ECHELON CORP
Form 10-Q
November 10, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10 Q

(Mark one)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2014
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 incorporation or organization)	(IRS Employer 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 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 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, 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 o No x
As of October 31, 2014, 43,955,848 shares of the registrant's common stock were outstanding.

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FORM 10 Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2014
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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)

	September 30, 2014	December 31, 2013
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$23,482	$14,648
Restricted investments	6,253	—
Short-term investments	20,993	42,987
Accounts receivable, net [1]	3,453	10,522
Inventories	3,783	6,445
Deferred cost of goods sold	901	1,649
Other current assets	1,745	2,040
Current assets of discontinued operations held for sale	619	—
Total current assets	61,229	78,291
Property and equipment, net	10,994	18,670
Intangible assets, net	1,471	—
Goodwill	6,038	8,390
Other long term assets	770	777
Long-term assets of discontinued operations held for sale	36	—
Total assets	$80,538	$106,128
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$3,630	$5,424
Accrued liabilities	8,350	7,395
Current portion of lease financing obligations	2,424	2,257
Deferred revenues	3,216	6,125
Current liabilities of discontinued operations held for sale	1,055	—
Total current liabilities	18,675	21,201
LONG-TERM LIABILITIES:		
Lease financing obligations, excluding current portion	14,085	15,928
Other long-term liabilities	1,732	1,022
Total long-term liabilities	15,817	16,950
STOCKHOLDERS' EQUITY:		
Common stock	472	466
Additional paid-in capital	355,987	354,680
Treasury stock	(28,130)	(28,130)
Accumulated other comprehensive income	79	1,015
Accumulated deficit	(282,616)	(260,843)
Total Echelon Corporation stockholders' equity	45,792	67,188

Noncontrolling interest in discontinued operations of subsidiary held for sale	254	789
Total stockholders' equity	46,046	67,977
Total liabilities and stockholders' equity	$80,538	$106,128

[1] Includes related party receivable of none and $1.6 million as of September 30, 2014 and December 31, 2013, respectively.

See accompanying notes to condensed consolidated financial statements.

ECHELON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenues:				
Product	$9,164	$10,161	$29,035	$33,269
Service	14	16	48	70
Total revenues (2)	9,178	10,177	29,083	33,339
Cost of revenues:				
Cost of product (1)	3,877	3,711	11,586	12,742
Cost of service (1)	303	84	916	345
Total cost of revenues	4,180	3,795	12,502	13,087
Gross profit	4,998	6,382	16,581	20,252
Operating expenses:				
Product development (1)	2,305	2,711	7,224	8,092
Sales and marketing (1)	2,160	2,232	6,600	6,931
General and administrative (1)	3,538	3,925	10,887	11,045
Loss on write down of property, equipment and other	4,409	—	4,409	—
Litigation charges	—	—	—	3,452
Restructuring charges	227	—	227	2,254
Total operating expenses	12,639	8,868	29,347	31,774
Loss from continuing operations	(7,641)	(2,486)	(12,766)	(11,522)
Interest and other (expense) income, net	719	(606)	661	(486)
Interest expense on lease financing obligations	(271)	(305)	(839)	(938)
Loss from continuing operations before provision for income taxes	(7,193)	(3,397)	(12,944)	(12,946)
Income tax expense	33	113	114	256
Net loss from continuing operations attributable to Echelon Corporation Stockholders	(7,226)	(3,510)	(13,058)	(13,202)
Net loss from discontinued operations, net of income taxes	(2,141)	(269)	(9,250)	(975)
Net loss from discontinued operations attributable to non-controlling interest, net of income taxes	$179	$266	$535	$590
Net loss from discontinued operations attributable to Echelon Corporation Stockholders, net of income taxes	$(1,962)	$(3)	$(8,715)	$(385)
Net loss attributable to Echelon Corporation Stockholders	$(9,188)	$(3,513)	$(21,773)	$(13,587)
Basic and diluted net loss per share from continuing operations attributable to Echelon Corporation Stockholders	$(0.17)	$(0.08)	$(0.30)	$(0.31)
	$(0.05)	$0.00	$(0.20)	$(0.01)

Basic and diluted net loss per share from discontinued operations attributable to Echelon Corporation Stockholders				
Basic and diluted net loss per share attributable to Echelon Corporation Stockholders	$(0.21)	$(0.08)	$(0.50)	$(0.32)
Shares used in computing net loss per share:				
Basic	43,507	43,184	43,367	43,039
Diluted	43,507	43,184	43,367	43,039

(1) See Note 6 for summary of amounts included representing stock-based compensation expense.

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(2) Includes related party amounts of $683 and $499 for the three months ended September 30, 2014 and 2013, respectively; and related party amounts of $2,546 and $4,200 for the nine months ended September 30, 2014 and 2013, respectively. See Note 5 and Note 12 for additional information on related party transactions.

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net loss from continuing operations	$(7,226)	$(3,510)	$(13,058)	$(13,202)
Net loss from discontinued operations, net of income taxes	$(2,141)	$(269)	$(9,250)	$(975)
Net loss	$(9,367)	$(3,779)	$(22,308)	$(14,177)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustment	(902)	539	(932)	262
Unrealized holding loss on available-for-sale securities	(1)	9	(4)	9
Total other comprehensive loss	(903)	548	(936)	271
Comprehensive loss	$(10,270)	$(3,231)	$(23,244)	$(13,906)
Less: comprehensive loss from discontinued operations, attributable to non-controlling interests	$179	$266	$535	$590
Comprehensive income (loss) attributable to Echelon Corporation Stockholders	$(10,091)	$(2,965)	$(22,709)	$(13,316)

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

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	Nine Months Ended September 30, 2014	2013
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net loss including noncontrolling interest	$(22,308)	$(14,177)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,640	3,083
Goodwill impairment charges	3,388	—
Increase in allowance for doubtful accounts	22	41
Loss on disposal of Grid business	254	—
Loss on disposal of and write down of property, equipment and other	5,101	24
Reduction of (increase in) accrued investment income	18	(2)
Stock-based compensation	992	2,177
Change in operating assets and liabilities:		
Accounts receivable	2,953	490
Inventories	1,217	3,686
Deferred cost of goods sold	242	(885)
Other current assets	312	565
Accounts payable	(543)	(2,332)
Accrued liabilities	(865)	3,617
Deferred revenues	(751)	1,181
Deferred rent	(29)	(28)
Net cash used in operating activities	(7,357)	(2,560)
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchases of available for sale short term investments	(58,148)	(38,953)
Proceeds from maturities and sales of available for sale short term investments	80,116	38,955
Change in other long term assets	232	(62)
Cash paid for acquisition, net of cash acquired	(1,155)	—
Proceeds from divestiture of Grid business	4,861	—
Capital expenditures	(672)	(811)
Net cash provided by (used in) investing activities	25,234	(871)
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Principal payments of lease financing obligations	(1,676)	(1,530)
Proceeds from exercise of stock options	17	—
Restricted investments used as collateral for line of credit	(6,250)	—
Repurchase of common stock from employees for payment of taxes on vesting of restricted stock units and upon exercise of stock options	(411)	(423)
Net cash used in financing activities	(8,320)	(1,953)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(723)	178
NET CHANGE IN CASH AND CASH EQUIVALENTS	8,834	(5,206)
CASH AND CASH EQUIVALENTS:		
Beginning of period	14,648	18,876

End of period	$23,482	$13,670
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest on lease financing obligations	$830	$930
Cash paid for income taxes	$265	$318
NON CASH INVESTING ACTIVITIES:		
Fair value of stock issued in connection with acquisition	$715	$—

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 (see Note 16 for further details). All material inter-company transactions between and among the Company and its consolidated subsidiaries and other consolidated entities have been eliminated in consolidation.

In the third quarter of 2014, the Company announced and completed the sale of its Grid business to S&T AG, a publicly traded European IT systems provider with an existing focus on smart energy products and services. The results of the Grid business are now classified as discontinued operations. As a result of this transaction, the Company now operates in one reporting segment- the Industrial Internet of Things (IIoT) segment.

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, 2013 included in its Annual Report on Form 10 K.

There have been no material changes to the Company's significant accounting policies as compared to the significant accounting policies described in our Annual Report on Form 10 K for the fiscal year ended December 31, 2013.

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 with a relatively small group of customers, as approximately 34.3% and 36.2% of net revenues for the three and nine months ended September 30, 2014, respectively were derived from two customers. Customers in any of the Company's target market sectors may experience unexpected reductions in demand for their products and consequently reduce their purchases from us, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. In addition, if any of these customers are unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to the Company.
- The Company utilizes third-party contract electronic manufacturers to manufacture, assemble, and test its products. 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.
- Recently, in our effort to manage our costs and inventory risks, we decreased our inventory levels of certain products. If there is an unexpected increase in demand for these items, we might not be able to supply our customers with

products in a timely manner.

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Use of Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions, and estimates that affect amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Significant estimates and judgments are used for revenue recognition, 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

In April 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2014-08 ("ASU 2014-08"), Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. ASU 2014-08 changes the criteria for determining which disposals can be presented as discontinued operations and modifies the related disclosure requirements. Under the new guidance, a disposal of a component of an entity or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has or will have a major effect of an entity's operations and financial results and is disposed of or classified as held for sale. ASU 2014-08 also introduces several new disclosures. The guidance is effective for annual and interim periods beginning after December 15, 2014, with early adoption permitted. The Company does not expect ASU 2014-08 to have a material impact on its consolidated financial statements.

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new standard is effective for the Company on January 1, 2017. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures. The Company has not yet selected a transition method nor has it determined the effect of the standard on its ongoing financial reporting.

Revenue Recognition

The Company's revenues are derived from the sale and license of its products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to its customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Service revenues consist of product technical support (including software post-contract support services), training, and custom software development services.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery to the customer's carrier (and acceptance, as applicable) has occurred, the sales price is fixed or determinable, collectability is probable, and there are no post-delivery obligations. For non-distributor hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of delivery to the customer's carrier. However, for arrangements that contain contractual acceptance provisions, revenue recognition may be delayed until acceptance by the customer or the acceptance provisions lapse unless the Company can objectively demonstrate that the contractual acceptance criteria have been satisfied, which is generally accomplished by establishing a history of acceptance for the same or similar products. For sales made to the Company's distributor partners, revenue recognition criteria are generally met at the time the distributor sells the products through to its end-use customer. Service revenue is recognized as the training services are performed, or ratably over the term of the support period.

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

The Company’s multiple deliverable revenue arrangements are primarily related to sales of its Grid products, which may include, within a single arrangement, electricity meters, data concentrators and related hardware (collectively, the “Hardware”); NES system software; Element Manager software; post-contract customer support (“PCS”) for the NES system and Element Manager software; extended warranties for the Hardware; and, occasionally, specified enhancements or upgrades to software used in the NES system. With the exception of the NES system software, each of these deliverables is considered a separate

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

The Company allocates revenue to each element in a multiple-element arrangement based upon their relative selling price. The Company determines the selling price for each deliverable using vendor specific objective evidence ("VSOE") of selling price or third party evidence ("TPE") of selling price, if it exists. If neither VSOE nor TPE of selling price exists for a deliverable, the Company uses its best estimated selling price ("BESP") for that deliverable. Since the use of the residual method is eliminated under the new accounting standards, any discounts offered by the Company are allocated to each of the deliverables. Revenue allocated to each element is then recognized when the basic revenue recognition criteria is met for the respective element.

Consistent with its methodology under previous accounting guidance, if available, the Company determines VSOE of fair value for each element based on historical stand-alone sales to third parties or from the stated renewal rate for the elements contained in the initial contractual arrangement. The Company currently estimates selling prices for its PCS and extended warranties based on VSOE of fair value.

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

When the Company is unable to establish a selling price using VSOE or TPE, which is generally the case for the Hardware and certain specified enhancements or upgrades to the Company's NES software, the Company uses its BESP in determining the allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. BESP is generally used for offerings that are not typically sold on a stand-alone basis or for new or highly customized offerings.

The Company establishes pricing for its products and services by considering multiple factors including, but not limited to, geographies, market conditions, competitive landscape, internal costs, gross margin objectives, and industry pricing practices. The determination of pricing also includes consultation with and formal approval by the Company's management, taking into consideration the Company's go-to-market strategy. These pricing practices apply to both the Company's Hardware and software products.

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

When establishing BESP for the Company's specified software enhancements or upgrades, the Company considers multiple factors including, but not limited to, the relative value of the features and functionality being delivered by the enhancement or upgrade as compared to the value of the software product to which the enhancement or upgrade relates, as well as the Company's pricing practices for NES system software PCS packages, which may include rights to the specified enhancements or upgrades.

The Company regularly reviews VSOE and has established a review process for TPE and BESP. The Company maintains internal controls over the establishment and updates of these estimates. There were no material impacts during the three and nine months ended September 30, 2014, resulting from changes in VSOE, TPE, or BESP, nor does the Company expect a material impact from such changes in the near term.

Deferred Revenue and Deferred Cost of Goods Sold

Deferred revenue consists substantially of amounts billed or payments received in advance of revenue recognition. Deferred cost of goods sold related to deferred product revenues includes direct product costs and applied overhead. Deferred

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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.

Restricted Investments

As of September 30, 2014, restricted investments consist of balances maintained by the Company with an investment advisor in money market funds and permitted treasury bills. These balances represent collateral for a $5.0 million line of credit issued to the Company by its primary bank. As of September 30, 2014, the Company’s primary bank has issued, against the line of credit, one standby letter of credit totaling $113,000. As of September 30, 2014, no amounts had been drawn against the line of credit or the letter of credit.

Because the Company’s agreement with the lender prevents the Company from withdrawing these funds, they are considered restricted.

Fair Value Measurements

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

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

This hierarchy requires the Company to minimize the use of unobservable inputs and to use observable market data, if available, when estimating fair value. Other than cash and money market funds, the Company's only financial assets or liabilities required to be measured at fair value on a recurring basis at September 30, 2014, are fixed income available-for-sale securities. See Note 2 of these Notes to Condensed Consolidated Financial Statements for a summary of the input levels used in determining the fair value of the Company's cash equivalents and short-term investments as of September 30, 2014.

Goodwill

Effective in the fourth quarter of 2013, the Company changed the way it managed the business and re-organized to focus the business on two operating segments - Grid and IIoT. As a result, the Company, with the assistance of an external service provider, reallocated goodwill of the Company to the Grid and IIoT operating segments using a relative fair value approach. Each operating segment's fair value was determined based on comparative market values and discounted cash flows. Goodwill is tested for impairment using a two-step approach. The Company evaluates goodwill, at a minimum, on an annual basis during the first quarter and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The fair values of the reporting units are estimated using a combination of the income approach and the market approach. 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. There was no indication of impairment when goodwill was reallocated to the new operating segments, as the respective fair values of each substantially exceed their carrying values (including goodwill) as of December 31, 2013.

For the quarter ended June 30, 2104, the Company concluded there were indicators of potential goodwill impairment for the Company’s Grid business, including continued weakness and increased uncertainty in the Grid market; changes in the extent and manner of use of the unit's long-lived assets; and changes in our long-term strategy for the Grid business. As a result of identifying indicators of impairment, the Company performed an impairment test of goodwill as of June 30, 2014.

In performing Step 1 of the impairment test, the Company estimated the fair value of the reporting unit using the income approach. The income approach is based on a discounted cash flow analysis and calculates the fair value of the reporting unit by estimating the after-tax cash flows attributable to the reporting unit and then discounting the after-tax cash flows to a present value, using a weighted average cost of capital (“WACC”). The cash flows used in the income approach were based on two scenarios, cash flows associated with a winding down of the business and cash flows associated with a sale of the business. Management's assumptions included forecasted revenues and operating income for the wind down scenario and estimated proceeds from the sale of the business based on known third-party interest. We calculated the fair value for the Grid business by using a probability weighted average of the estimated fair value from both scenarios, with significantly higher

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weight placed on the wind down scenario. Note that in the third quarter of 2014, the Company was able to locate a buyer for the business and agree upon terms of sale within a short period of time, that led to the ultimate disposition of the business at September 30, 2014.

Based on the above analysis, it was determined that the carrying value of the Grid business, including goodwill, exceeded the fair value of the reporting unit, requiring the Company to perform Step 2 of the goodwill impairment test to measure the amount of impairment loss, if any. In performing Step 2 of the goodwill impairment test, the Company compared the implied fair value of the reporting unit's goodwill to its carrying value of goodwill. This test resulted in a non-cash, goodwill impairment charge of $3.4 million, which was recognized during the three months ended June 30, 2014. This impairment has been reported as part of the discontinued operations results for the nine months ended September 30, 2014. As a result, the Company has no goodwill remaining related to the Grid business.

As of September 30, 2014, the entire goodwill balance is attributable to the IIoT reporting unit. Further, the addition to goodwill of $1.3 million during the quarter was due to the acquisition of Lumewave, Inc (see note 4 for details). There have been no goodwill impairment losses related to the IIoT reporting unit.

The fair value estimates used in the goodwill impairment analysis required significant judgment. The Company's fair value estimates for purposes of determining the goodwill impairment charge are considered Level 3 fair value measurements. We based our fair value estimates on assumptions that we believe to be reasonable but that are inherently uncertain, including estimates of future revenues and operating margins, potential proceeds from a third-party, weighted average cost of capital, probability weighting of exit scenarios and assumptions about the overall economic climate and the competitive environment for our business. Our estimates assume that revenues will decline into the foreseeable future. There can be no assurance that our estimates and assumptions will prove to be accurate predictions of the future. If our assumptions regarding business plans, competitive environments or anticipated operating results are not correct, we may be required to record additional goodwill impairment charges in future periods.

Long-Lived Assets

We evaluate the recoverability of property, plant and equipment in accordance with ASC No. 360, Accounting for the Property, Plant, and Equipment ("ASC No. 360"). We perform periodic reviews to determine whether facts and circumstances exist that would indicate that the carrying amounts of property, plant and equipment might not be fully recoverable. If facts and circumstances indicate that the carrying amount of property, plant and equipment might not be fully recoverable, we compare projected undiscounted net cash flows associated with the related asset or group of assets over their estimated remaining useful lives against their respective carrying amounts. In the event that the projected undiscounted cash flows are not sufficient to recover the carrying value of the assets, the assets are written down to their estimated fair values based on the expected discounted future cash flows attributable to the assets. Evaluation of impairment of property, plant and equipment requires estimates in the forecast of future operating results that are used in the preparation of the expected future undiscounted cash flows. Actual future operating results and the remaining economic lives of our property, plant and equipment could differ from our estimates used in assessing the recoverability of these assets. These differences could result in impairment charges, which could have a material adverse impact on our results of operations.

As of June 30, 2014, in light of the facts mentioned in the Goodwill section above, prior to assessing the goodwill for impairment, the Company evaluated whether the long-lived assets of the Grid business were impaired. As the Company had not yet made a final decision between the two likely scenarios for the Grid business as of June 30, 2014, the Company assessed the realizability of long-lived assets using cash flows associated with two scenarios for this reporting unit (i.e. sale or wind down of the Grid business). The Company applied a probability weighting of the two scenarios, placing significantly more weight on the cash flows associated with a wind down versus the cash flows from the potential sale of the Grid business. The wind down scenario also included an assessment of the residual value of the Grid business' long-lived assets. The results of this analysis showed that the carrying value of the Grid business' long-lived assets exceeded their fair value and accordingly the Company recorded a write down of property, equipment and other assets of $687,000 during the quarter ended June 30, 2014. The remaining book value of the long-lived assets will be depreciated over the revised shorter estimated useful lives. This impairment charge has been reported as part of the discontinued operations for the nine months ended September 30, 2014. In the third quarter of 2014, the Company was able to locate a buyer for the business and agree upon terms of sale within a short period of time, that led to the ultimate disposition of the business at September 30, 2014 and required the Company to record a loss of $254,000 on the sale of this business.

As a result of the sale of the Grid business on September 30, 2014, the Company made the decision to cease use of one building within its corporate headquarters and recharacterize the building as a rental property. Consequently, management

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performed an impairment analysis on this building and determined that its carrying value was not recoverable. In performing this analysis, management analyzed the expected cash flows from different sub-lease scenarios using recent lease data for similar facilities in the area including market activity, expected tenant improvements and commissions and period of time between recharacterization and lease up. As a result of this analysis,the Company recorded a write down of the building of $4.4 million during the three months ended September 30, 2014.

2. Financial Instruments:

The Company's financial instruments consist of cash equivalents, restricted investments, short-term investments, accounts receivable, accounts payable, and lease financing obligations. The carrying value of the Company's financial instruments approximates fair value. Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of investments, which are classified as either cash equivalents, restricted investments, or short-term investments, and accounts receivable. With respect to its investments, the Company has an investment policy that limits the amount of credit exposure to any one financial institution and restricts placement of the Company's investments to financial institutions independently evaluated as highly creditworthy. With respect to its accounts receivable, the Company performs ongoing credit evaluations of each of its customers' financial condition. For a customer whose credit worthiness does not meet the Company's minimum criteria, the Company may require partial or full payment prior to shipment. Alternatively, prior to shipment, customers may be required to provide the Company with an irrevocable letter of credit or arrange for some other form of coverage to mitigate the risk of uncollectibility, such as a bank guarantee. Additionally, the Company establishes an allowance for doubtful accounts and sales return allowances based upon factors surrounding the credit risk of specific customers, historical trends, and other available information.

Items Measured at Fair Value on a Recurring Basis

On a recurring basis, the Company measures certain of its financial assets, namely its cash equivalents and available-for-sale investments, at fair value. The Company does not have any financial liabilities measured at fair value on a recurring basis. The fair value of the Company's financial assets measured at fair value on a recurring basis was determined using the following inputs at September 30, 2014 (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds [1]	$12,008	$12,008	$—	