) See Note 2 of Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

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Revenues

Total revenues

(Dollars in thousands)	Three Months Ended March 31, 2007	March 31, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Total revenues	$ 39,269	$ 10,745	$ 28,524	265.5%

The $28.5 million increase in total revenues for the quarter ended March 31, 2007 as compared to the same period in 2006 was primarily the result of a $24.7 million increase in NES revenues (see discussion below), a $2.9 million increase in LonWorks Infrastructure revenues (see discussion below), and a $955,000 increase in Enel project revenues (see discussion below).

LonWorks Infrastructure revenues

(Dollars in thousands)	Three Months Ended March 31, 2007	March 31, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
LonWorks Infrastructure revenues	$ 13,252	$ 10,379	$ 2,873	27.7%

Our LonWorks Infrastructure revenues are primarily comprised of sales of our hardware and software products, and to a lesser extent, revenues we generate from our customer support and training offerings. The $2.9 million increase in LonWorks Infrastructure revenue for the quarter ended March 31, 2007 as compared to the same period in 2006 was primarily the result of a revision we made to our revenue recognition methodology for sales made to our European distributor, EBV, during the first quarter of 2006 (see discussion below). The revision resulted in a one-time decrease in our LonWorks Infrastructure revenues during the first quarter of 2006 of approximately $2.9 million.

We believe that, as long as current worldwide economic conditions do not deteriorate, full year 2007 LonWorks Infrastructure revenues will improve from the $49.4 million recorded in 2006. This expected improvement, however, will be subject to further fluctuations in exchange rates between the U.S. dollar and the foreign currencies in which we generate revenues, principally the Japanese Yen. If the U.S. dollar were to strengthen against these currencies, our revenues would decrease. Conversely, if the U.S. dollar were to weaken against these currencies, our revenues would increase. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in foreign currencies and the magnitude of the exchange rate fluctuation from year to year. The portion of our LonWorks Infrastructure revenues conducted in currencies other than the U.S. dollar, principally the Japanese Yen, was about 6.1% for the quarter ended March 31, 2007 and 6.2% for the same period in 2006. We do not currently expect that, during the remainder of 2007, the amount of our LonWorks Infrastructure revenues conducted in these or other foreign currencies will fluctuate significantly from that experienced in 2006. 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 LonWorks Infrastructure 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.

NES revenues

(Dollars in thousands)	Three Months Ended March 31, 2007	March 31, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
NES revenues	$ 24,861	$ 166	$ 24,695	14,876.5%

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NES revenues generated during the quarter ended March 31, 2007 were primarily related to large scale deployments of our NES system products. NES revenues generated during the quarter ended March 31, 2006 were primarily related to the completion of system trials and, to a lesser extent, shipments of NES products.

We expect that, during 2007, shipments of our NES products will continue to increase over 2006 levels. Our ability to recognize revenue on these shipments depends on several factors, including, but not limited to, delivery to the customer of all of the software called for in any given agreement, modification of the 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 will likely require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period. In some instances, the reasons for these deferrals may not be fully under our control, which could result in the actual timing of revenue being significantly different than we currently anticipate.

We also expect that many foreign utilities will require us to price our NES system in the respective utility s local currency, which will expose us to foreign currency risk. The portion of our NES revenues conducted in currencies other than the U.S. dollar, principally the Australian dollar, was about 1.2% for the quarter ended March 31, 2007. There were no NES revenues conducted in foreign currencies during the quarter ended March 31, 2006. In most cases, in the event of a significant contract award, we intend to hedge this foreign currency risk so long as we can secure forward currency contracts that are reasonably priced and that are consistent with the scheduled deliveries for that project. In addition, we will face foreign currency exposures from the time we submit our foreign currency denominated bid until the award of a contract by the utility (the bid to award term). This bid to award term can often exceed several months. If a utility awards us a contract that gives the utility the right to exercise options for additional supply in the future, we would also be exposed to foreign currency risk until such time as these options, if any, were exercised. We may decide that it is too expensive to hedge the foreign currency risks during the bid to award term or for any unexercised options. Any resulting adverse foreign currency fluctuations could significantly harm our revenues, results of operations, and financial condition.

Enel project revenues

(Dollars in thousands)	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006	2007 over 2006 $ Change	2007 over 2006% Change
Enel project revenues	$ 1,155	$ 200	$ 955	477.5%

In October 2006, we entered into two new agreements with Enel, a development and supply agreement and a software enhancement agreement. Under the development and supply agreement, Enel will purchase additional metering kit and data concentrator products from us, assuming initial acceptance tests are completed successfully. Under the software enhancement agreement, we will provide software enhancements to Enel for use in its Contatore Elettronico system. There were no revenues from either of these new agreements during 2006. The $1.2 million of Enel project revenue recognized during the quarter ended March 31, 2007 related to initial shipments under the new development and supply agreement. Both the development and supply agreement and the software enhancement agreement expire on December 31, 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances. Early in 2006, Enel asked us to provide them with spare parts for use in their system in Italy. The $200,000 of Enel project revenue recognized in the first quarter of 2006 represents our initial shipments against that request. We sell our products to Enel and its designated manufacturers in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency risks.

We believe that full year 2007 revenues attributable to the Enel project will increase modestly over the $7.1 million reported in 2006 and will relate primarily to products shipped to Enel and its designated manufacturers under the new development and supply agreement.

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EBV revenues

(Dollars in thousands)	Three Months Ended March 31, 2007	March 31, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
EBV revenues	$ 4,648	$ 2,444	$ 2,204	90.2%

Sales to EBV, our largest distributor and the primary independent distributor of our products in Europe, accounted for 11.8% of our total revenues for the quarter ended March 31, 2007 and 22.7% of our total revenues for the same period in 2006. The primary factor contributing to the $2.2 million increase between the two quarters was the fact that, during the first quarter of 2006, we revised our revenue recognition methodology for sales made to EBV. Under the revised methodology, revenues, as well as cost of goods sold, are deferred on items shipped to EBV that remain in EBV s inventories at quarter-end. Revenue is then recognized on these products, along with the corresponding gross margin, when EBV sells them to its customers in future periods. This revision resulted in a one-time revenue decrease of approximately $2.9 million for the quarter ended March 31, 2006. The revision did not have an impact on cash flows from operations or require any changes to historical financial statements.

Excluding the impact of the accounting method revision, EBV s shipments to its customers were virtually unchanged during the first quarter of 2007 as compared to the same period in 2006. We currently sell our products to EBV in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency exchange rate risks. However, EBV has the right, on notice to our company, to require that we sell our products to them in Euros.

Our contract with EBV, which has been in effect since 1997 and to date has been renewed annually thereafter, expires in December 2007. If our agreement with EBV is not renewed, or is renewed on terms that are less favorable to us, our revenues could decrease and our future financial position could be harmed.

Product revenues

(Dollars in thousands)	Three Months Ended March 31, 2007	March 31, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Product revenues	$ 39,077	$ 10,574	$ 28,503	269.6%

The $28.5 million increase in product revenues for the quarter ended March 31, 2007 as compared to the same period in 2006 was primarily the result of a $24.6 million increase in NES product revenues, a $2.9 million increase in LonWorks Infrastructure product revenues, and a $955,000 increase in Enel Project related revenues.

Service revenues

(Dollars in thousands)	Three Months Ended March 31, 2007	March 31, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Service revenues	$ 192	$ 171	$ 21	12.3%

The $21,000 increase in service revenues during the quarter ended March 31, 2007 as compared to the same period in 2006 was primarily due to an increase in NES support revenues, partially offset by a reduction in LonWorks Infrastructure customer support and training revenues. We do not currently believe that our 2007 service revenues will change substantially from prior year levels.

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Gross Profit and Gross Margin (As Restated)

(Dollars in thousands)	Three Months Ended March 31, 2007 (As Restated)[1]	March 31, 2006 (As Restated)[1]	2007 over 2006 $ Change[1]	2007 over 2006 % Change[1]
Gross Profit	$ 10,152	$ 5,744	$ 4,408	76.7%
Gross Margin	25.9%	53.5%		(27.6)

(1) See Note 2 of Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

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.

The 27.6 percentage point decrease in gross margin during the first quarter of 2007 was due primarily to the mix of revenues reported. During the quarter ended March 31, 2007, approximately 63.3% of our revenues were attributable to sales of our NES system products, and 33.8% of our revenues were attributable to sales of our LonWorks Infrastructure products and services, while the remaining 2.9% was attributable to the Enel project. During the quarter ended March 31, 2006, approximately 96.6% of our revenues were attributable to sales of our LonWorks Infrastructure products and services, 1.9% of our revenues were attributable to the Enel Project, and the remaining 1.5% of our revenues were generated from sales of our NES system products. In general, gross margins generated from sales of our NES system products are much lower than those generated from both sales of our LonWorks Infrastructure products and services as well as sales made under the Enel Project. As a result, when NES revenues are higher as a percentage of overall revenues, as they were during the quarter ended March 31, 2007, overall gross margins will be lower. Conversely, when NES revenues comprise a lower percentage of overall revenues, as they were during the quarter ended March 31, 2006, overall gross margins will be higher.

Partially offsetting the decrease in gross margins during the first quarter of 2007 as compared to the same period in 2006 was the impact of higher revenues on gross margins. As discussed above, a portion of our cost of goods sold relates to indirect costs. Some of these costs do not increase or decrease in conjunction with revenue levels, but rather remain relatively constant from quarter to quarter. As a result, when revenues increase, as they did in the quarter ended March 31, 2007 as compared to the same period in 2006, gross margins are favorably impacted.

We expect that, for full year 2007, overall gross margin will decrease significantly from the 58.2% experienced in 2006 due to expected significant increase in NES revenues.

Operating Expenses (As Restated)

Product Development (As Restated)

(Dollars in thousands)	Three Months Ended March 31, 2007 (As Restated)[1]	March 31, 2006 (As Restated)[1]	2007 over 2006 $ Change [1]	2007 over 2006 % Change [1]
Product Development	$ 7,778	$ 6,959	$ 819	11.8%

(1) See Note 2 of Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

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

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The $819,000 increase in product development expenses for the quarter ended March 31, 2007 as compared to the same period in 2006 was primarily due to increases in expensed material, fees paid to third party service providers, and compensation expenses for our product development personnel.

We expect that, for full year 2007, product development expenses will increase over 2006 levels. This increase will primarily be the result of increased development efforts related to our NES system products.

Sales and Marketing (As Restated)

	Three Months Ended			
	March 31,	March 31,	2007 over	2007 over
(Dollars in thousands)	2007 (As Restated)[1]	2006 (As Restated)[1]	2006 $ Change [1]	2006 % Change [1]
Sales and Marketing	$ 5,427	$ 5,162	$ 265	5.1%

(1) See Note 2 of Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

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

The $265,000 increase in sales and marketing expenses for the quarter ended March 31, 2007 as compared to the same period in 2006 was primarily due to increases in travel and entertainment expenses, compensation expenses, and tradeshows and other advertising related expenses. Contributing to this increase was the impact of foreign currency exchange rate fluctuations between the U.S. dollar and the local currencies in several of the foreign countries in which we operate, including the Euro, the British Pound Sterling, and the Japanese Yen. Approximately $118,000 of the $265,000 quarter-over-quarter increase was the result of these foreign currency exchange rate fluctuations.

We expect that, during 2007, our sales and marketing expenses will increase over 2006 levels. In addition, if the United States dollar were to weaken against the foreign currencies where we do business, our sales and marketing expenses could increase further. 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 (As Restated)

	Three Months Ended			
	March 31,	March 31,	2007 over	2007 over
(Dollars in thousands)	2007 (As Restated)[1]	2006 (As Restated)[1]	2006 $ Change [1]	2006 % Change [1]
General and Administrative	$ 3,568	$ 3,265	$ 303	9.3%

(1) See Note 2 of Notes to Condensed Consolidated Financial Statements for an explanation of the restatement.

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 the company, facility costs, insurance, and other general corporate expenses.

The $303,000 increase in general and administrative expenses during the quarter ended March 31, 2007 as compared to the same period in 2006 was primarily attributable to an increase in compensation related expenses for our executive, accounting, and administrative personnel.

We believe that, during 2007, general and administrative costs will increase modestly above 2006 levels.

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Interest and Other Income, Net

(Dollars in thousands)	Three Months Ended March 31, 2007	March 31, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Interest and Other Income, Net	$ 1,497	$ 1,394	$ 103	7.4%

Interest and other income, net primarily reflects interest earned by our company on cash and short-term investment balances. In addition, foreign exchange translation gains and losses related to short-term intercompany balances are also reflected in this amount.

Interest income increased by approximately $103,000 during the quarter ended March 31, 2007 as compared to the same period in 2006. This increase is primarily attributable to an overall improvement in the average yield on our investment portfolio, partially offset by a reduction in our average invested cash balance. In addition, a reduction in foreign exchange translation losses on our short-term intercompany balances during the first quarter of 2007 also contributed to the $103,000 improvement in interest and other income, net between the two quarters.

Although interest rates have increased substantially since June 2004, we expect that our anticipated operating losses for 2007 will require us to use a portion of our existing cash and short-term investment portfolio to fund ongoing business operations. In addition, we may decide to continue repurchasing our common stock in accordance with our board of directors approved stock repurchase program, which expires in March 2008. As a result, we expect that the average amount of our invested cash will decrease during 2007, which will result in reduced interest income if interest rates remain unchanged. In addition, future fluctuations in the exchange rates between the United States dollar and the currencies in which we maintain our short-term intercompany balances (principally the European Euro and the British Pound Sterling) will also affect our interest and other income, net.

Interest Expense on Lease Financing Obligations (As Restated)