

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

Form 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2019
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period _____ to _____

Commission file number: 001-33660

CLEARONE, INC.

(Exact name of registrant as specified in its charter)

| | |
|---|--|
| <u>Delaware</u> (State or other jurisdiction of incorporation or organization) | <u>87-0398877</u> (I.R.S. employer identification number) |
| <u>5225 Wiley Post Way, Suite 500, Salt Lake City, Utah</u> (Address of principal executive offices) | <u>84116</u> (Zip Code) |

Registrant's telephone number, including area code: (801) 975-7200

Indicate by check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a 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. (Check one):

Larger Accelerated Filer Accelerated Filer
Non-Accelerated Filer Smaller Reporting Company
Emerging Growth Company

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

| <u>Title of each class</u> | <u>Trading Symbol(s)</u> | <u>Name of each exchange on which registered</u> |
|----------------------------|--------------------------|--|
| Common Stock, \$0.001 | CLRO | The NASDAQ Capital Market |

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.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of ClearOne common stock outstanding as of August 14, 2019 was 16,646,323.

CLEARONE, INC.
QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2019

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PART I - FINANCIAL INFORMATION**Item 1. FINANCIAL STATEMENTS**

CLEARONE, INC
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except par value)

| | <u>June 30, 2019</u> | <u>December 31, 2018</u> |
|--|----------------------|--------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 2,352 | \$ 11,211 |
| Marketable securities | 3,092 | 951 |
| Receivables, net of allowance for doubtful accounts of \$671 and \$631, respectively | 6,491 | 6,782 |
| Inventories, net | 12,258 | 13,228 |
| Prepaid expenses and other assets | 1,202 | 2,193 |
| Total current assets | 25,395 | 34,365 |
| Long-term marketable securities | 6,854 | 3,764 |
| Long-term inventories, net | 7,715 | 8,953 |
| Property and equipment, net | 1,196 | 1,388 |
| Operating lease - right of use assets, net | 2,684 | — |
| Intangibles, net | 11,871 | 10,249 |
| Other assets | 192 | 196 |
| Total assets | <u>\$ 55,907</u> | <u>\$ 58,915</u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,979 | \$ 3,729 |
| Accrued liabilities | 2,813 | 1,996 |
| Deferred product revenue | 239 | 283 |
| Total current liabilities | 5,031 | 6,008 |
| Deferred rent | — | 135 |
| Operating lease liability | 2,269 | — |
| Other long-term liabilities | 571 | 571 |
| Total liabilities | 7,871 | 6,714 |
| Shareholders' equity: | | |
| Common stock, par value \$0.001, 50,000,000 shares authorized, 16,646,323 and 16,630,597 shares issued and outstanding | 17 | 17 |
| Additional paid-in capital | 57,985 | 57,840 |
| Accumulated other comprehensive loss | (44) | (181) |
| Accumulated deficit | (9,922) | (5,475) |
| Total shareholders' equity | 48,036 | 52,201 |
| Total liabilities and shareholders' equity | <u>\$ 55,907</u> | <u>\$ 58,915</u> |

See accompanying notes

CLEARONE, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND
COMPREHENSIVE LOSS

(Dollars in thousands, except per share amounts)

| | <u>Three months ended June 30,</u> | | <u>Six months ended June 30,</u> | |
|---|------------------------------------|-------------------|----------------------------------|-------------------|
| | <u>2019</u> | <u>2018</u> | <u>2019</u> | <u>2018</u> |
| Revenue | \$ 6,420 | \$ 6,971 | \$ 12,725 | \$ 14,260 |
| Cost of goods sold | 3,481 | 3,721 | 7,082 | 6,911 |
| Gross profit | <u>2,939</u> | <u>3,250</u> | <u>5,643</u> | <u>7,349</u> |
| Operating expenses: | | | | |
| Sales and marketing | 2,261 | 2,760 | 4,214 | 5,628 |
| Research and product development | 1,307 | 1,920 | 2,894 | 3,976 |
| General and administrative | 1,475 | 1,542 | 3,030 | 3,159 |
| Total operating expenses | <u>5,043</u> | <u>6,222</u> | <u>10,138</u> | <u>12,763</u> |
| Operating loss | (2,104) | (2,972) | (4,495) | (5,414) |
| Other income, net | 51 | 49 | 93 | 73 |
| Loss before income taxes | (2,053) | (2,923) | (4,402) | (5,341) |
| Provision for (benefit from) income taxes | 45 | (760) | 45 | (1,332) |
| Net loss | <u>\$ (2,098)</u> | <u>\$ (2,163)</u> | <u>\$ (4,447)</u> | <u>\$ (4,009)</u> |
| Basic weighted average shares outstanding | 16,630,770 | 8,301,094 | 16,630,684 | 8,304,093 |
| Diluted weighted average shares outstanding | 16,630,770 | 8,301,094 | 16,630,684 | 8,304,093 |
| Basic loss per share | \$ (0.13) | \$ (0.26) | \$ (0.27) | \$ (0.48) |
| Diluted loss per share | \$ (0.13) | \$ (0.26) | \$ (0.27) | \$ (0.48) |
| Comprehensive income: | | | | |
| Net loss | \$ (2,098) | \$ (2,163) | \$ (4,447) | \$ (4,009) |
| Unrealized gain (loss) on available-for-sale securities, net of tax | 84 | (1) | 154 | (71) |
| Change in foreign currency translation adjustment | 9 | (60) | (17) | (38) |
| Comprehensive loss | <u>\$ (2,005)</u> | <u>\$ (2,224)</u> | <u>\$ (4,310)</u> | <u>\$ (4,118)</u> |

See accompanying notes

CLEARONE, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands, except per share amounts)

| | Six months ended June 30, | |
|---|----------------------------------|-----------------|
| | 2019 | 2018 |
| Cash flows from operating activities: | | |
| Net loss | \$ (4,447) | \$ (4,009) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization expense | 964 | 769 |
| Amortization of right-of-use assets | 282 | — |
| Amortization of deferred rent | — | 1 |
| Stock-based compensation expense | 129 | 266 |
| Provision for doubtful accounts, net | 40 | 59 |
| Change of inventory to net realizable value | 368 | 425 |
| Deferred income taxes | — | (927) |
| Changes in operating assets and liabilities: | | |
| Receivables | 251 | 2,585 |
| Inventories | 1,840 | (33) |
| Prepaid expenses and other assets | 584 | 54 |
| Accounts payable | (1,750) | (595) |
| Accrued liabilities | 255 | 38 |
| Income taxes payable | 411 | (540) |
| Deferred product revenue | (44) | (37) |
| Operating lease liabilities | (281) | — |
| Other long-term liabilities | — | 79 |
| Net cash used in operating activities | <u>(1,398)</u> | <u>(1,865)</u> |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | (72) | (130) |
| Purchase of intangibles | (24) | (98) |
| Capitalized patent defense costs | (2,298) | (2,383) |
| Proceeds from maturities and sales of marketable securities | 2,011 | 5,128 |
| Purchases of marketable securities | (7,088) | (1,403) |
| Net cash provided by (used in) investing activities | <u>(7,471)</u> | <u>1,114</u> |
| Cash flows from financing activities: | | |
| Net proceeds from equity-based compensation programs | 16 | 20 |
| Dividend payments | — | (583) |
| Repurchase and cancellation of stock | — | (147) |
| Net cash provided by (used in) financing activities | <u>16</u> | <u>(710)</u> |
| Effect of exchange rate changes on cash and cash equivalents | <u>(6)</u> | <u>(31)</u> |
| Net decrease in cash and cash equivalents | (8,859) | (1,492) |
| Cash and cash equivalents at the beginning of the period | 11,211 | 5,571 |
| Cash and cash equivalents at the end of the period | <u>\$ 2,352</u> | <u>\$ 4,079</u> |

See accompanying notes

CLEARONE, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands, except per share amounts)

The following is a summary of supplemental cash flow activities:

| | <u>Six months ended June 30,</u> | |
|----------------------------|----------------------------------|-------------|
| | <u>2019</u> | <u>2018</u> |
| Cash paid for income taxes | \$ — | \$ 11 |

See accompanying notes

CLEARONE, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited - Dollars in thousands, except per share amounts)

1. Business Description, Basis of Presentation and Significant Accounting Policies

Business Description:

ClearOne, Inc., together with its subsidiaries (collectively, “ClearOne” or the “Company”), is a global market leader enabling conferencing, collaboration, and AV streaming solutions for voice and visual communications. The performance and simplicity of our advanced, comprehensive solutions offer unprecedented levels of functionality, reliability and scalability.

Basis of Presentation:

The fiscal year for ClearOne is the twelve months ending on December 31. The consolidated financial statements include the accounts of ClearOne and its subsidiaries. All significant inter-company accounts and transactions have been eliminated.

These accompanying interim unaudited condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) and are not audited. Certain information and footnote disclosures that are usually included in financial statements prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) have been either condensed or omitted in accordance with SEC rules and regulations. The accompanying condensed consolidated financial statements contain all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of our financial position as of June 30, 2019 and December 31, 2018, the results of operations for the three and six months ended June 30, 2019 and 2018, and the cash flows for the six months ended June 30, 2019 and 2018. The results of operations for the three and six months ended June 30, 2019 and 2018 are not necessarily indicative of the results for a full-year period. These interim unaudited condensed consolidated financial statements should be read in conjunction with the financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2018 filed with the SEC.

Significant Accounting Policies:

The significant accounting policies were described in Note 1 to the audited consolidated financial statements included in the Company’s annual report on Form 10-K for the year ended December 31, 2018. There have been no changes to these policies during the six months ended June 30, 2019 that are of significance or potential significance to the Company except for the change in accounting for leases as described below.

Recent accounting standard related to Leases: In February 2016, the FASB issued ASU 2016-02, Leases (“ASU 2016-02”). This new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. In July 2018, the FASB issued ASU No. 2018-11 which provides an alternative transition method that allows entities to apply the new leases standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The Company has adopted the requirements of ASU 2016-02 on January 1, 2019, the first day of fiscal year 2019, using the optional transition method. The Company elected to use certain practical expedient options, which allows an entity not to reassess whether any existing or expired contracts contain leases. There was an increase in assets of \$2,966 and liabilities of \$3,101 due to the recognition of the required right-of-use asset and corresponding liability for all lease obligations that are currently classified as operating leases with the difference of \$135 related to existing deferred rent that reduced the ROU asset recorded. The standard did not have a material impact on our condensed consolidated statements of operations and comprehensive loss.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited - Dollars in thousands, except per share amounts)

Accounting Policy related to Leases: We determine if an arrangement is a lease at inception. Operating leases are included in operating lease - right of use ("ROU") assets, accrued liabilities, and operating lease liability in our consolidated balance sheets. As of adoption of ASC 842 and as of June 30, 2019 and December 31, 2018, the Company was not party to finance lease arrangements.

ROU assets represent our right to use an underlying asset for the lease term and operating lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and operating lease liabilities are recognized at the commencement date based on the present value of lease payments over the lease term. As most of our leases do not provide an implicit rate, we use our incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. We use the implicit rate when readily determinable. The operating lease ROU asset also includes any lease payments made and excludes lease incentives. Our lease terms may include options to extend or terminate the lease when it is reasonably certain that we will exercise that option. Lease expense is recognized on a straight-line basis over the lease term.

Under the available practical expedient, we account for the lease and non-lease components as a single lease component.

Other recent accounting pronouncements: The Company has determined that other recently issued accounting standards will either have no material impact on its consolidated financial position, results of operations or cash flows, or will not apply to its operations.

2. Revenue Information

The following table disaggregates the Company's revenue into primary product groups:

| | Three months ended June 30, | | Six months ended June 30, | |
|--------------------|-----------------------------|----------|---------------------------|-----------|
| | 2019 | 2018 | 2019 | 2018 |
| Audio Conferencing | \$ 2,889 | \$ 3,593 | \$ 5,600 | \$ 7,252 |
| Microphones | 2,230 | 2,255 | 4,336 | 4,565 |
| Video products | 1,301 | 1,123 | 2,789 | 2,443 |
| | \$ 6,420 | \$ 6,971 | \$ 12,725 | \$ 14,260 |

The following table disaggregates the Company's revenue into major regions:

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|----------|---------------------------|-----------|
| | 2019 | 2018 | 2019 | 2018 |
| North and South America | \$ 3,493 | \$ 4,111 | \$ 7,253 | \$ 8,456 |
| Asia (including Middle East) and Australia | 1,969 | 1,861 | 3,833 | 3,899 |
| Europe and Africa | 958 | 999 | 1,639 | 1,905 |
| | \$ 6,420 | \$ 6,971 | \$ 12,725 | \$ 14,260 |

3. Earnings (Loss) Per Share

Earnings (loss) per common share is computed based on the weighted-average number of common shares outstanding and, when appropriate, dilutive potential common stock outstanding during the period. Stock options are considered to be potential common stock. The computation of diluted earnings (loss) per share does not assume exercise or conversion of securities that would have an anti-dilutive effect.

Basic earnings (loss) per common share is the amount of net earnings (loss) for the period available to each weighted-average share of common stock outstanding during the reporting period. Diluted earnings (loss) per common share is the amount of earnings (loss) for the period available to each weighted-average share of common stock outstanding during the reporting period and to each share of potential common stock outstanding during the period, unless inclusion of potential common stock would have an anti-dilutive effect.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited - Dollars in thousands, except per share amounts)

The following table sets forth the computation of basic and diluted earnings (loss) per common share:

| | Three months ended June 30, | | Six months ended June 30, | |
|---|------------------------------------|------------------|----------------------------------|------------------|
| | 2019 | 2018 | 2019 | 2018 |
| Numerator: | | | | |
| Net loss | \$ (2,098) | \$ (2,163) | \$ (4,447) | \$ (4,009) |
| Denominator: | | | | |
| Basic weighted average shares outstanding | 16,630,770 | 8,301,094 | 16,630,684 | 8,304,093 |
| Dilutive common stock equivalents using treasury stock method | — | — | — | — |
| Diluted weighted average shares outstanding | <u>16,630,770</u> | <u>8,301,094</u> | <u>16,630,684</u> | <u>8,304,093</u> |
| Basic loss per common share | \$ (0.13) | \$ (0.26) | \$ (0.27) | \$ (0.48) |
| Diluted loss per common share | \$ (0.13) | \$ (0.26) | \$ (0.27) | \$ (0.48) |
| Weighted average options outstanding | 569,997 | 724,373 | 578,543 | 736,160 |
| Anti-dilutive options not included in the computations | 569,997 | 724,373 | 578,543 | 736,160 |

4. Marketable Securities

The Company has classified its marketable securities as available-for-sale securities. These securities are carried at estimated fair value with unrealized holding gains and losses included in accumulated other comprehensive income (loss) in stockholders' equity until realized. Gains and losses on marketable security transactions are reported on the specific-identification method. Dividend and interest income are recognized when earned.

The amortized cost, gross unrealized holding gains, gross unrealized holding losses, and fair value for available-for-sale securities by major security type and class of securities at June 30, 2019 and December 31, 2018 were as follows:

| | Amortized cost | Gross unrealized holding gains | Gross unrealized holding losses | Estimated fair value |
|-------------------------------------|---------------------------|---|--|---------------------------------|
| June 30, 2019 | | | | |
| Available-for-sale securities: | | | | |
| Corporate bonds and notes | \$ 5,756 | \$ 96 | \$ (7) | \$ 5,845 |
| Municipal bonds | 4,082 | 20 | (1) | 4,101 |
| Total available-for-sale securities | <u>\$ 9,838</u> | <u>\$ 116</u> | <u>\$ (8)</u> | <u>\$ 9,946</u> |
| December 31, 2018 | | | | |
| Available-for-sale securities: | | | | |
| Corporate bonds and notes | \$ 2,911 | \$ 1 | \$ (31) | \$ 2,881 |
| Municipal bonds | 1,849 | — | (15) | 1,834 |
| Total available-for-sale securities | <u>\$ 4,760</u> | <u>\$ 1</u> | <u>\$ (46)</u> | <u>\$ 4,715</u> |

Maturities of marketable securities classified as available-for-sale securities were as follows at June 30, 2019:

| | Amortized cost | Estimated fair value |
|---------------------------------------|---------------------------|---------------------------------|
| Due within one year | \$ 3,081 | \$ 3,092 |
| Due after one year through five years | 6,757 | 6,854 |
| Due after five years | — | — |
| Total available-for-sale securities | <u>\$ 9,838</u> | <u>\$ 9,946</u> |

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited - Dollars in thousands, except per share amounts)

Debt securities in an unrealized loss position as of June 30, 2019 were not deemed impaired at acquisition and subsequent declines in fair value are not deemed attributed to declines in credit quality. Management believes that it is more likely than not that the securities will receive a full recovery of par value, although there can be no assurance that such recovery will occur. The available-for-sale marketable securities with continuous gross unrealized loss position for less than 12 months and 12 months or greater and their related fair values were as follows:

| | <u>Less than 12 months</u> | | <u>More than 12 months</u> | | <u>Total</u> | |
|----------------------------|-----------------------------|--|-----------------------------|--|-----------------------------|--|
| | <u>Estimated fair value</u> | <u>Gross unrealized holding losses</u> | <u>Estimated fair value</u> | <u>Gross unrealized holding losses</u> | <u>Estimated fair value</u> | <u>Gross unrealized holding losses</u> |
| As of June 30, 2019 | | | | | | |
| Corporate bonds and notes | \$ 293 | \$ (5) | \$ 562 | \$ (2) | \$ 855 | \$ (7) |
| Municipal bonds | — | — | 690 | (1) | 690 | (1) |
| Total | <u>\$ 293</u> | <u>\$ (5)</u> | <u>\$ 1,252</u> | <u>\$ (8)</u> | <u>\$ 1,545</u> | <u>\$ (8)</u> |

5. Intangible Assets

Intangible assets as of June 30, 2019 and December 31, 2018 consisted of the following:

| | <u>Estimated useful lives (years)</u> | <u>June 30, 2019</u> | <u>December 31, 2018</u> |
|------------------------------------|---------------------------------------|----------------------|--------------------------|
| Tradename | 5 to 7 | \$ 555 | \$ 555 |
| Patents and technological know-how | 10 | 15,653 | 13,377 |
| Proprietary software | 3 to 15 | 2,981 | 2,981 |
| Other | 3 to 5 | 323 | 323 |
| Total intangible assets | | 19,512 | 17,236 |
| Accumulated amortization | | (7,641) | (6,987) |
| Total intangible assets, net | | <u>\$ 11,871</u> | <u>\$ 10,249</u> |

The amortization of intangible assets for the three and six months ended June 30, 2019 and 2018 was as follows:

| | <u>Three months ended June 30,</u> | | <u>Six months ended June 30,</u> | |
|-----------------------------------|------------------------------------|-------------|----------------------------------|-------------|
| | <u>2019</u> | <u>2018</u> | <u>2019</u> | <u>2018</u> |
| Amortization of intangible assets | \$ (336) | \$ (265) | \$ (700) | \$ (513) |

The estimated future amortization expense of intangible assets is as follows:

| <u>Years ending December 31,</u> | <u>Amount</u> |
|----------------------------------|---------------|
| 2019 (Remainder) | \$ 656 |
| 2020 | 1,175 |
| 2021 | 1,175 |
| 2022 | 1,175 |
| 2023 | 1,168 |
| Thereafter | 6,522 |
| Total | <u>11,871</u> |

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited - Dollars in thousands, except per share amounts)

6. Inventories

Inventories, net of reserves, as of June 30, 2019 and December 31, 2018 consisted of the following:

| | <u>June 30, 2019</u> | <u>December 31, 2018</u> |
|-------------------|----------------------|--------------------------|
| Current: | | |
| Raw materials | \$ 482 | \$ 1,795 |
| Finished goods | 11,776 | 11,433 |
| | <u>\$ 12,258</u> | <u>\$ 13,228</u> |
| Long-term: | | |
| Raw materials | \$ 2,039 | \$ 2,165 |
| Finished goods | 5,676 | 6,788 |
| | <u>\$ 7,715</u> | <u>\$ 8,953</u> |

Long-term inventory represents inventory held in excess of our current (next 12 months) requirements based on our recent sales and forecasted level of sales. We expect to sell the above inventory, net of reserves, at or above the stated cost and believe that no loss will be incurred on its sale, although there can be no assurance of the timing or amount of any sales.

Net loss incurred on valuation of inventory at lower of cost or market value and write-off of obsolete inventory for the three and six months ended June 30, 2019 and 2018 was as follows:

| | <u>Three months ended June 30,</u> | | <u>Six months ended June 30,</u> | |
|--|------------------------------------|-------------|----------------------------------|-------------|
| | <u>2019</u> | <u>2018</u> | <u>2019</u> | <u>2018</u> |
| Net loss incurred on valuation of inventory at lower of cost or market value and write-off of obsolete inventory | \$ (183) | \$ (170) | \$ (368) | \$ (425) |

7. Leases and Deferred Rent

Rent expense is recognized on a straight-line basis over the period of the lease taking into account future rent escalation and holiday periods.

Rent expense for the three and six months ended June 30, 2019 and 2018 was as follows:

| | <u>Three months ended June 30,</u> | | <u>Six months ended June 30,</u> | |
|--------------|------------------------------------|-------------|----------------------------------|-------------|
| | <u>2019</u> | <u>2018</u> | <u>2019</u> | <u>2018</u> |
| Rent expense | \$ (192) | \$ (227) | \$ (363) | \$ (473) |

We occupy a 5,000 square-foot facility in Gainesville, Florida under the terms of an operating lease that expires in February 2021 with the possibility of renewing the lease for 10 more years. The Gainesville facility is used primarily to support our research and development activities.

We currently occupy a 21,443 square-foot facility in Salt Lake City, Utah under the terms of an operating lease expiring in March 2024, with an option to extend for additional five years. The facility supports our principal administrative, sales, marketing, customer support, and research and product development activities.

We occupy a 10,700 square-foot warehouse in Shenzhen, China under the terms of an operating lease expiring in September 2019, which serves as manufacturing support center for Asia.

We occupy a 7,070 square-foot facility in Austin, Texas - under the terms of an operating lease expiring in October 2019. This facility supports our sales, marketing, customer support, and research and development activities.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited - Dollars in thousands, except per share amounts)

We occupy a 3,068 square-foot facility in Zaragoza, Spain under the terms of an operating lease expiring in March 2020. This office supports our research and development and customer support activities

We occupy a 6,175 square-foot facility in Chennai, India - under the terms of an operating lease expiring in August 2021. This facility supports our administrative, marketing, customer support, and research and product development activities.

We occupy a 40,000 square-foot warehouse in Salt Lake City, Utah under the terms of an operating lease expiring in April 2025, which serves as our primary inventory fulfillment and repair center.

Supplemental cash flow information related to leases was as follows:

| | Six months ended June 30, 2019 |
|---|---|
| Cash paid for amounts included in the measurement of lease liabilities: | |
| Operating cash flows from operating leases | \$ 356 |
| Right-of-use assets obtained in exchange for lease obligations: | |
| Operating leases | \$ — |

Supplemental balance sheet information related to leases was as follows:

| | June 30, 2019 |
|---|----------------------|
| Operating lease right-of-use assets | \$ 2,684 |
| Current portion of operating lease liabilities, included in accrued liabilities | \$ 551 |
| Operating lease liabilities, net of current portion | 2,269 |
| Total operating lease liabilities | <u>2,820</u> |
| Weighted average remaining lease term for operating leases (in years) | 4.9 |
| Weighted average discount rate for operating leases | 6.1% |

The following represents maturities of operating lease liabilities as of June 30, 2019:

| Years ending December 31, | |
|----------------------------------|-----------------|
| 2019 (Remainder) | \$ 356 |
| 2020 | 700 |
| 2021 | 646 |
| 2022 | 595 |
| 2023 | 606 |
| Thereafter | <u>375</u> |
| Total lease payments | 3,278 |
| Less: Imputed interest | <u>(458)</u> |
| Total | <u>\$ 2,820</u> |

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited - Dollars in thousands, except per share amounts)

8. Shareholders' Equity

| | Three months ended June 30, | | Six months ended June 30, | |
|--|------------------------------------|------------------|----------------------------------|------------------|
| | 2019 | 2018 | 2019 | 2018 |
| Common stock and additional paid-in capital | | | | |
| Balance, beginning of period | \$ 57,940 | \$ 47,620 | \$ 57,857 | \$ 47,472 |
| Share-based compensation expense | 55 | 129 | 129 | 266 |
| Proceeds from employee stock purchase plan | 7 | 9 | 16 | 20 |
| Balance, end of period | <u>\$ 58,002</u> | <u>\$ 47,758</u> | <u>58,002</u> | <u>47,758</u> |
| Accumulated other comprehensive loss | | | | |
| Balance, beginning of period | \$ (137) | \$ (113) | \$ (181) | \$ (65) |
| Unrealized gain (loss) on available-for-sale securities, net of tax | 84 | (1) | 154 | (71) |
| Foreign currency translation adjustment | 9 | (60) | (17) | (38) |
| Balance, end of period | <u>\$ (44)</u> | <u>\$ (174)</u> | <u>\$ (44)</u> | <u>\$ (174)</u> |
| Retained earnings (accumulated deficit) | | | | |
| Balance, beginning of period | \$ (7,824) | \$ 9,367 | \$ (5,475) | \$ 9,160 |
| Stock repurchased | — | — | — | (147) |
| Cash dividends, \$0.07 per share | — | — | — | (583) |
| Impact on retained earnings for change in revenue recognition policy | — | — | — | 2,782 |
| Net loss | (2,098) | (2,164) | (4,447) | (4,009) |
| Balance, end of period | <u>\$ (9,922)</u> | <u>\$ 7,203</u> | <u>\$ (9,922)</u> | <u>\$ 7,203</u> |
| Total shareholders' equity | <u>\$ 48,036</u> | <u>\$ 54,787</u> | <u>\$ 48,036</u> | <u>\$ 54,787</u> |

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited - Dollars in thousands, except per share amounts)

9. Share-based Compensation

Employee Stock Option Plans

The Company's share-based incentive plans offering stock options are offered under the Company's 2007 Equity Incentive Plan (the "2007 Plan"), which was restated and approved by the shareholders on December 12, 2015. Provisions of the restated 2007 Plan include the granting of up to 2,000,000 incentive and non-qualified stock options, stock appreciation rights, restricted stock and restricted stock units. Options may be granted to employees, officers, non-employee directors and other service providers and may be granted upon such terms as the Compensation Committee of the Board of Directors determines in their sole discretion. As of June 30, 2019, there were 569,585 options outstanding under the 2007 Plan. As of June 30, 2019, the 2007 Plan had 925,509 authorized unissued options.

A summary of the stock option activity under the Company's plans for the six months ended June 30, 2019 is as follows:

| | <u>Number of shares</u> | <u>Weighted average exercise price</u> |
|--|-----------------------------|--|
| Options outstanding at beginning of year | 624,256 | \$ 8.87 |
| Granted | — | — |
| Less: | | |
| Exercised | — | — |
| Forfeited prior to vesting | — | — |
| Canceled or expired | (54,671) | 9.44 |
| Options outstanding at June 30, 2019 | <u>569,585</u> | <u>8.81</u> |
| Options exercisable at end of June 30, 2019 | <u>527,352</u> | <u>\$ 8.63</u> |

As of June 30, 2019, the total remaining unrecognized compensation cost related to non-vested stock options, net of forfeitures, was approximately \$139, which will be recognized over a weighted average period of 0.8 year.

Share-based compensation expense has been recorded as follows:

| | <u>Three months ended June 30,</u> | | <u>Six months ended June 30,</u> | |
|----------------------------------|------------------------------------|---------------|----------------------------------|---------------|
| | <u>2019</u> | <u>2018</u> | <u>2019</u> | <u>2018</u> |
| Cost of goods sold | \$ 2 | \$ 4 | \$ 4 | \$ 9 |
| Sales and marketing | — | 10 | 1 | 20 |
| Research and product development | 11 | 27 | 23 | 57 |
| General and administrative | 42 | 88 | 101 | 180 |
| | <u>\$ 55</u> | <u>\$ 129</u> | <u>\$ 129</u> | <u>\$ 266</u> |

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited - Dollars in thousands, except per share amounts)

10. Fair Value Measurements

The fair value of the Company's financial instruments reflects the amounts that the Company estimates it will receive in connection with the sale of an asset or pay in connection with the transfer of a liability in an orderly transaction between market participants at the measurement date (exit price). The fair value hierarchy prioritizes the use of inputs used in valuation techniques into the following three levels:

Level 1 - Quoted prices in active markets for identical assets and liabilities.

Level 2 - Observable inputs other than quoted prices in active markets for identical assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. This category generally includes U.S. Government and agency securities; municipal securities; mutual funds and securities sold and not yet settled.

Level 3 - Unobservable inputs.

The substantial majority of the Company's financial instruments are valued using observable inputs. The following table sets forth the fair value of the financial instruments re-measured by the Company as of June 30, 2019 and December 31, 2018:

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
|---------------------------|----------------|-----------------|----------------|-----------------|
| June 30, 2019 | | | | |
| Corporate bonds and notes | \$ — | \$ 5,845 | \$ — | \$ 5,845 |
| Municipal bonds | — | 4,101 | — | 4,101 |
| Total | <u>\$ —</u> | <u>\$ 9,946</u> | <u>\$ —</u> | <u>\$ 9,946</u> |
| December 31, 2018 | | | | |
| Corporate bonds and notes | \$ — | \$ 2,881 | \$ — | \$ 2,881 |
| Municipal bonds | — | 1,834 | — | 1,834 |
| Total | <u>\$ —</u> | <u>\$ 4,715</u> | <u>\$ —</u> | <u>\$ 4,715</u> |

11. Income Taxes

The current year loss did not result in income tax benefit due to recording a full valuation allowance against expected benefits. The valuation allowance was recorded as we concluded that it was more likely than not that our deferred tax assets were not realizable primarily due to the Company's recent pre-tax losses. Income tax expense for the three and six months ended 2019 represents income tax expense recorded for jurisdictions outside the United States.

12. Subsequent Events

On August 5, 2019, the Honorable Edmond E. Chang of the Northern District of Illinois issued a preliminary injunction order in the ongoing litigation in that district between the Company and Shure Incorporated, Case No. 11-cv-3087. In that litigation, ClearOne asserts that Shure's MXA910 Ceiling Array Microphone, which competes with ClearOne's beamforming microphone array products, infringes patents related to those products. The August 5 order held that ClearOne had "met its burden of demonstrating entitlement to the extraordinary relief of a preliminary injunction" on U.S. Patent No. 9,813,806. The Court held that "Shure is likely infringing the '806 Patent and has not raised a substantial question of the patent's validity." The injunction order prohibits Shure from "manufacturing, marketing, and selling the MXA910 to be used in its drop-ceiling mounting configuration, including marketing and selling the MXA910 in a way that encourages or allows integrators to install it in a drop-ceiling mounting configuration."

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

This report on Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). All statements in this report, other than statements of historical fact, are forward-looking statements for purposes of these provisions, including any projections of earnings, revenues or other financial items, any statements of the plans and objectives of management for future operations, any statements concerning proposed new products or services, any statements regarding future economic conditions or performance, and any statements of assumptions underlying any of the foregoing. All forward-looking statements included in this report are made as of the date hereof and are based on information available to us as of such date. We assume no obligation to update any forward-looking statement. In some cases, forward-looking statements can be identified by the use of terminology such as "may," "will," "expects," "plans," "anticipates," "intends," "believes," "estimates," "potential," or "continue," or the negative thereof or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements contained herein are based upon reasonable assumptions at the time made, there can be no assurance that any such expectations or any forward-looking statement will prove to be correct. Our actual results will vary, and may vary materially, from those projected or assumed in the forward-looking statements. Future financial condition and results of operations, as well as any forward-looking statements, are subject to inherent risks and uncertainties, many of which we cannot predict with accuracy and some of which we might not anticipate, including, without limitation, product recalls and product liability claims; infringement of our technology or assertion that our technology infringes the rights of other parties; termination of supplier relationships, or failure of suppliers to perform; inability to successfully manage growth; delays in obtaining regulatory approvals or the failure to maintain such approvals; concentration of our revenue among a few customers, products or procedures; development of new products and technology that could render our products obsolete; market acceptance of new products; introduction of products in a timely fashion; price and product competition, availability of labor and materials, cost increases, and fluctuations in and obsolescence of inventory; volatility of the market price of our common stock; foreign currency fluctuations; changes in key personnel; work stoppage or transportation risks; integration of business acquisitions; and other factors referred to in our reports filed with the SEC, including our Annual Report on Form 10-K for the year ended December 31, 2018. All subsequent forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. Additional factors that may have a direct bearing on our operating results are discussed in Part I, Item 1A "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2018.

BUSINESS OVERVIEW

ClearOne is a global Company that designs, develops and sells conferencing, collaboration, and AV networking solutions for voice and visual communications. The performance and simplicity of our advanced, comprehensive solutions offer a high level of functionality, reliability and scalability. We derive a major portion of our revenue from audio conferencing products and microphones by promoting our products in the professional audio-visual channel. We have extended our total addressable market from the installed audio conferencing market to adjacent complementary markets – microphones, video collaboration and AV networking. We have achieved this through strategic technological acquisitions as well as by internal product development.

During the first quarter of 2019, we began shipping our patented Beamforming Microphone Array Ceiling Tile (BMA CT) to our partners. All of the innovations developed for the BMA CT make the integrator's job easier and more profitable. The BMA CT dramatically transforms how integrators can approach system design for ceiling tile installations, allowing for multi-array setups that can utilize a single, low-channel count digital-signal-processing (DSP) mixer while maintaining ClearOne's high level of performance and reliability. Further simplification comes from the array's built-in power amplifier, which allows each array to drive two 10-Watt, 8-Ohm loudspeakers. The BMA CT also features ClearOne's proprietary adaptive steering technology (think of it as smart switching). This provides impeccable room coverage while eliminating the need to adjust individual beams. Integrators can daisy chain ceiling tiles via P-Link (ClearOne's proprietary peripheral link) for larger conference setups – for simpler wiring and longer distances compared to networked home-run connections. P-Link also allows integrators to daisy chain additional peripherals such as wireless mics, USB Expanders, and GPIO Expanders. The system supports all of this functionality with zero consumption of analog I/O and signal processing in the DSP mixer leaving those resources available for other needs. The Company was awarded a Sound & Video Contractor magazine "Best of Show Award" for BMA CT, showcased at InfoComm conference in Orlando, Florida in June 2019.

We also introduced COLLABORATE[®] Space to our growing family of collaboration solutions. It's a suite that unifies messaging, calls and meetings and will energize workflows and increase productivity for everyone involved in the enterprise. Designed as a persistent, user-friendly collaboration suite, COLLABORATE Space contains many powerful UCC capabilities, as well as the seamless ability to make calls outside the network.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

With COLLABORATE Space, users can work together one-on-one, or in groups of hundreds, with integrated file sharing, searchable archives, and user presence information. They can connect with colleagues and contacts, via audio and video, with the most intuitive collaboration tools. Users can meet immediately or schedule a meeting and access a full suite of collaboration features, including file sharing, whiteboarding, annotation, chat, and meeting minutes.

During the first six months of 2019, we continued our serious litigation efforts to stop infringement of our strategic patents. We also continued our programs to cut costs and to speed up product development that we believe will enable us to get back to a growth path.

Overall revenue declined in the second quarter of 2019 when compared to the second quarter of 2018, with declines seen in all product categories except video. We believe the on-going infringement of ClearOne's patents is the major cause of our revenue decline in the audio conferencing and microphones categories. Our gross profit margin decreased marginally to 46% during the second quarter of 2019 from 47% for the second quarter of 2018. Net loss decreased marginally from \$2.2 million in the second quarter of 2018 to \$2.1 million in the second quarter of 2019. The decrease in net loss in 2019 was primarily due to reduced operating expenses offset by reduced gross profit and tax benefit.

Overall revenue declined in the first six months of 2019 when compared to same period in 2018, with declines seen in all product categories, except video. We believe the on-going infringement of ClearOne's patents is the major cause of our revenue decline in the audio conferencing and microphones categories. We are inappropriately being forced to compete against our own patented technology. We believe the revenue decline in video products was caused partially by increased competition in the space as well as due to reduced attention from our partners caused by the alternatives made available through infringement of our patents. Our gross profit margin decreased to 44% during the first six months of 2019 from 52% during the same six months in 2018. Gross profit margin decreased primarily due to increased material costs and reduction of higher margin professional audio conferencing products in the revenue mix. Net loss during the first six months of 2019 increased to \$4.4 million from \$4.0 million during the same period in 2018. The increase in net loss in 2019 was primarily due to reduced tax benefit and gross profit partially offset by reduced operating expenses.

We believe the recent decision by the U.S. District Court in August granting our request for a preliminary injunction to prevent our competitor from manufacturing, marketing, and selling its competing ceiling microphone array in an infringing configuration is an incredibly valuable ruling for ClearOne and its business. The decision validates the strength and importance of ClearOne's intellectual property rights, recognizes ClearOne's innovations in this space, and stops our competitor from further infringing our Graham patent (U.S. Patent No.9,813,806) pending a full trial. Although there can be no assurance of any outcome of a full trial, we believe this ruling will help pave way for ClearOne's recovery from the immense harm inflicted by our competitor's infringement of our valuable patents.

Industry conditions

We operate in a very dynamic and highly competitive industry which is dominated on the one hand by a few players with respect to certain products like traditional video conferencing appliances while on the other influenced heavily by a fragmented reseller market consisting of numerous regional and local players. The industry is also characterized by venture capitalist funded start-ups and private companies willing to fund cumulative cash losses in order to gain market share and achieve certain non-financial goals.

Economic conditions, challenges and risks

The audio-visual products market is characterized by intense competition and rapidly evolving technology. Our competitors vary within each product category. Our installed professional audio conferencing products, which is our flagship product category, continue to be ahead of the competition despite the reduction in revenues. Our strength in this space is largely due to our fully integrated suite of products consisting of DSP mixers, wide range of professional microphone products and video collaboration products. Despite our strong leadership position in the installed professional audio conferencing market, we face challenges to revenue growth due to the limited size of the market and pricing pressures from new competitors attracted to the commercial market due to higher margins.

Revenue from our video products are critical to our long-term growth. We face intense competition in this market from well-established market leaders as well as emerging players rich with marketing funds. We expect our strategy of combining Spontania, our cloud-based video conferencing product, Collaborate, our appliance-based media collaboration product, our high-quality professional cameras, and our high-end audio conferencing technology will generate high growth in the near future. We believe we are also well positioned to capitalize on the continuing migration away from the traditional hardware-based video conferencing systems to software-based video conferencing applications.

We derive a major portion of our revenue (approximately 47% for the year ended December 31, 2018) from international operations and expect this trend to continue in the future. Most of our revenue from outside the U.S. is billed in U.S. dollars and is not exposed to any significant currency risk. However, we are exposed to foreign exchange risk if the U.S. dollar is strong against other currencies as it will make U.S. Dollar denominated prices of our products less competitive.

A detailed discussion of our results of operations follows below.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Results of Operations for the three and six months ended June 30, 2019

The following table sets forth certain items from our unaudited condensed consolidated statements of operations (dollars in thousands) for the three and six months ended June 30, 2019 ("2019-Q2") ("2019-H1") and 2018 ("2018-Q2") ("2018-H1"), respectively, together with the percentage of total revenue which each such item represents:

| | Three months ended June 30, | | | Six months ended June 30, | | |
|---|-----------------------------|------------|--------------------------------|---------------------------|------------|--------------------------------|
| | 2019 | 2018 | Percentage Change 2019 vs 2018 | 2019 | 2018 | Percentage Change 2019 vs 2018 |
| Revenue | \$ 6,420 | \$ 6,971 | -8% | \$ 12,725 | \$ 14,260 | -11% |
| Cost of goods sold | 3,481 | 3,721 | -6% | 7,082 | \$ 6,911 | 2% |
| Gross profit | 2,939 | 3,250 | -10% | 5,643 | 7,349 | -23% |
| Sales and marketing | 2,261 | 2,760 | -18% | 4,214 | \$ 5,628 | -25% |
| Research and product development | 1,307 | 1,920 | -32% | 2,894 | \$ 3,976 | -27% |
| General and administrative | 1,475 | 1,542 | -4% | 3,030 | \$ 3,159 | -4% |
| Total operating expenses | 5,043 | 6,222 | -18% | 10,138 | \$ 12,763 | -21% |
| Operating loss | (2,104) | (2,972) | -29% | (4,495) | (5,414) | -17% |
| Other income, net | 51 | 49 | 4% | 93 | \$ 73 | 27% |
| Loss before income taxes | (2,053) | (2,923) | -30% | (4,402) | \$ (5,341) | -18% |
| Provision for (benefit from) income taxes | 45 | (760) | 103% | 45 | \$ (1,332) | 102% |
| Net loss | \$ (2,098) | \$ (2,163) | -3% | \$ (4,447) | (4,009) | 11% |

Revenue

Our revenue decreased to \$6.4 million in 2019-Q2 compared to \$7.0 million in 2018-Q2. The highest decline was seen in the audio conferencing category with a 20% decline followed by microphones with a marginal 1% decline. Revenue from video products grew by 16% on the back of growth in sales of videoconferencing appliances, cameras and cloud-based videoconferencing services. The decline in the audio conferencing category was due to a decline in all subcategories including professional installed audio conferencing, personal conferencing and tabletop conferencing. The decline in microphones category was due to a decline in beamforming microphones offset by increase in revenue from wireless mics. The on-going infringement of ClearOne's patents is the major cause of our revenue decline in audio conferencing and microphones categories. The share of audio conferencing products in our product mix decreased from 52% in 2018-Q2 to 45% in 2019-Q2. The share of microphones increased from 32% to 35%. Share of video products in the revenue mix increased from 16% to 20%. During 2019-Q2 revenue declined in the USA, Canada, Australia, Japan, China and Northern Europe offset by revenue increases in the Middle East, India, South Asia, South Korea and Central Europe and Southern Europe. Asia Pacific, including the Middle East, increased by 6%, Europe and Africa declined by 8% and the Americas declined by 15%.

Our revenue decreased to \$12.7 million in 2019-H1 compared to \$14.3 million in 2018-H1. The highest decline was seen in audio conferencing category with 23% decline followed by microphones with 5% decline. Revenue from video products grew by 14% on the back of growth in sales of videoconferencing appliances, cameras, cloud-based videoconferencing services and network media streaming products. The decline in audio conferencing category was due to a decline in all subcategories including professional installed audio conferencing, personal conferencing and tabletop conferencing. The decline in microphones category was due to a decline in beamforming microphones and ceiling microphones offset by increase in revenue from wireless mics. The on-going infringement of ClearOne's patents is the major cause of our revenue decline in audio conferencing and microphones categories. The share of audio conferencing products in our product mix decreased from 51% in 2018-H1 to 44% in 2019-H1. The share of microphones increased from 32% to 34%. Share of video products in the revenue mix increased from 17% to 22%. During 2019-H1 revenue declined in all regions except the Middle East, India, South Asia and Central Europe and Southern Europe. The decline was more pronounced in Canada, Australia, Japan and Northern Europe. Asia Pacific, including the Middle East declined by 2%, Europe and Africa declined by 14% and Americas declined by 14%.

We believe, although there can be no assurance, that we will return to a growth path if we are able to successfully implement our strategic initiatives focused on product innovation, cost reduction and defense of our intellectual property.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Costs of Goods Sold and Gross Profit

Cost of goods sold includes expenses associated with finished goods purchased from outsourced manufacturers, the repackaging of our products, our manufacturing and operations organization, property and equipment depreciation, warranty expense, freight expense, royalty payments, and the allocation of overhead expenses.

Our gross profit for 2019-Q2 was approximately \$2.9 million or 46% compared to approximately \$3.3 million, or 47%, for 2018-Q2.

Our gross profit margin decreased to 44% during 2019-H1 from 52% during 2018-H1. Gross profit margin decreased primarily due to increased material costs and reduction of higher margin professional audio conferencing products in the revenue mix.

Our profitability in the near-term continues to depend significantly on our revenues from professional installed audio-conferencing products. We hold long-term inventory and if we are unable to sell our long-term inventory, our profitability might be affected by inventory write-offs and price mark-downs. Our long-term inventory includes approximately \$2.0 million of wireless microphone-related finished goods and assemblies, \$1.6 million of Converge Pro 2 products and about \$1.7 million of raw materials that will be used for manufacturing professional audio conferencing products. Any business changes that are adverse to these product lines could potentially impact our ability to sell these long-term inventory in addition to our current inventory.

Operating Expenses

Operating expenses include sales and marketing ("S&M") expenses, research and product development ("R&D") expenses and general and administrative ("G&A") expenses. Total operating expenses were \$5.0 million for 2019-Q2 compared to \$6.2 million for 2018-Q2. Total operating expenses were \$10.1 million for 2019-H1 compared to \$12.8 million for 2018-H1. The following contains a more detailed discussion of expenses related to sales and marketing, research and product development, general and administrative, and other items.

Sales and Marketing - S&M expenses include selling, customer service, and marketing expenses such as employee-related costs, allocations of overhead expenses, trade shows, and other advertising and selling expenses.

S&M expenses for 2019-Q2 decreased to \$2.3 million from \$2.8 million for 2018-Q2. The decrease was mainly due to decreases in employee related costs including benefits, allocations of overhead expenses and advertising costs partially offset by increase in marketing expenses related to tradeshows.

S&M expenses for 2019-H1 decreased to \$4.2 million from \$5.6 million for 2018-H1. The decrease was mainly due to decreases in employee related costs including benefits, demonstration inventory costs, and advertising costs partially offset by increase in marketing expenses related to tradeshows and training programs.

Research and Product Development - R&D expenses include research and development, product line management, engineering services, and test and application expenses, including employee related costs, outside services, expensed materials, depreciation, and an allocation of overhead expenses.

R&D expenses were approximately \$1.3 million for 2019-Q2, as compared to \$1.9 million for 2018-Q2. The decrease was primarily due to reductions in employee related costs, project related costs and allocations of overhead expenses.

R&D expenses were approximately \$2.9 million for 2019-H1, as compared to \$4.0 million for 2018-H1. The decrease was primarily due to reductions in employee related costs, project related costs, allocations of overhead expenses and legal expenses.

General and Administrative - G&A expenses include employee-related costs, professional service fees, allocations of overhead expenses, litigation costs, and corporate administrative costs, including costs related to finance and human resources.

G&A expenses remained almost the same at \$1.5 million in 2019-Q2 and 2018-Q2. G&A expenses for 2019-H1 decreased marginally to \$3.0 million compared to \$3.2 million in 2018-H1.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Other income (expense), net

Other income (expense), net, includes interest income, interest expense, and foreign currency changes. It remained almost the same in 2019-Q2 and 2018-Q2. It increased marginally in 2019-H1 compared to 2018-H1.

Provision for income taxes

During 2019-H1, we did not recognize any benefit from the losses incurred due to setting up of full valuation allowance. Income tax expense for 2019-Q2 and 2019-H1 represents income tax expense recorded for jurisdictions outside the United States. During 2018-H1 we accrued income taxes at the forecasted effective tax benefit rate of 26.8%.

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2019, our cash and cash equivalents were approximately \$2.4 million compared to \$11.2 million as of December 31, 2018. Our working capital was \$20.4 million and \$28.4 million as of June 30, 2019 and December 31, 2018, respectively.

Net cash used in operating activities was approximately \$1.4 million in 2019-H1, a decrease of cash used of approximately \$0.5 million from \$1.9 million of cash used in operating activities in 2018-H1. The decrease in cash used was primarily due to an increase in non-cash charges of \$1.2 million partially offset by increase in cash outflows due to change in operating assets and liabilities of \$0.3 million and an increase in net loss by \$0.5 million.

Net cash used by investing activities was \$7.5 million for 2019-H1 compared to net cash flows provided by investing activities of \$1.1 million during the 2018-H1, an increase in cash used of \$8.6 million. The increase was primarily due to an increase in net purchases of marketable securities of approximately \$8.8 million partially offset by decrease in capitalized patent defense costs by \$0.2 million.

Capitalization of patent defense costs. We capitalize external legal costs incurred in the defense of our patents when we believe that a significant, discernible increase in value will result from the defense and a successful outcome of the legal action is probable. When we capitalize patent defense costs we amortize the costs over the remaining estimated useful life of the patent, which is 15 to 17 years. During 2019-Q2 we spent \$1.1 million of legal costs related to the defense of our patents and capitalized the entire amount.

We are currently pursuing all available legal remedies to defend our strategic patents from infringement. We have already spent about \$10.8 million from 2016 through June 30, 2019 towards this litigation and may be required to spend more to continue our legal defense. We believe the recent decision by the U.S. District Court in August granting our request for a preliminary injunction to prevent our competitor from manufacturing, marketing, and selling its competing ceiling microphone array in an infringing configuration is an incredibly valuable ruling for ClearOne and its business. The decision validates the strength and importance of ClearOne's intellectual property rights, recognizes ClearOne's innovations in this space, and stops our competitor from further infringing our Graham patent (U.S. Patent No.9,813,806) pending a full trial. We believe this ruling will help pave way for ClearOne's recovery from the immense harm inflicted by our competitor's infringement of our valuable patents.

We have been actively engaged in preserving cash by suspending our dividend program, allowing our share repurchase program to expire and implementing company-wide cost reduction measures. In addition, we expect to generate additional cash as our inventory levels are brought down to historical levels. We also believe that the measures taken by us will yield higher revenues in the future. We believe all of these and effective management of working capital will provide the liquidity needed to meet our short-term and long-term operating requirements and finance our growth plans. We also believe that our strong portfolio of intellectual property and our solid brand equity in the market will enable us to raise additional capital if and when needed to meet our short and long-term financing needs. In addition to capital expenditures, we may use cash in the near future for selective infusions of technology, sales and marketing, infrastructure, and other investments to fuel our growth.

At June 30, 2019, we had open purchase orders of approximately \$1.5 million, primarily related to inventory purchases.

At June 30, 2019, we had inventory totaling \$20.0 million, of which non-current inventory accounted for \$7.7 million. This compares to total inventories of \$22.2 million and non-current inventory of \$9.0 million as of December 31, 2018.

OFF-BALANCE SHEET ARRANGEMENTS

We have no off-balance-sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial conditions, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources, results of operations or liquidity.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our results of operations and financial position are based upon our unaudited consolidated financial statements included under Item 1 of this Form 10-Q, which have been prepared in conformity with accounting principles generally accepted in the United States. We review the accounting policies used in reporting our financial results on a regular basis. We believe certain of our accounting policies are critical to understanding our financial position and results of operations. Except with respect to our revenue recognition practices included in Note 1. “Business Description, Basis of Presentation and Significant Accounting Policies” under Item 1 of this Form 10-Q, there have been no changes to the critical accounting policies as explained in our Annual Report on Form 10-K for the year ended December 31, 2018.

RECENT ACCOUNTING PRONOUNCEMENTS

For a discussion of recent accounting pronouncements, see Note 1: “Business Description, Basis of Presentation and Significant Accounting Policies” in the notes to our unaudited consolidated financial statements included under Item 1 of this Form 10-Q.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES

An evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as of June 30, 2019 was performed under the supervision and with the participation of our management, including our Chief Executive Officer and our Principal Financial and Accounting Officer. Based upon this evaluation, our Chief Executive Officer and Senior Vice President of Finance concluded that, as of the end of the period covered by this Quarterly Report, our disclosure controls and procedures were not effective at a reasonable assurance level as of June 30, 2019 due to the material weakness in internal control over financial reporting as described below.

Management identified a material weakness in the operating effectiveness of internal control over financial reporting relating to the accurate and timely reporting of its financial results and disclosures and its testing and assessment of the design and effectiveness of internal controls over financial reporting in a timely manner.

To address the material weakness, management is working with our third-party internal controls consultant to assist with the implementation of a remediation plan which will supplement the existing controls. The remediation plan will include an assessment of personnel levels and responsibilities, additional training of financial reporting personnel and ability to handle new requirements and projects on a timely basis with respect to the preparation of the consolidated financial statements and public company reporting requirements and timelines. The material weakness will be fully remediated when, in the opinion of management, the control processes have been operating for a sufficient period of time to provide reasonable assurance as to their effectiveness. The remediation and ultimate resolution of the material weakness will be reviewed with the Audit Committee of the Board of Directors.

Except as noted above, there has been no change in the Company's internal control over financial reporting as of June 30, 2019, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

On February 15, 2019, the Company filed a petition for inter partes review of Shure's U.S. Patent No. 9,565,493 ("493 Patent"), arguing that all claims of the '493 Patent should be cancelled in light of several prior art references, including ClearOne's U.S. Patent No. 9,813,806 (the "'806 Patent"). Shure has opposed the petition, and a decision by the Patent Trial and Appeal Board whether to institute inter partes review is expected by August 20, 2019.

On July 18, 2019, Shure, Inc. filed a lawsuit against the Company in the U.S. Court for the District of Delaware. The lawsuit alleges ClearOne's BMACT product, launched in February of 2019, infringes Shure's '493 Patent. Furthermore, Shure alleged in the lawsuit that ClearOne engaged in unfair competition, tortious interference, deceptive trade practices and false advertising. Shure is seeking monetary damages and multiple injunctive reliefs. The Company believes that the lawsuit is a baseless retaliatory action by Shure and intends to vigorously defend it.

On August 5, 2019, the Honorable Edmond E. Chang of the Northern District of Illinois issued a preliminary injunction order in the ongoing litigation in that district between the Company and Shure Incorporated, Case No. 11-cv-3087. In that litigation, ClearOne asserts that Shure's MXA910 Ceiling Array Microphone, which competes with ClearOne's beamforming microphone array products, infringes patents related to those products. The August 5 order held that ClearOne had "met its burden of demonstrating entitlement to the extraordinary relief of a preliminary injunction" on U.S. Patent No. 9,813,806. The Court held that "Shure is likely infringing the '806 Patent and has not raised a substantial question of the patent's validity." The injunction order prohibits Shure from "manufacturing, marketing, and selling the MXA910 to be used in its drop-ceiling mounting configuration, including marketing and selling the MXA910 in a way that encourages or allows integrators to install it in a drop-ceiling mounting configuration."

Item 1A. RISK FACTORS

There have been no material changes to the risk factors included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) None.

Item 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

Item 5. OTHER INFORMATION

Not applicable.

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Item 6. EXHIBITS

Exhibit No. Title of Document

| | |
|---------|---|
| 31.1 | Section 302 Certification of Chief Executive Officer (filed herewith) |
| 31.2 | Section 302 Certification of Principal Financial Officer (filed herewith) |
| 32.1 | Section 906 Certification of Chief Executive Officer (filed herewith) |
| 32.2 | Section 906 Certification of Principal Financial Officer (filed herewith) |
| 101.INS | XBRL Instance Document (filed herewith) |
| 101.SCH | XBRL Taxonomy Extension Schema (filed herewith) |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase (filed herewith) |
| 101.DEF | XBRL Taxonomy Extension Definitions Linkbase (filed herewith) |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase (filed herewith) |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase (filed herewith) |

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ClearOne, Inc.,
(Registrant)

August 14, 2019

By: /s/ Zeynep Hakimoglu
Zeynep Hakimoglu
President, Chief Executive Officer and Chairman of the Board
(Principal Executive Officer)

August 14, 2019

By: /s/ Narsi Narayanan
Narsi Narayanan
Senior Vice President of Finance
(Principal Accounting and Principal Financial Officer)

CERTIFICATION

I, Zeynep Hakimoglu, certify that:

1. I have reviewed this quarterly report of ClearOne, Inc. on Form 10-Q;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

August 14, 2019

By: /s/ Zeynep Hakimoglu
Zeynep Hakimoglu
Chief Executive Officer
(Principal Executive Officer)

CERTIFICATION

I, Narsi Narayanan, certify that:

1. I have reviewed this quarterly report of ClearOne, Inc. on Form 10-Q;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ Narsi Narayanan

Narsi Narayanan

Senior Vice President of Finance

(Principal Accounting and Principal Financial Officer)

August 14, 2019

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

**Pursuant to 18 U.S.C. Section 1350,
As adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

I, Zeynep Hakimoglu, certify, to my best knowledge and belief, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of ClearOne, Inc. on Form 10-Q for the quarter ended June 30, 2019 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of ClearOne, Inc.

By: /s/ Zeynep Hakimoglu
Zeynep Hakimoglu
Chief Executive Officer
(Principal Executive Officer)

August 14, 2019

CERTIFICATION OF CHIEF FINANCIAL OFFICER

**Pursuant to 18 U.S.C. Section 1350,
As adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

I, Narsi Narayanan, certify, to my best knowledge and belief, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of ClearOne, Inc. on Form 10-Q for the quarter ended June 30, 2019, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of ClearOne, Inc.

By: /s/ Narsi Narayanan

Narsi Narayanan

Senior Vice President of Finance

(Principal Accounting and Principal Financial Officer)

August 14, 2019