ECHELON CORP
Form 10-Q
May 10, 2018

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

FORM 10-Q

(Mark One)
[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2018
or
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ___________ to ___________
Commission file number 001-37755
ECHELON CORPORATION
(Exact Name of Registrant as Specified in its Charter)

Delaware	77-0203595
State or Other Jurisdiction of Incorporation or Organization	I.R.S. Employer Identification No.
2901 Patrick Henry Drive Santa Clara, CA	95054
Address of Principal Executive Offices	Zip Code

(408) 938-5200
Registrant's Telephone Number, Including Area Code

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x
Emerging growth company o	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes o No o

APPLICABLE ONLY TO CORPORATE ISSUERS

As of April 30, 2018, 4,542,273 shares of the registrant’s common stock were outstanding.

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FORM 10 Q
FOR THE QUARTER ENDED MARCH 31, 2018
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FORWARD-LOOKING INFORMATION

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

In this report, the words "may," "could," "would," "might," "will," "should," "plan," " forecast," "anticipate," "believe," "expe "estimate," "predict," "potential," "continue," "future," "moving toward" or the negative of these terms or other similar express 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, except as required by law.

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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, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 5,846	$ 7,261
Short-term investments	11,960	11,967
Restricted investments	1,250	1,250
Accounts receivable, net	2,556	2,296
Inventories	3,566	3,251
Deferred cost of revenues	529	1,039
Other current assets	1,516	1,152
Total current assets	27,223	28,216
Property and equipment, net	453	458
Intangible assets, net	668	725
Other long term assets	558	987
Total assets	$ 28,902	$ 30,386
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 2,570	$ 2,317
Accrued liabilities	2,256	1,878
Deferred revenues	849	1,812
Total current liabilities	5,675	6,007
LONG-TERM LIABILITIES:		
Other long-term liabilities	616	652
Total long-term liabilities	616	652
STOCKHOLDERS' EQUITY:		
Common stock	49	48
Additional paid-in capital	359,715	359,339
Treasury stock	(28,130)	(28,130)
Accumulated other comprehensive loss	(1,681)	(1,821)
Accumulated deficit	(307,342)	(305,963)
Total Echelon Corporation stockholders' equity	22,611	23,473
Noncontrolling interest in subsidiary	—	254
Total stockholders' equity	22,611	23,727
Total liabilities and stockholders' equity	$ 28,902	$ 30,386

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,	
	2018	2017
Revenues	$7,837	$7,703
Cost of revenues [1]	3,460	3,292
Gross profit	4,377	4,411
Operating expenses:		
Product development [1]	3,005	2,227
Sales and marketing [1]	1,310	1,462
General and administrative [1]	1,705	1,924
Total operating expenses	6,020	5,613
Loss from operations	(1,643)	(1,202)
Interest and other income (expense), net	258	(65)
Loss before provision for income taxes	(1,385)	(1,267)
Income tax benefit	(6)	(6)
Net loss	$(1,379)	$(1,261)
Basic and diluted net loss per share	$(0.30)	$(0.28)
Shares used in computing net loss per share:		
Basic	4,527	4,434
Diluted	4,527	4,434

[1] See Note 4 for summary of amounts included representing stock-based compensation expense.
See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2018	2017
Net loss	$(1,379)	$(1,261)
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustment	140	83
Unrealized holding gain (loss) on available-for-sale securities	—	(1)
Total other comprehensive income (loss)	140	82
Comprehensive loss	$(1,239)	$(1,179)

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, 2018	2017
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net loss	$(1,379)	$(1,261)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	119	110
Reduction in allowance for doubtful accounts	—	(7)
Increase in accrued investment income	(44)	(16)
Stock-based compensation	444	467
Gain on liquidation of joint venture	(424)	—
Change in operating assets and liabilities:		
Accounts receivable	(270)	(224)
Inventories	(315)	54
Deferred cost of revenues	48	(159)
Other current assets	65	(124)
Accounts payable	290	42
Accrued liabilities	135	(545)
Deferred revenues	(3)	185
Deferred rent	(19)	(18)
Net cash used in operating activities	(1,353)	(1,496)
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchases of available for sale short term investments	(5,948)	(5,979)
Proceeds from maturities and sales of available for sale short term investments	6,000	6,000
Change in other long term assets	9	11
Capital expenditures	(87)	(16)
Net cash provided by (used in) investing activities	(26)	16
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Repurchase of common stock from employees for payment of taxes on vesting of restricted stock units and upon exercise of stock options	(66)	(17)
Net cash used in financing activities	(66)	(17)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	30	19
NET CHANGE IN CASH AND CASH EQUIVALENTS	(1,415)	(1,478)
CASH AND CASH EQUIVALENTS:		
Beginning of period	7,261	9,803
End of period	$5,846	$8,325
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for income taxes	$35	$37

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The condensed consolidated financial statements include the accounts of Echelon Corporation, a Delaware corporation, its wholly-owned subsidiaries, and a subsidiary in which it has a controlling interest (collectively referred to as the “Company”). The Company reports non-controlling interests in consolidated entities as a component of equity separate from the Company’s equity. All material inter-company transactions between and among the Company and its consolidated subsidiaries and other consolidated entities have been eliminated in consolidation.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for the fair presentation of the results of operations for the interim periods covered, and of the financial condition of the Company at the date of the interim balance sheet. The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements for the year ended December 31, 2017 included in its Annual Report on Form 10 K.

Apart from the Company's adoption of new revenue recognition guidance discussed more fully below, there have been no material changes to the Company’s significant accounting policies as compared to the significant accounting policies described in its Annual Report on Form 10 K for the fiscal year ended December 31, 2017.

Risks and Uncertainties

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

- The Company’s sales are currently concentrated, as approximately 40.4% of revenues for the three months ended March 31, 2018, were derived from two customers, Avnet Europe Comm VA ("Avnet"), the Company's primary distributor of its IIoT products in Europe and Japan; and Engenuity Systems, Inc., a reseller of the Company's products focused primarily in the United States. Customers in any of the Company’s target market sectors may experience unexpected reductions in demand for their products and consequently reduce their purchases from the Company, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. In addition, if any of these customers are unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to the Company.
- The Company utilizes third-party contract electronic manufacturers to manufacture, assemble, and test its products. If any of these third-parties were unable to obtain the necessary capital to operate their business, they may be unable to provide the Company with timely services or to make timely deliveries of products.
- From time to time, the Company has experienced shortages or interruptions in supply for certain products or components used in the manufacture of the Company’s products that have been or will be discontinued. In order to ensure an adequate supply of these items, the Company has occasionally purchased quantities of these items that are in excess of the Company’s then current estimate of short-term requirements. If the long-term requirements do not materialize as originally expected, or if the Company develops alternative solutions that no longer employ these items and the Company is not able to dispose of these excess products or components, the Company could be subject to increased levels of excess and obsolete inventories.
- In an effort to manage costs and inventory risks, the Company has decreased the inventory levels of certain products. If there is an unexpected increase in demand for these items, the Company might not be able to supply its customers with products in a timely manner.
- Due to the nature of development efforts in general, the Company can experience delays in the introduction of new or improved products beyond its original projected shipping date for such products. These delays can result in increased development costs and delays in the ability to generate revenues from these new products. Furthermore, when such

new products are developed, there is no guarantee that they will meet customer requirements or will otherwise be

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acceptable to them, which could cause them to discontinue buying these products. This could have a material adverse effect on the Company's revenues and results of operations.

Use of Estimates

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

Recently Issued Accounting Standards

(i) New Accounting Standards Recently Adopted

In May 2014, the FASB issued a new standard related to revenue recognition, ASC 606 - Revenue from Contracts with Customers ("ASC 606"). Under the standard, revenue is recognized when a customer obtains control of promised goods or services in an amount that reflects the consideration the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

The Company adopted ASC 606 effective January 1, 2018, using the full retrospective method, which required the Company to restate each prior reporting period presented. The most significant impact of the standard relates to the Company's accounting for sales made to distributors under agreements that contain a limited right to return unsold products and price adjustment provisions. Under previous revenue guidance, the Company historically concluded that the price to these distributors was not fixed or determinable at the time it delivers products to them. Accordingly, revenue from sales to these distributors has not historically been recognized until the distributor resells the product. By contrast, under the new standard, the Company will recognize revenue, including estimates for applicable variable consideration, predominately at the time of shipment to these distributors, thereby accelerating the timing of revenue for products sold through the distribution channel. Revenue recognition related to transactions not involving the Company's distributor partners remains substantially unchanged.

Adoption of the standard using the full retrospective method required the Company to restate certain previously reported results. In summary, adoption of the standard resulted in the recognition of slightly lower revenue for the quarter ended March 31, 2017. In addition, as of December 31, 2017, adoption of the standard resulted in a reduction of deferred revenues driven by the recognition of revenues associated with on-hand distributor inventory as of that date, the revenue for which was deferred under previous guidance; a decrease of deferred cost of goods sold, again driven by the recognition of revenue that was deferred under previous guidance; and a decrease in accounts receivable, driven by the incremental reserves required for estimated price adjustments that will be issued to the distributors in the future based on the additional revenue recognized under the new guidance. Adoption of the standard impacted our previously reported results as follows (in thousands, except earnings per share amounts):

	Three Months Ended March 31, 2017		
	As Reported	New Revenue Standard Adjustment	As Adjusted
Statement of Operations:			

Revenue	$7,799	$ (96)	$ 7,703
Net loss	(1,199)	(62)	(1,261)
Basic and diluted loss per share	$(0.27)	$ (0.01)	$ (0.28)

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	December 31, 2017		
	As Reported	New Revenue Standard Adjustment	As Adjusted
Balance Sheets:			
Accounts receivable, net	$2,721	$ (425)	$ 2,296
Deferred cost of goods sold	1,767	(728)	1,039
Deferred revenues	4,805	(2,993)	1,812
Stockholders' equity	21,887	1,840	23,727

(ii) New Accounting Standards Not Yet Effective

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which requires, among other things, the recognition of lease assets and lease liabilities on the balance sheet by lessees for certain leases classified as operating leases under previous GAAP. ASU 2016-02 is effective for annual and interim periods beginning after December 15, 2018. ASU 2016-02 mandates a modified retrospective transition method with early adoption permitted. The Company is currently evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures.

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 other services offered to its customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Service revenues consist of product technical support and training.

The Company recognizes revenue upon transfer of control of promised products or services to customers in an amount that reflects the consideration the Company expects to receive in exchange for those products or services. The Company enters into contracts that can include various combinations of products and services, which in most instances are capable of being distinct and accounted for as separate performance obligations. In the case of product sales, the Company's performance obligations are generally met and revenue is recognized at the time of shipment of the products to the customer because the customer has significant risks and rewards of ownership of the asset and the Company has a present right to payment at that time. For service revenues, these criteria are generally met at the time the services have been performed for the same reasons. Revenue is recognized net of allowances for returns and any taxes collected from customers, which are subsequently remitted to governmental authorities.

The Company's contracts with customers often include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. For example, in certain instances, the Company's outdoor lighting control customers may contract with the Company to perform certain services when deploying the Company's outdoor lighting control solution. These services require that the Company "commission" the outdoor lighting control system by integrating the hardware (purchased from the Company and installed by the customer) with the Company's Central Management System ("CMS") software. These systems depend on a significant level of integration and interdependency between the hardware and the CMS. Judgment is required to determine whether the commissioning services are considered distinct and accounted for separately, or not distinct and accounted for together with the system hardware and CMS.

The transaction price for a contract is allocated to each distinct performance obligation and recognized as revenue when, or as, each performance obligation is satisfied. For contracts with multiple performance obligations, the Company allocates the transaction price to each performance obligation using the best estimate of the standalone selling price ("SSP") of each distinct good or service in a contract. Judgment is required to determine the SSP for each distinct performance obligation. The primary method used to estimate the SSP is the observable price when the good or service is sold separately in similar circumstances and to similar customers. If the SSP is not directly observable, it is estimated using either a market adjustment or cost plus margin approach.

The Company's products are generally sold without a right of return. However, the Company may provide other credits or incentives, which are accounted for as variable consideration when estimating the amount of revenue to recognize. For example, in many instances, the Company issues Point of Sale ("POS") credits to its distributors when they sell certain of the Company's products to their end use customers. In these cases, the Company is required to estimate (and reserve for) the amount of future POS credits it will issue to the distributors associated with unsold inventory they have on hand at the end of

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the period. The Company also grants its distributor partners a limited ability to return unsold product in the form of stock rotation rights. Judgment is required to determine the amount of variable consideration associated with these POS credits and stock rotation rights, which are estimated at contract inception and updated at the end of each reporting period as additional information becomes available and only to the extent that it is probable that a significant reversal of any incremental revenue will not occur.

In accordance with ASC 606, the Company disaggregates its revenue from contracts with customers into geographical regions as the Company determined that disaggregating revenue into these categories meets the disclosure objective in ASC 606, which is to depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by regional economic factors. Information regarding revenues disaggregated by geographic area can be found in Note 10 - Segment Disclosure. The Company has not provided disaggregation information associated with product and service revenues as the amount of service revenues are immaterial in the periods presented. Similarly, no disaggregation information has been provided for revenues based on the timing of when goods and services are transferred as the amount of revenue associated with products and services recognized over time is also immaterial.

The Company invoices its customers upon shipment in the case of hardware sales, and upon the completion of the required services for service revenues. These invoices are generally issued with net 30 day payment terms. However, in certain instances, the Company may offer payment terms of up to 75 days.

The Company generally sells its hardware products with a one-year warranty against defects or failure. However, in some cases, the Company's hardware products come with a standard five-year warranty. As of March 31, 2018 and December 31, 2017, the Company's warranty reserves totaled $428,000 and $350,000, respectively, and are included in Accrued liabilities and Other long-term liabilities on the unaudited condensed consolidated balance sheets.

The Company's contract assets were immaterial at both March 31, 2018 and December 31, 2017. The Company's contract liabilities consist generally of deferred revenue where the Company has unsatisfied performance obligations, and are classified as such on the unaudited condensed consolidated balance sheets. The following table reflects changes in contract balances for the three months ended March 31, 2018 and 2017 (in thousands):

Three Months Ended	
March 31, 2018	March 31, 2017