

2013 ANNUAL REPORT



ClearOne[®]

MEDIA COLLABORATION

ClearOne's new line of media collaboration products set themselves apart from anything available in the market. Our portfolio features cloud-based and on-premise video applications, group and room systems, desktop and mobile clients, infrastructure, and management solutions.



NETWORK STREAMING AND SIGNAGE

ClearOne's easily scalable IP-based, AV-distribution network streaming, recording and digital signage solutions deliver the highest-quality video over existing LAN infrastructures.

UC VOICE

ClearOne offers a broad portfolio of award-winning products designed to enhance the user's unified communications experience, from the desktop to the small working conference room— each solution boasting ClearOne's unmatched, rich audio performance.





PROFESSIONAL VOICE

ClearOne's professional audio conferencing systems and professional microphones bring state-of-the-art audio technology to large-scale conferencing venues such as boardrooms, conference centers, auditoriums, courtrooms, and distance-learning centers. Optimized for professional audio conferencing.

PROFESSIONAL MICROPHONES

ClearOne's professional microphones are the most innovative in the market. Optimized for professional audio conferencing with CONVERGE Pro and INTERACT Pro products, the game-changing Beamforming Microphone Array, the new Wireless Microphone System, the powerful Ceiling Microphone Array, and our full line of tabletop microphones all deliver seamless, crystal-clear voice for any conferencing venue.





Dear Fellow Shareholders:

In 2013 and thus far in 2014, we successfully completed two acquisitions, expanded our offering with high quality products and solutions, and meaningfully increased our revenues. Our balance sheet remains healthy, as we continued to strengthen our team and invest in our Company's future.

Financial Overview

For the year ended December 31, 2013, revenue increased 7% to \$49.6 million from \$46.4 million for 2012. Gross profit was \$29.9 million, or 60% of revenue, compared with \$27.3 million, or 59% of revenue, for the previous year. Operating income was \$7.6 million and net income was \$5.2 million, equal to \$0.55 per diluted share. In the year earlier period, operating income was \$42.5 million and net income was \$26.6 million, or \$2.89 per diluted share, which included \$38.5 million of proceeds from litigation. On adjusted basis, which excludes the effect of litigation proceeds and other expenses, both operating income and net income rose substantially in 2013 compared with 2012.

At December 31, 2013, the company had cash, cash equivalents and investments of \$42.7 million and no long-term debt.

The positive momentum we generated last year has continued into 2014. For the year-to-date period, which includes the first three quarters of 2014, revenue increased 20% to \$42.6 million from \$35.4 million for the nine months ended September 30, 2013. Gross profit increased 19% to \$25.4 million, or 60% of revenue, compared with \$21.3 million, or 60% of revenue, for the first nine months of 2013. Operating income was up modestly to \$4.9 million compared with the prior year period. Net income was \$3.1 million, or \$0.32 per diluted share, down from \$3.4 million, or \$0.36 per diluted share, for the comparable 2013 period, primarily due to an increase in the provision for income taxes.

At September 30, 2014, cash, cash equivalents and investments decreased to \$34.3 million from \$42.7 million at December 31, 2013, primarily due to the acquisitions of two companies, discussed in more detail below.

Acquisitions

In March 2014, we completed the acquisition of Sabine, Inc., a supplier of professional wireless microphone solutions. Prior to the acquisition, Sabine had been one of our strategic partners, supplying wireless microphone systems sold under the ClearOne brand. Wireless microphones are an integral component of our product offering and complement our CONVERGE® Pro and INTERACT® Pro products. Our professional microphone lineup now includes a full portfolio of wired and wireless solutions, as well as the pro audio industry's only professional Beamforming Microphone Array.

And in April 2014, we acquired Spontania, a carrier-grade, cloud-based video collaboration solutions business. Spontania complements COLLABORATE®, ClearOne's premise-based, enterprise media collaboration offering. The addition of Spontania makes ClearOne the only company offering an entirely software-based video conferencing product line that provides on-premise and cloud-based Software-as-a-Service (SaaS) and Platform-as-a-Service (PaaS) solutions. To boost growth of this business and enhance our strategic positioning, we augmented our sales and marketing team with industry veterans. Recently, we also established two separate partnerships with service providers to incorporate the Spontania cloud-based media collaboration platform into their workflow applications – one related to telemedicine and the other to education.

Launches, Milestones and Awards

Our ongoing investment in research and development, continues to pay dividends in the form of new, highly differentiated products. Apart from adding new products to our portfolio through acquisitions of Sabine and Spontania, we launched a number of other products in 2013 and 2014 so far, including the industry's first professional-grade Beamforming Microphone Array; VIEW® Pro encoders and decoders which provide the best in high-profile, 4:4:4 multimedia streaming with lossless compression; CONNECT® Dante™ network bridge which enables no-hassle connectivity of our flagship professional audio products to the fast emerging Dante enabled network ecosystem; and CONVERGE® Matrix, our new sound reinforcement and distribution system.

In addition to being well received by the channel and customers, our Beamforming Microphone Array won several awards and recognitions including winning the TMCnet's 2014 Communications Solutions Product of the Year Award and nomination as a finalist in the 2013 Utah Innovation awards.

ClearOne continues to be recognized for its industry leadership evidenced by our 2014 Frost & Sullivan Global Installed Audio Conferencing Systems Market Leadership Award. Frost & Sullivan listed several key factors that have enabled ClearOne's

continued success and leadership in the Installed Audio Conferencing Systems market: a complete professional audio conferencing systems product portfolio, a long history of product innovation, a large and well-developed partner ecosystem, and expanded use cases that allow the company to develop and implement industry-specific solutions.

We also reached an intellectual property milestone with the filing of our 100th patent application, of which 61 have been granted and the remaining 39 are in-process.

Opportunities Ahead

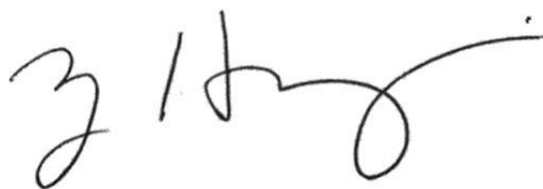
In our effort to expand our customer base and grow market share, we established or expanded relationships with a number of important channel partners, which include professional audio visual and IT distributors and value added resellers. More importantly, we have begun to see positive results from our growth strategy, having effectively extended our business beyond voice conferencing. Our new offerings, which include audio distribution, wired and wireless microphones, multimedia streaming and media collaboration, address considerably larger market opportunities than our legacy installed voice conferencing business and allow us to enter new markets and penetrate deeper into existing ones.

We have so far repurchased \$5.1 million of the company's outstanding shares of common stock out of a \$10.0 million stock repurchase program.

All of our efforts are focused on the further growth and development of ClearOne. We are confident that our products and services are well timed for the evolving communications and collaboration landscape.

On behalf of the Board and management, we express our deep appreciation for the continued support of our shareholders.

Sincerely,

A handwritten signature in black ink, appearing to read 'Zee Hakimoglu', with a long horizontal flourish extending to the right.

Zee Hakimoglu
Chairman, President and Chief Executive Officer
November 10, 2014

SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

<u>Year ended December 31,</u>	<u>2013</u>		<u>2012</u>		<u>2011</u>	
Revenue	\$	49,592	\$	46,417	\$	46,067
Operating income	\$	7,622	\$	42,521	\$	10,572
Net income	\$	5,179	\$	26,647	\$	6,929
Diluted earnings per share	\$	0.55	\$	2.89	\$	0.75
Cash and cash equivalents	\$	17,192	\$	55,509	\$	16,683
Total Assets	\$	81,061	\$	91,939	\$	49,559
Shareholders' equity	\$	70,335	\$	66,668	\$	39,664

QUARTERLY STOCK PRICE

Our common stock has traded on the NASDAQ Capital Market under the symbol CLRO since August 14, 2007. The following table sets forth high and low sale prices (or high and low bid quotations) of our common stock for each fiscal quarter indicated as reported on the NASDAQ Capital Market.

<u>Year ended December 31,</u>	<u>2013</u>		<u>2012</u>	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
Q1 - Jan 1 to Mar 31	\$ 8.95	\$ 4.03	\$ 5.20	\$ 4.14
Q2 - Apr 1 to Jun 30	9.81	8.00	4.72	3.70
Q3 - Jul 1 to Sep 30	8.74	7.38	4.26	3.70
Q4 - Oct 1 to Dec 31	9.69	8.02	4.76	3.76

On March 14, 2014, the closing price for our common stock as reported on the NASDAQ Capital Market was \$11.25.

As of March 14, 2014, there were 9,309,529 shares of our common stock issued and outstanding and held by approximately 347 shareholders of record. This number includes each broker dealer and clearing corporation that holds shares for customers as a single shareholder.

SHARE REPURCHASES

In May 2012, our Board of Directors authorized a stock repurchase program. Under the program, we were originally authorized to repurchase up to \$2 million of our outstanding common stock from time to time over the following 12 months. Any stock repurchases may be made through open market and privately negotiated transactions, at times and in such amounts as management deems appropriate, including pursuant to one or more Rule 10b5-1 trading plans. Rule 10b5-1 permits us to establish, while not in possession of material nonpublic information, prearranged plans to buy stock at a specific price in the future, regardless of any subsequent possession of material nonpublic information. The timing and actual number of shares repurchased will depend on a variety of factors, including market conditions and other factors. The stock repurchase program may be suspended or discontinued at any time without prior notice.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These statements reflect our views with respect to future events based upon information available to us at this time. These forward-looking statements are subject to uncertainties and other factors that could cause actual results to differ materially from these statements. Forward-looking statements are typically identified by the use of the words “believe,” “may,” “could,” “will,” “should,” “expect,” “anticipate,” “estimate,” “project,” “propose,” “plan,” “intend,” and similar words and expressions. Examples of forward-looking statements are statements that describe the proposed development, manufacturing, and sale of our products; statements that describe our results of operations, pricing trends, the markets for our products, our anticipated capital expenditures, our cost reduction and operational restructuring initiatives, and regulatory developments; statements with regard to the nature and extent of competition we may face in the future; statements with respect to the sources of and need for future financing; and statements with respect to future strategic plans, goals, and objectives. Forward-looking statements are contained in this report under “Business” included in Item 1 of Part I, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in Item 7 of Part II of this Annual Report on Form 10-K. The forward-looking statements are based on present circumstances and on our predictions respecting events that have not occurred, that may not occur, or that may occur with different consequences and timing than those now assumed or anticipated. Actual events or results may differ materially from those discussed in the forward-looking statements as a result of various factors, including the risk factors discussed in this report under the caption “Item 1A Risk Factors.” These cautionary statements are intended to be applicable to all related forward-looking statements wherever they appear in this report. The cautionary statements contained or referred to in this report should also be considered in connection with any subsequent written or oral forward-looking statements that may be issued by us or persons acting on our behalf. Any forward-looking statements are made only as of the date of this report and we assume no obligation to update forward-looking statements to reflect subsequent events or circumstances.

BUSINESS DESCRIPTION

References in this Annual Report on Form 10-K to “ClearOne,” “we,” “us,” “CLRO” or “the Company” refer to ClearOne, Inc., a Utah corporation, and, unless the context otherwise requires or is otherwise expressly stated, its subsidiaries.

GENERAL

ClearOne was formed as a Utah corporation in 1983 organized under the laws of the State of Utah. The company is headquartered in Salt Lake City, Utah, with offices in Austin, Texas, Corvallis, Oregon, Hong Kong, the United Kingdom and Israel.

We are a global company that designs, develops and sells conferencing, collaboration, streaming and digital signage solutions for audio/voice and visual communications. The performance and simplicity of our advanced comprehensive solutions enhance the quality of life and offer unprecedented levels of functionality, reliability and scalability.

We design, develop, market, and service a comprehensive line of high-quality conferencing products for personal use, as well as traditional tabletop, mid-tier premium and higher-end professional products for large, medium and small businesses. We occupy the number one global market share position, with nearly 50% market share in the professional audio conferencing market for our products used by large businesses and organizations such as enterprise, healthcare, education and distance learning, government, legal and finance. Our solutions save organizations time and money by creating a natural environment for collaboration and communication.

We have an established history of product innovation and plan to continue to apply our expertise in audio, video and network engineering to develop and introduce innovative new products and enhance our existing products. Our end-users range from some of the world's largest and most prestigious companies and institutions to small and medium-sized businesses, higher education and government organizations, as well as individual consumers. We sell our commercial products to these end-users primarily through a global network of independent distributors who, in turn, sell our products to dealers, systems integrators and other value-added resellers.

Acquisitions

On February 16, 2012, we completed the acquisition of the video conferencing business of Israel-based VCON Video Conferencing, Ltd. ("VCON"). VCON was a pioneer in software based video conferencing solutions with product offerings that include group video conferencing endpoints, desktop video conferencing endpoints, video conferencing infrastructure solutions and software development kits. This acquisition and the combination of our streaming and digital signage technologies has provided us with complementary technology opportunities allowing us to enter new growth markets. Pursuant to the asset purchase agreement, ClearOne paid consideration of \$4.6 million in cash to VCON for all the assets, including intellectual property, fixed assets and inventory, and assumed no debt.

On January 7, 2014, we entered into an agreement to acquire Spontania from Spain-based Dialcom Networks, S.L. in an all-cash deal for €3.65 million (approximately US \$5.0 million). Spontania is a software-based cloud collaboration solution which combines the benefits of video conferencing and web conferencing into an enterprise solution that can scale to tens of thousands of users. The addition of Spontania is expected to make ClearOne the only company offering an entirely software-based video conferencing product line that provides on-premise and cloud-based Software-as-a-Service (SaaS) and Platform-as-a-Service (PaaS) solutions and is expected to complement ClearOne's existing premise-based, enterprise video conferencing offering, COLLABORATE®, obtained from the VCON acquisition.

ClearOne plans to fund the acquisition of substantially all of the assets of the Spontania business with available cash and will not assume any debt or cash. The acquisition is expected to close by the end of the first quarter of 2014, subject to customary closing conditions, including applicable regulatory approvals.

On March 7, 2014, we completed the acquisition of Sabine, Inc. which will provide the company with reliable and exclusive access to the wireless microphones that are a critical component of ClearOne's complete microphone portfolio. Under the terms of the transaction, ClearOne paid approximately \$7.20 million in cash and approximately \$1.50 million in ClearOne shares. In addition, ClearOne paid off Sabine debt of \$1.25 million and may be required to make earn-out payments over the next three years based on achievement of certain performance criteria. ClearOne expects to maintain Sabine operations at its current headquarters in Alachua, Florida.

Company Information

Our website address is www.clearone.com. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to such reports are available, free of charge, on our website in the "Investor Relations" section under "Company." These reports are made available as soon as reasonably practicable after we file such material with, or furnish it to, the SEC.

For a discussion of certain risks applicable to our business, results of operations, financial position, and liquidity, see the risk factors described in "Item 1A, Risk Factors" below.

STRATEGY

We currently participate in the following markets:

- Professional audio visual, including audio conferencing and video conferencing and collaboration;
- Professional microphones;
- Unified communications, including telephony;
- Multimedia streaming and control; and
- Digital signage.

Our business goals are to:

- Maintain our leading global market share in professional audio conferencing products for large businesses and organizations;
- Leverage the video conferencing & collaboration, streaming and digital signage technologies we recently acquired to enter new growth markets;
- Focus on the small and medium business (SMB) market with scaled, lower cost and less complex products and solutions;
- Capitalize on the growing adoption of unified communications and introduce new products through emerging information technology channels;
- Capitalize on emerging market opportunities as audio visual, information technology, unified communications and traditional digital signage converge to meet enterprise and commercial multimedia needs; and
- Expand and strengthen our sales channels.

We will continue to focus on our core strengths, which include the following:

- Providing a superior conferencing and collaboration experience;
- Significantly impacting multimedia distribution and control;
- Offering greater value to our customers and partners;
- Leveraging and extending ClearOne technology, leadership and innovation;
- Leveraging our strong domestic and international channels to distribute new products; and
- Strengthening existing customer and partner relationships through dedicated support.

PRODUCTS

Our products can be broadly categorized into the following:

- Professional audio communication products;
- Unified communications audio end points; and
- Visual communication products.

PROFESSIONAL AUDIO COMMUNICATION PRODUCTS

Our full range of professional audio communication products includes (i) professional conferencing and sound-reinforcement products used in enterprise, healthcare, education and distance learning, government, legal and finance organizations, (ii) mid-tier premium conferencing products for smaller rooms and small and medium businesses which interface with video and web conferencing systems, and (iii) professional microphones used in various applications.

Our professional audio communication products contributed 73% and 70% of our consolidated revenue in 2013 and 2012, respectively.

Our professional audio communication products and unified communications audio end points feature our proprietary HDConference®, Distributed Echo Cancellation® and noise cancellation technologies to enhance communication during a conference call by eliminating echo and background noise. Most of our products also feature some of our other HDConference proprietary audio processing technologies such as adaptive modeling and first-microphone priority, which combine to deliver clear, crisp and full-duplex audio. These technologies enable natural and fatigue-free communication between distant conferencing participants.

Professional Conferencing, Sound Reinforcement

We occupy the number one position in the global professional audio conferencing market with nearly 50% of the total global market share. We have been developing high-end, professional conferencing products since 1991 and believe we have established strong brand recognition for these products worldwide. Our professional conferencing products include the CONVERGE® Pro and Converge SR product lines.

Our flagship Converge Pro product line leads our professionally installed audio products line. The Converge Pro product line includes the Converge Pro 880, Converge Pro 880T, Converge Pro 880TA, Converge Pro 840T, Converge Pro 8i, Converge Pro TH20 and Converge Pro VH20, and Converge SR product line including Converge SR1212 and SR1212A which together offer various levels of integration and features to allow a commercial system integrator to optimize a system to fit diverse conferencing applications and environments.

Mid-Tier Premium Conferencing

Our INTERACT® product line is a mid-tier, lower cost, conferencing product line designed to meet the needs of our larger customers with smaller conferencing rooms as well as small and medium businesses. The INTERACT product series is comprised of the INTERACT AT and the INTERACT Pro. Both systems can be easily connected to enterprise telephones, analog POTS lines, existing HD video codecs and soft video clients. These INTERACT systems also include a USB audio interface to connect to PCs, laptops and tablets, as well as to rich multimedia devices, such as video or web conferencing systems and emerging unified communication systems for enhanced collaboration.

Professional Microphones

The ClearOne Beamforming Microphone Array is the Pro-Audio industry's first professional-grade microphone array with Beamforming and adaptive steering technology and ClearOne's next-generation Acoustic Echo Cancellation. The ultra-sleek design fits into any conferencing environment and delivers the clearest audio pickup available. The 24 microphone element industry-leading Beamforming Microphone Array has focused acoustic beams, digital signal processing, adaptive steering, and acoustic echo canceling to produce the clearest and most intelligible conferencing sound possible. ClearOne began shipping the Beamforming Microphone Array in March 2013.

ClearOne also introduced WS800 Wireless Microphone Systems, including four new models of wireless microphones/transmitters (Tabletop/boundary, Gooseneck, Handheld, Bodypack) and a base-station receiver with either 4 or 8

channels, which connect to professional audio mixers. The wireless system combines ease-of-use with the most reliable security and power. ClearOne began shipping the WS800 Wireless Microphone Systems in January 2013.

The ClearOne Ceiling Microphone Array enhances almost any professional conferencing application which demands high-quality audio. The Ceiling Microphone Array is easily installed and combines affordability with exceptional audio quality. With three wide-range microphones mounted together into a single unit array, the Ceiling Microphone Array provides the rich sound of three individual unidirectional microphones while maintaining full 360-degree coverage.

UNIFIED COMMUNICATIONS AUDIO END POINTS

Our unified communications audio end points include (i) traditional tabletop conferencing phones used in conference rooms and offices and (ii) affordable personal conferencing products that can be used with PCs, laptops, tablets, smartphones, and other portable devices. Our unified communications audio end points contributed approximately 19% and 22% of our consolidated revenue in 2013 and 2012, respectively.

Traditional Tabletop Conferencing

Our MAX® product line is comprised of the following product families: MAX EX and MAXAttach® wired phones; MAX Wireless and MAXAttach Wireless; and MAX IP and MAXAttach IP VoIP tabletop conferencing phones. Designed for use in executive offices or small conference rooms with multiple participants, MAX Wireless can be moved from room to room within 150 feet of its base station. MAXAttach Wireless was the industry's first and remains the only dual-phone, completely wireless solution. This system gives customers tremendous flexibility in covering larger conference room areas. MAX EX and MAXAttach wired phones can be daisy chained together, up to a total of four phones. This provides even distribution of microphones, loudspeakers, and controls for better sound quality and improved user access in medium to large conference rooms. In addition, all MAXAttach wired phones can be used separately when they are not needed in a daisy-chain configuration. MAX IP and MAXAttach IP are VoIP tabletop conference phones which are based on the industry-standard SIP signaling protocol. These phones can also be daisy-chained together, up to a total of four phones.

Personal Conferencing Products

Our CHAT® product line includes affordable and stylish personal speakerphones and USB headsets. CHAT speaker phones provide full-duplex and rich full bandwidth frequency response for superior audio clarity. CHAT products are designed for a wide variety of applications and devices (fixed or portable) for greatly enhanced collaboration wherever and whenever needed. CHAT speaker phones are offered as personal speakerphones and group speakerphones.

CHAT personal speakerphones are approximately the size of a deck of cards, and connect to PCs and MACs, laptops, tablets, enterprise handsets, smartphones, cell phones, and MP3 players for rich, clear, hands-free audio and playback. CHAT group speakerphones are designed for small group use. These can also connect many of the same devices and applications as the CHAT personal speakerphones, but feature three microphones in larger design for use by a larger number of participants. CHAT group speakerphones have the ability to add high-quality, full-duplex speakerphones to user enterprise telephone handsets such as Avaya and Cisco. CHAT group speakerphones make it possible to introduce rich, crystal clear conferencing capability without the need for introducing a separate traditional conference phone. CHATAttach® is comprised of two CHAT group speakerphones which can be daisy-chained together to function as a single conferencing system.

CHAT USB headsets for unified communications combine the comfort, durability and legacy audio quality for which ClearOne is renowned. These affordable USB headsets incorporate advanced microphone noise-canceling technology and acoustic shock protection technologies.

VISUAL COMMUNICATION PRODUCTS

Our visual communication products are sold under following three broad categories: (i) video conferencing, (ii) streaming and (iii) digital signage.

Video Conferencing Products:

Our comprehensive portfolio of industry-leading COLLABORATE® branded HD videoconferencing solutions bring cutting-edge software-based full HD (1080p) video conferencing technology with H.264 High Profile encoding that reduces bandwidth utilization up to 50 percent. COLLABORATE is comprised of feature-rich room systems and desktop video applications, as well as enhanced network management, infrastructure solutions and software development kits.

COLLABORATE Infrastructure is for customers who desire an on-premise infrastructure solution. ClearOne offers a single-unit infrastructure server that will serve the needs of both the small to mid-sized businesses and enterprise customers hoping to expand locations. The heavy burden of adding video collaboration pervasively has always been the cost of expensive infrastructure solutions. ClearOne's single-unit solution provides the infrastructure component at a low price, including directory services, firewall traversal, MCU, H.323 gatekeeper, SIP registrar, license server, call control, and a full management system.

COLLABORATE Desktop is a versatile application for any PC or laptop user in organizations of any size. Available with up to 1080p resolution, the COLLABORATE Desktop offers multiple media transmitting capabilities for video, audio and data. Using ClearOne's DualStream™ technology, the application has the ability to send and receive video and data streams simultaneously with its additional streaming capability, ClearOne's Simulcast™ allows COLLABORATE Desktop users to chair or participate in corporate broadcasts.

COLLABORATE Room is a best-in-class video conferencing and collaboration solution offering a price-point and feature set vastly superior to that of competing room conferencing solutions. Designed for small and medium businesses and corporate meeting rooms, the COLLABORATE Room features software-based and server-less embedded multipoint (up to 9-way) video conferencing, SIP/H.323 bridging interoperability, built-in recording and streaming, built-in remote content and data sharing, and interactive multicast.

Streaming Products:

Our Streaming products sold under VIEW® and NetStreams brands deliver the ultimate IP A/V experience by streaming time sensitive high definition audio and video and control over TCP/IP networks. By combining audio and/or video content, meta-data and control signals into one digital stream in harmony with industry standards, it's distributed, edge of the network architecture allows the hardware and the processing power to be distributed across any existing TCP/IP network. This leverages many of the advantages of using TCP/IP over traditional analog systems and other centrally controlled IP-based systems. The ClearOne VIEW products are powered by ClearOne's patented StreamNet® technology. A user can activate and control a single audio source or combination of audio sources, video sources, security systems, HVAC systems, lighting, and other room or facility monitoring functions such as paging or security access by just a single touch to its attractive touch screens. Alternatively, any PC, laptop, tablet, iPod, or other device with a built-in web browser with Flash can control the equipment connected to the system. The VIEW systems have no limits on the numbers of sources, displays, or amplifiers in a project and can be used in venues from high-end residential homes to large-scale commercial projects.

Converting an audio or video signal to TCP/IP preserves the digital quality of the signal across the network. Unlike analog systems, which lose quality over long distances, TCP/IP packets are decoded to retain the same digital quality as contained when they were encoded. The addition of Digital Encoder and Digital Decoder products with DVI/HDMI input and output enhances the flexibility of complete AV distribution system and makes it as easy to use as analog devices.

MagicBox Digital Signage Products

We make digital signage and video messaging systems with an emphasis on ease of use and flexibility with hardware and software applications. Our Aavelin-branded media players come with different hardware configurations for Digital Signage applications. By using the Composer Desktop software application or WebSuite application through Software as a Service (SaaS) or Entry Level Server (ELS) with Aavelin media players, the contents can be managed, scheduled and published to one or many media players to display on screens. Our RoomRoster-branded room information solution is a combination of display and data wrapped in one design. It consists of the room sign and database integration used to display room schedules and other information in real-time.

MARKETING AND SALES

We primarily use a two-tier channel model through which we sell our commercial products to a worldwide network of independent audiovisual, information technology and telecommunications distributors, who then sell our products to independent systems integrators, dealers, and value-added resellers, who in turn work directly with the end-users of our products for product fulfillment and installation, if needed. Our products are also specified and recommended by professional audio-video consultants. We also sell our commercial products directly to certain dealers, systems integrators, value-added resellers, and end-users. We sell our residential products through a global network of residential electronics dealers, system integrators, and other value-added resellers.

During the year ended December 31, 2013, approximately \$32.3 million, or 65% of our total product sales, were generated in the United States and product sales of approximately \$17.3 million, or 35% of our total product sales, were generated outside the United States. Revenue from product sales to customers in the United States was approximately \$30.3 million, or 65% of total product sales and revenue from products outside of the United States was approximately \$16.1 million and accounted for approximately 35% of our total product sales for the year ended December 31, 2012. We sell directly to our distributors, resellers and end-users in approximately 70 countries worldwide. We anticipate that the portion of our total product revenue from international sales will continue to be a significant portion of our total revenue as we further enhance our focus on developing new products, establishing new channel partners, strengthening our presence in key growth areas, complying with regional environmental regulatory standards, and improving product localization with country-specific product documentation and marketing materials.

Distributors, Resellers and Independent Integrators

We sold our products directly to approximately 520 distributors and direct resellers throughout the world during 2013. Distributors and resellers purchase our products at a discount from list price and resell them worldwide to hundreds of independent system integrators, telephony value-added resellers, IT value-added resellers, and PC dealers on a non-exclusive basis. Our distributors maintain their own inventory and accounts receivable and are required to provide technical and non-technical support for our products to the next level of distribution participants. We work with our distributors and resellers to establish appropriate inventory stocking levels. We also work with our distributors and resellers to maintain relationships with our existing systems integrators, dealers, and other value-added resellers.

While dealers, resellers, and system integrators all sell our products directly to the end-users, system integrators typically add significant value to each sale by combining our products with products from other manufacturers as part of an integrated system solution. Commercial dealers and value-added resellers usually purchase our products from distributors and may bundle our products with products from other manufacturers for resale to the end-user. We maintain close working relationships with all our reseller partners and offer them education and training on all of our products.

Marketing

Much of our marketing effort is conducted in conjunction with our channel partners who provide leverage for us in reaching existing and prospective customers worldwide. We also regularly attend industry forums and exhibit our products at multiple regional and international trade shows, often with our channel partners. These trade shows provide exposure for our brand and products to a wide audience. We market our ClearOne-branded commercial products on our website www.clearone.com and our MagicBox branded digital signage products on our website www.magicboxinc.com. We also conduct public relations initiatives to get press coverage and product reviews in industry and non-industry publications alike.

Customers

We do not get any reports from our distributors and resellers that identify our end-users. As a result, we do not know whether any end-user accounted for more than 10 percent of our total revenue during any of the periods reported in this Annual Report. However, revenues included sales to Starin Marketing, which represented approximately 18.2% of consolidated revenue, and VSO Marketing, which represented approximately 10.8% of consolidated revenue during the year ended December 31, 2013. During the year ended December 31, 2012, revenues included sales to Starin Marketing, which represented 17.5% of our consolidated revenue during that period. As discussed above, distributors facilitate product sales to a large number of independent systems integrators, dealers, and value-added resellers, and subsequently to their end-users. The loss of one or more distributors could reduce revenue and have a material adverse effect on our business and results of operations. Our shipped orders on which we had not recognized revenue were \$4.2 million and \$3.6 million as of December 31, 2013 and 2012, respectively. As of December 31, 2013, we had a backlog of un-shipped orders of approximately \$473 thousand.

Competition

The audio visual product markets are characterized by intense competition, rapidly evolving technology, and increased business consolidation. We compete with businesses having substantially greater financial, research and product development, manufacturing, marketing, and other resources. If we are not able to continually design, manufacture, and successfully market new or enhanced products or services that are comparable or superior to those provided by our competitors and at comparable or better prices, we could experience pricing pressures and reduced sales, gross profit margins, profits, and market share, each of which could have a materially adverse effect on our business. Our competitors vary within each product category. We believe we are able to differentiate ourselves and therefore successfully compete as a result of the high audio quality of our products resulting from a combination of proprietary and highly advanced audio signal processing technologies and networking technology in the form of trade secrets and patented intellectual property, technical and channel support services, and the strength of our channels and brands.

We believe the principal factors driving sales are the following:

- Quality, features and functionality, and ease of use of the products;
- Broad and deep global channel partnerships;
- Significant established history of successful worldwide installations for diverse vertical markets;
- Brand name recognition and acceptance;
- Quality of customer and partner sales and technical support services; and
- Effective sales and marketing.

BUSINESS DESCRIPTION

In the professional audio conferencing system and sound reinforcement markets, our main competitors include Biamp, Crestron, Extron, Harman/BSS, Lectrosonics, Peavey, Phoenix, Polycom, Shure and Vaddio and their original equipment manufacturing (OEM) partners, along with several other companies potentially poised to enter the market. We occupy the number one position in the global professional audio conferencing market with nearly 50% of the global market share. In the traditional tabletop conferencing market, we face significant competition from Avaya (Konftel), Phoenix, and Polycom, and especially from their OEM partnerships. A significant portion of the tabletop market is covered by sales through OEM partnerships. While we believe MAX products have unique features and superior quality, our limited OEM partnerships and pricing pressures from higher volume competitors limit our ability to expand our existing share of this market. In the professional microphones market, our primary competitors include Audio-technica, Audix, Polycom, Revolabs, Sennheiser, Shure, and their OEM partners. Our primary competitors in the personal conferencing market are GN Netcom (Jabra), Phoenix Audio, Plantronics, Polycom, Yamaha and their OEM partners. Our video conferencing products face tremendous competition from well established players, including Avaya (Radvision), CISCO, Logitech (Lifesize), Polycom and Vidyo. We believe the migration of video conferencing from hardware-based codecs to software-based codecs provides an opportunity for us to differentiate our products and win market share. Our commercial streaming products face intense competition from a few well-established corporations of diversified capabilities and strengths, including AMX, BiAmp, Crestron, Extron, and Haivision. We believe that our pioneering and patented StreamNet technology delivers superior audio and video streaming performance and flexibility and provides us with a competitive edge over other industry players. In digital signage, our primary competitors include Scala, Tightrope and Visix.

Regulatory Environment

Regulations regarding product safety, product operational agency compliance, the materials used in manufacturing, the process of disposing of electronic equipment and the efficient use of energy may require extensive lead-time to obtain regulatory approvals of new products in both domestic and international markets. Such regulations may impact our ability to expand our sales in a timely and cost-effective manner and, as a result, our business could be harmed.

Sources and Availability of Raw Materials

We manufacture our products through electronics manufacturing services ("EMS") providers, who are generally responsible for sourcing and procuring required raw materials and components. Most of the components that our EMS providers require for manufacturing our products are readily available from a number of sources.

We continually work with our EMS providers to seek alternative sources for all our components and raw material requirements to ensure higher quality and better pricing. Most of our EMS providers and their vendors are duly qualified by our corporate quality assurance process. We work with our EMS providers to ensure that raw materials and components conform to our specifications.

Manufacturing

Currently, all of our products except digital signage products are manufactured by EMS providers. Our primary EMS provider is Flextronics. The digital signage products are assembled in our Salt Lake City, Utah facility.

Seasonality

Our revenue has historically been the strongest in the fourth quarter and the weakest in the first quarter, even though a consistent pattern could not be established for seasonality between the quarters. There can be no assurance that any historic sales patterns will continue and, as a result, sales for any prior quarter are not necessarily indicative of the sales to be expected in any future quarter.

Research and Product Development

We are committed to research and product development and view our continued investment in research and product development as a key ingredient to our long-term business success. Our research and product development expenditures were approximately \$7.6 million during the year ended December 31, 2013 and \$8.3 million during the year ended December 31, 2012.

Our core competencies in research and product development include (a) many audio technologies, including acoustic echo cancellation, noise cancellation and other advanced adaptive digital signal processing technologies, (b) networking and multimedia streaming technologies, and (c) video technologies. We also have expertise in wireless technologies, VoIP, software and network application, and digital signage system development. We believe that continued investment in our core technological competencies is vital to developing new products and to enhancing existing products.

Intellectual Property and Other Proprietary Rights

We believe that our success depends in part on our ability to protect our proprietary rights. We rely on a combination of patent, copyright, trademark, and trade secret laws and confidentiality agreements and processes to protect our proprietary rights. The laws of foreign countries may not protect our intellectual property to the same degree as the laws of the United States.

We generally require our employees, certain customers and partners to enter into confidentiality and non-disclosure agreements before we disclose any confidential aspect of our technology, services, or business. In addition, our employees are required to assign to us any proprietary information, inventions, or other technology created during the term of their employment with us. However, these precautions may not be sufficient to protect us from misappropriation or infringement of our intellectual property.

Employees

As of December 31, 2013, we had 141 full-time employees. Of these employees, 91 were located in our Salt Lake City locations, 30 in other U.S. locations, and 20 in locations outside the U.S. None of our employees are subject to a collective bargaining agreement and we believe our relationship with our employees is good. We also hire contractors with specific skill sets to meet our operational needs.

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

The following discussion should be read in conjunction with our consolidated financial statements and related notes included in this report, as well as our other filings with the SEC. This discussion contains forward-looking statements based on current expectations that involve risks and uncertainties, such as our plans, objectives, expectations, and intentions, as set forth under "Disclosure Regarding Forward-Looking Statements." Our actual results and the timing of events could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth in the following discussion and under the caption "Risk Factors" in Item 1A and elsewhere in this report.

OVERVIEW

Throughout this discussion, we compare results of operations for the year ended December 31, 2013 ("2013") to the year ended December 31, 2012 ("2012" or "the comparable period").

We continued in our path of growth recording our fourth consecutive year of revenue growth. Except for the second quarter, which had a small revenue growth, all quarters in 2013 recorded impressive growths in revenue and profitability.

On February 16, 2012, we completed the acquisition of the video conferencing business of Israel-based VCON Video Conferencing, Ltd. ("VCON"). VCON was a pioneer in software-based video conferencing solutions with product offerings that included group video conferencing endpoints, desktop video conferencing endpoints, video conferencing infrastructure solutions and software development kits. This acquisition and the combination of streaming and digital signage technologies have provided us with complementary technology opportunities allowing us to enter new growth markets. Pursuant to the asset purchase agreement, ClearOne paid consideration of \$4.6 million in cash to VCON for all VCON's assets, including intellectual property, fixed assets and inventory, and assumed no debt.

On January 7, 2014, we entered into an agreement to acquire Spontania from Spain-based Dialcom Networks, S.L. in an all-cash deal for €3.65 million (approximately US \$5.0 million). Spontania is a software-based cloud collaboration solution which combines the benefits of video conferencing and web conferencing into a unique, effective and powerful enterprise solution that can scale to tens of thousands of users.

The addition of Spontania is expected to make ClearOne the only company offering an entirely software-based video conferencing product line that provides on-premise and cloud-based Software-as-a-Service (SaaS) and Platform-as-a-Service (PaaS) solutions, and is expected to complement ClearOne's existing premise-based, enterprise video conferencing offering, COLLABORATE®, obtained from the VCON acquisition.

ClearOne plans to fund the acquisition of substantially all of the assets of the Spontania business with available cash and will not assume any debt or cash. The acquisition is expected to close by the end of the first quarter of 2014, subject to customary closing conditions, including applicable regulatory approvals.

On March 7, 2014, we completed the acquisition of Sabine, Inc., which will provide the company with reliable and exclusive access to the wireless microphones that are a critical component of ClearOne's complete microphone portfolio. Under the terms of the transaction, ClearOne paid approximately \$7.20 million in cash and approximately \$1.50 million in ClearOne shares. In addition, ClearOne paid off Sabine debt of \$1.25 million and may be required to make earn-out payments over the next three years, based on achievement of certain performance criteria. ClearOne expects to maintain Sabine operations at its current headquarters in Alachua, Florida.

Overall revenue increased in 2013 due to significant growth in revenue from professional audio conferencing products. Revenue from unified communications products and video products declined during the year. Our gross profit during 2013 increased at a higher rate than the increase in our revenue. Net income decreased to \$5.2 million from \$26.6 million in 2012.

Net income in 2013 declined primarily as a result of reduction in litigation proceeds from \$38.5 million in 2012 to \$639 thousand in 2013. Without considering litigation proceeds, net income before taxes would be \$7.1 million in 2013 and \$4.1 million in 2012.

We derive a major portion (approximately 69%) of our revenue from the Americas, which include North America and Latin America. Our share of revenue from foreign markets outside the Americas was slightly lower in 2013 when compared to 2012.

The audio visual products market is characterized by intense competition and rapidly evolving technology. Our competitors vary within each product category. Our professional audio communication products, which contribute the most to our revenue, continues to perform strongly largely due to professional conferencing and professional microphone products. Despite our strong leadership position in the professional audio communications products market, we face challenges to revenue growth due to limited size of the market and pricing pressures from new competitors. Continuing popularity of mid-tier premium conferencing products within the product mix in opposition to higher cost professional conferencing products also poses a challenge to our revenue growth.

We expect the acquisition of Sabine in March 2014 will further drive our growth in revenue from professional microphone products. As professional microphones complement our professional conferencing products, we expect this acquisition to drive our overall revenue growth. We continue to focus on deepening and expanding our partnerships with large IT distributors to increase our penetration of the unified communications audio end points market through. We believe we are also well positioned to capitalize on the continuing migration away from the traditional hardware based video conferencing to software based video conferencing.

We believe that we will continue our progress if current economic conditions continue or improve. Even though our cash position continues to be strong, our announced acquisitions will increase our operating costs. We will continue to exercise fiscal discipline and balance the need to invest in the growth of our product offerings against the need to maintain the profitability of the company.

DISCUSSION OF RESULTS OF OPERATIONS - YEAR ENDED DECEMBER 31, 2013 COMPARED TO YEAR ENDED DECEMBER 31, 2012

The following table sets forth certain items from our consolidated statements of operations for the years ended December 31, 2013 and 2012, together with the percentage of total revenue which each item represents.

	Year ended December 31,				Variance	
	2013		2012		Favorable (Unfavorable)	
	Amount (in thousands)	% of Revenue	Amount (in thousands)	% of Revenue	Amount (in thousands)	%
Revenue	\$ 49,592	100.0 %	\$ 46,417	100.0 %	\$ 3,175	6.8 %
Cost of goods sold	19,735	39.8 %	19,089	41.1 %	(646)	(3.4) %
Gross profit	29,857	60.2 %	27,328	58.9 %	2,529	9.3 %
Sales and marketing	8,896	17.9 %	8,112	17.5 %	(784)	(9.7) %
Research and product development	7,562	15.2 %	8,261	17.8 %	699	8.5 %
General and administrative	6,416	12.9 %	6,934	14.9 %	518	7.5 %
Proceeds from litigation	(639)	(1.3) %	(38,500)	(82.9) %	(37,861)	(98.3) %
Operating income	7,622	15.4 %	42,521	91.6 %	(34,899)	(82.1) %
Other income, net	147	0.3 %	34	0.1 %	113	332.4 %
Income before income taxes	7,769	15.7 %	42,555	91.7 %	(34,786)	(81.7) %
Provision for income taxes	(2,590)	(5.2) %	(15,908)	(34.3) %	13,318	83.7 %
Net income	\$ 5,179	10.4 %	\$ 26,647	57.4 %	\$ (21,468)	(80.6) %

Revenue

Our revenue was \$49.6 million for the year ended December 31, 2013 compared to \$46.4 million for the comparable period in 2012. Revenue during 2013 increased by approximately \$3.2 million, or 7%, from the comparable period in 2012. Revenue increased primarily due to 12% increase in revenue from professional audio conferencing products. Revenue from unified communications audio end points declined by 6% and revenue from video products declined by 2%. The share of professional audio communications products in our mix increased to approximately 73% in 2013 from approximately 70% in 2012. During 2013, revenue from Europe, Middle East and Africa grew by 3% while revenue from the Americas grew by 10%.

At each quarter end, we evaluate the inventory in the distribution channel through information provided by certain of our distributors. The level of inventory in the channel fluctuates up or down each quarter based upon our distributors' individual operations. Accordingly, each quarter-end revenue deferral is calculated and recorded based upon the underlying channel inventory at quarter-end. During 2013 and 2012, the change in deferred revenue based on the movement of inventory in the channel was a \$565 thousand and \$189 thousand, respectively.

Cost of Goods Sold and Gross Profit

Cost of goods sold ("COGS") includes expenses associated with finished goods purchased from outsourced manufacturers, the manufacture of our products (including material and direct labor), our manufacturing and operations organization, property and equipment depreciation, warranty expense, freight expense, royalty payments, and the allocation of overhead expenses.

Our gross profit during 2013 was approximately \$29.9 million compared to approximately \$27.3 million in the comparable period in 2012, an increase of 9.3%. The increase in gross profit was primarily due to increased revenues with a lower increase in our cost of goods sold. Gross profit margins ("GPM"), or gross profit as a percentage of sales, increased to 60% in 2013 from 59% in 2012.

Our profitability in the near-term continues to depend significantly on our revenues from professional audio communications products. We hold long-term inventory and if we are unable to sell our long-term inventory, profitability might be affected by inventory write-offs and price mark-downs.

Operating Expenses and Profits (Losses)

Operating profits (losses), or income from operations, is the surplus after operating expenses are deducted from gross profits. 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 excluding net litigation proceeds were \$22.9 million in 2013 compared to \$23.3 million during the 2012. Net litigation proceeds were \$639 thousand in 2013 compared to \$38.5 million in 2012. 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 sales, customer service, and marketing expenses such as employee-related costs, allocations of overhead expenses, trade shows, and other advertising and selling expenses. Total S&M expenses were approximately \$8.9 million in 2013 compared to \$8.1 million in 2012. S&M expenses as a percentage of revenue were 17.9% and 17.5% in 2013 and 2012, respectively. The increase in S&M expenses is primarily due to an increase in associate commissions as a result of increased sales in 2013.

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. Total R&D expenses were \$7.6 million in 2013 compared to \$8.3 million during the comparable period. As a percentage of revenue, R&D expenses were 15.2% in 2013 compared to 17.8% in 2012. The decrease was mainly due to reduced employee costs and depreciation charge, partially offset by increased R&D project costs.

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. Total G&A expenses were approximately \$6.4 million in 2013 compared with approximately \$6.9 million in 2012. The decrease in G&A expenses was primarily due to special bonuses awarded in 2012 to key contributors associated with the legal settlement and decreased legal services in 2013. These decreases were partially offset by increased fees for audit services.

Proceeds from litigation. In 2013, we received \$639 thousand in litigation proceeds primarily consisting of the receipt of a net refund amount of \$364 thousand for the bail bond amount we were initially required to pay in the Strohm case (see "Strohm" under Note 8 - Commitments and Contingencies to our Consolidated Financial Statements), and \$272 thousand for the recovery of money held in escrow related to the VCON acquisition completed in February 2012. In 2012, we received \$45 million from UBS as settlement of a dispute that was under arbitration. The settlement award was subject to a 15% contingency legal fee of \$6.75 million paid in December 2012 to our litigation counsel. (See section titled "ARS Special Arbitration" under Note 8 - Commitments and Contingencies to our Consolidated Financial Statements.)

Provision for income taxes

The tax expense of \$2.6 million during 2013 was primarily the result of tax on current year income. This compared to a tax expense of \$15.9 million during 2012, which included taxes relating to the receipt of proceeds from the UBS dispute settlement.

LIQUIDITY, CAPITAL RESOURCES AND FINANCIAL POSITION

As of December 31, 2013, our cash and cash equivalents were approximately \$17.2 million compared to \$55.5 million as of December 31, 2012. The change in cash and cash equivalents was due to the investment of the majority of our 2012 cash and cash equivalent holdings into marketable securities. Our working capital was \$39.4 million and \$56.5 million as of December 31, 2013 and 2012, respectively.

Net cash flows used in operating activities were approximately \$10.0 million during 2013, a decrease of approximately \$53.9 million from \$43.9 million provided by operating activities in 2012. The change was primarily due to the increase of the 2012 income taxes payable as a result of the UBS dispute settlement, the payment of those taxes in 2013, and the decrease in net income from 2012 to 2013 was mainly due to the UBS dispute settlement in 2012.

Net cash flows used in investing activities were \$26.5 million during 2013 compared to net cash flows used in investing activities of \$5.2 million during 2012. During 2013, the cash outflows on investing activities consisted of acquisitions of marketable securities along with purchases of property and equipment. During 2012, the cash outflows on investing activities consisted of the acquisition of VCON's business for \$4.6 million and other purchases of property and equipment. Please refer to Note 3 - Business Combinations, Goodwill and Intangible Assets in the Notes to Consolidated Financial Statements (Part IV) for details on the company's acquisitions.

Net cash used in financing activities in 2013 consisted of proceeds received from the exercise of stock options amounting to \$489 thousand and associated tax benefits of \$104 thousand, offset by the acquisition of outstanding stock totaling \$2.4 million under the stock repurchase program. Net cash provided by financing activities in 2012 consisted of proceeds from the exercise of stock options totaling \$490 thousand and associated tax benefits totaling \$2 thousand, offset by the acquisition of outstanding stock totaling \$384 thousand under the stock repurchase program.

We believe that future income from operations 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 financial position and sound business structure will enable us to raise additional capital 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 & marketing, infrastructure, and other investments to fuel our growth, as well as acquisitions that may strategically fit our business and are accretive to our performance. We may also use cash to finance the repurchase of our outstanding stock.

At December 31, 2013, we had open purchase orders related to our electronics manufacturing service providers and other contractual obligations of approximately \$2.9 million, primarily related to inventory purchases.

At December 31, 2013, we had inventory totaling \$12.8 million, of which non-current inventory accounted for \$0.6 million. This compares to total inventories of \$12.8 million and non-current inventory of \$2.0 million as of December 31, 2012. As our business prospects continue to improve, we expect to continue to reduce our non-current inventory and convert it into cash.

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 consolidated financial statements, which have been prepared in conformity with U.S. generally accepted accounting principles. We review the accounting policies used in reporting our financial results on a regular basis. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. We evaluate our assumptions and estimates on an ongoing basis and may employ outside experts to assist in our evaluations. We believe that the estimates we use are reasonable; however, actual results could differ from those estimates. Our significant accounting policies are described in Note 2 - Summary of Significant Accounting Policies to the

Consolidated Financial Statements included in Part IV of this report. We believe the following critical accounting policies identify our most critical accounting policies, which are the policies that are both important to the representation of our financial condition and results and require our most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Revenue and Associated Allowances for Revenue Adjustments and Doubtful Accounts

Included in continuing operations is product revenue, primarily from product sales to distributors, dealers, and end-users. Product revenue is recognized when (i) the products are shipped and any right of return expires, (ii) persuasive evidence of an arrangement exists, (iii) the price is fixed and determinable, and (iv) collection is reasonably assured.

We provide a right of return on product sales to certain distributors under a product rotation program. Under this seldom-used program, once a quarter, a distributor is allowed to return products purchased during the prior quarter for a total value generally not exceeding 15% of the distributor's net purchases during the preceding quarter. The distributor is, however, required to place a new purchase order for an amount not less than the value of products returned under the stock rotation program. When products are returned, the associated revenue, cost of goods sold, inventory and accounts receivable originally recorded are reversed. When the new order is placed, the revenue, associated cost of goods sold, inventory and accounts receivable are recorded and the product revenue is subject to the deferral analysis described below. In a small number of cases, the distributors are also permitted to return the products for other business reasons.

Revenue from product sales to distributors is not recognized until the return privilege has expired or until it can be determined with reasonable certainty that the return privilege has expired, which approximates when the product is sold-through to customers of our distributors (dealers, system integrators, value-added resellers, and end-users), rather than when the product is initially shipped to a distributor. At each quarter-end, we evaluate the inventory in the distribution channel through information provided by our distributors. The level of inventory in the channel will fluctuate up-ward or down-ward each quarter based upon our distributors' individual operations. Accordingly, each quarter-end deferral of revenue and associated cost of goods sold are calculated and recorded based upon the actual channel inventory reported at quarter-end. Further, with respect to distributors and other channel partners not reporting the channel inventory, the revenue and associated cost of goods sold are deferred until we receive payment for the product sales made to such distributors or channel partners.

The accuracy of the deferred revenue and costs depend to a large extent on the accuracy of the inventory reports provided by our distributors and other resellers, and any material error in those reports would affect our revenue deferral. However, we believe that the controls we have in place, including periodic physical inventory verifications and analytical reviews, would help us identify and prevent any material errors in such reports. As part of these controls, we sample test the inventory of a limited number of distributors on an annual basis, most recently in the fourth quarter of 2013, to verify inventory levels reported.

The amount of deferred cost of goods sold was included in distributor channel inventories. The following table details the amount of deferred revenue, cost of goods sold, and gross profit:

	As of December 31,	
	2013	2012
Deferred revenue	\$ 4,158	3,593
Deferred cost of goods sold	1,520	1,289
Deferred gross profit	\$ 2,638	2,304

We offer rebates and market development funds to certain of our distributors, dealers/resellers, and end-users based upon volume of product purchased by them. We record rebates quarterly as a reduction of revenue in accordance with GAAP.

We offer credit terms on the sale of our products to a majority of our channel partners and perform ongoing credit evaluations of our customers' financial condition. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability or unwillingness of our channel partners to make required payments based upon our historical collection experience and expected collectability of all accounts receivable. Our actual bad debts in future periods may differ from our current estimates and the differences may be material, which may have an adverse impact on our future accounts receivable and cash position.

Impairment of Goodwill and Intangible Assets

We allocated the purchase price for the acquisitions of NetStreams in 2009, MagicBox in 2011 and VCON in 2012 on the basis of well-established valuation techniques performed by qualified experts. Goodwill is measured as the excess of the cost of acquisition over the sum of the amounts assigned to tangible and identifiable intangible assets acquired less liabilities assumed. We perform impairment tests of goodwill and intangible assets with indefinite useful lives on an annual basis in the fourth fiscal quarter, or sooner if a triggering event occurs suggesting possible impairment of the values of these assets. In association with the acquisition of NetStreams, \$726 thousand and \$400 thousand were recorded as goodwill and intangible assets with indefinite useful life, respectively. With respect to the MagicBox acquisition, \$427 thousand and \$159 thousand were recorded as goodwill and intangible assets with indefinite useful life, respectively. Assets, with initial indefinite useful lives, have subsequently received finite life assignments. Goodwill of \$2.3 million was recorded in connection with the VCON acquisition. There were no related impairments recorded in 2013 or 2012 as no impairment indicators existed. However, due to uncertainty in the industrial, technological, and competitive environments in which we operate, we might be required to exit or dispose of the assets acquired through the NetStreams, MagicBox or VCON acquisitions, which could result in an impairment of goodwill and intangible assets.

Impairment of Long-Lived Assets

We assess the impairment of long-lived assets, such as property and equipment and definite-lived intangibles subject to amortization, annually or whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset or asset group to estimated future undiscounted net cash flows of the related asset or group of assets over their remaining lives. If the carrying amount of an asset exceeds its estimated future undiscounted cash flows, an impairment charge is recognized for the amount by which the carrying amount exceeds the estimated fair value of the asset. Impairment of long-lived assets is assessed at the lowest levels for which there are identifiable cash flows that are independent of other groups of assets. The impairment of long-lived assets requires judgments and estimates. If circumstances change, such estimates could also change. Assets held for sale are reported at the lower of the carrying amount or fair value, less the estimated costs to sell.

Accounting for Income Taxes

We are subject to income taxes in both the United States and in certain non-U.S. jurisdictions. We estimate our current tax position together with our future tax consequences attributable to temporary differences resulting from differing treatment of items, such as deferred revenue, depreciation, and other reserves for tax and accounting purposes. These temporary differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income, prior year carryback, or future reversals of existing taxable temporary differences. To the extent we believe that recovery is not more likely than not, we establish a valuation allowance against these deferred tax assets. Significant judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities, and any valuation allowance recorded against our deferred tax assets.

To the extent we establish a valuation allowance in a period, we must include and expense the allowance within the tax provision in the consolidated statement of operations. In accordance with ASC Topic 740, "Accounting for Income Taxes", we analyzed our valuation allowance at December 31, 2013 and determined that based upon available evidence it is more likely

than not that certain of our deferred tax assets related to capital loss carryovers and state research and development credits will not be realized and, accordingly, we have recorded a valuation allowance against these deferred tax assets in the amount of \$378 thousand. Please refer to note on income taxes in the Notes to Consolidated Financial Statements for additional information.

Lower-of-Cost or Market Adjustments and Reserves for Excess and Obsolete Inventory

We account for our inventory on a first-in, first-out basis, and make appropriate adjustments on a quarterly basis to write down the value of inventory to the lower-of-cost or market. In addition to the price of the product purchased, the cost of inventory includes our internal manufacturing costs, including warehousing, material purchasing, quality and product planning expenses.

We perform a quarterly analysis of obsolete and slow-moving inventory to determine if any inventory needs to be written down. In general, we write-down our excess and obsolete inventory by an amount that is equal to the difference between the cost of the inventory and its estimated market value if market value is less than cost, based upon assumptions about future product life-cycles, product demand, shelf life of the product, inter-changeability of the product and market conditions. Those items that are found to have a supply in excess of our estimated current demand are considered to be slow-moving or obsolete and classified as long-term. An appropriate reserve is made to write down the value of that inventory to its expected realizable value. These charges are recorded in cost of goods sold. The reserve against slow-moving or obsolete inventory is increased or reduced based on several factors which, among other things, require us to make an estimate of a product's life-cycle, potential demand and our ability to sell these products at estimated price levels. While we make considerable efforts to calculate reasonable estimates of these variables, actual results may vary. If there were to be a sudden and significant decrease in demand for our products, or if there were a higher incidence of inventory obsolescence because of changing technology and customer requirements, we could be required to increase our inventory allowances, and our gross profit could be adversely affected.

Share-Based Payments

We estimate the fair value of stock options using the Black-Scholes option pricing model, which requires certain estimates, including an expected forfeiture rate and expected term of options granted. We also make decisions regarding the method of calculating expected volatilities and the risk-free interest rate used in the option-pricing model. The resulting calculated fair value of stock options is recognized as compensation expense over the requisite service period, which is generally the vesting period. When there are changes to the assumptions used in the option-pricing model, including fluctuations in the market price of our common stock, there will be variations in the calculated fair value of our future stock option awards, which results in variation in the compensation cost recognized.

IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

After evaluating the recent accounting pronouncements through the date of this filing, the Company has concluded that their application will have no material impact on the Company's financial results.

CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except par value)

	December 31, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 17,192	\$ 55,509
Marketable securities	3,200	—
Receivables, net of allowance for doubtful accounts of \$129 and \$60, as of December 31, 2013 and 2012 respectively	9,378	8,388
Inventories	10,758	9,584
Distributor channel inventories	1,520	1,289
Deferred income taxes	3,325	3,148
Prepaid expenses and other assets	2,693	1,369
Total current assets	48,066	79,287
Long-term marketable securities	22,326	—
Long-term inventories, net	551	1,955
Property and equipment, net	1,825	1,708
Intangibles, net	3,710	4,258
Goodwill	3,472	3,472
Deferred income taxes	1,024	1,195
Other assets	87	64
Total assets	\$ 81,061	\$ 91,939
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 2,730	\$ 2,302
Accrued liabilities	1,761	2,143
Income taxes payable	—	14,782
Deferred product revenue	4,158	3,593
Total current liabilities	8,649	22,820
Deferred rent	286	422
Other long-term liabilities	1,791	2,029
Total liabilities	10,726	25,271
Shareholders' equity:		
Common stock, par value \$0.001, 50,000,000 shares authorized, 8,986,080 and 9,163,462 shares issued and outstanding as of December 31, 2013 and 2012, respectively	9	9
Additional paid-in capital	41,311	40,430
Accumulated other comprehensive income	23	—
Retained earnings	28,992	26,229
Total shareholders' equity	70,335	66,668
Total liabilities and shareholders' equity	\$ 81,061	\$ 91,939

See accompanying notes

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(Dollars in thousands, except per share amounts)

	Year ended December 31,	
	2013	2012
Revenue	\$ 49,592	\$ 46,417
Cost of goods sold	19,735	19,089
Gross profit	29,857	27,328
Operating expenses:		
Sales and marketing	8,896	8,112
Research and product development	7,562	8,261
General and administrative	6,416	6,934
Proceeds from litigation, net	(639)	(38,500)
Total operating expenses	22,235	(15,193)
Operating income	7,622	42,521
Other income, net	147	34
Income before income taxes	7,769	42,555
Provision for income taxes	(2,590)	(15,908)
Net income	\$ 5,179	\$ 26,647
Basic earnings per common share	\$ 0.57	\$ 2.93
Diluted earnings per common share	\$ 0.55	\$ 2.89
Basic weighted average shares outstanding	9,064,340	9,107,234
Diluted weighted average shares outstanding	9,455,518	9,214,685
Comprehensive income:		
Net income	\$ 5,179	\$ 26,647
Other comprehensive income:		
Unrealized gain on available-for-sale securities, net of tax of \$13	23	—
Comprehensive income	\$ 5,202	\$ 26,647

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Dollars in thousands)

	Common Stock			Accumulated Other Comprehensive Income	Retained Earnings (Accumulated Deficit)	Total Shareholders' Equity
	Shares	Amount	Additional Paid-in Capital			
As of December 31, 2011	9,098,152	\$ 9	\$ 40,073	\$ —	\$ (418)	\$ 39,664
Exercise of stock options	159,869	—	489	—	—	489
Stock repurchased	(94,744)	—	(384)	—	—	(384)
Tax benefit - stock option	—	—	10	—	—	10
Stock-based compensation	—	—	241	—	—	241
Employee stock purchase plan	185	—	1	—	—	1
Net income	—	—	—	—	26,647	26,647
As of December 31, 2012	9,163,462	9	40,430	—	26,229	66,668
Exercise of stock options	122,650	—	489	—	—	489
Stock repurchased	(300,087)	—	—	—	(2,416)	(2,416)
Tax benefit - stock option	—	—	96	—	—	96
Stock-based compensation	—	—	296	—	—	296
Employee stock purchase plan	55	—	—	—	—	—
Unrealized gain on available-for-sale securities, net of tax of \$13	—	—	—	23	—	23
Net income	—	—	—	—	5,179	5,179
As of December 31, 2013	8,986,080	\$ 9	\$ 41,311	\$ 23	\$ 28,992	\$ 70,335

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

	Year ended December 31,	
	2013	2012
Cash flows from operating activities:		
Net income	\$ 5,179	\$ 26,647
Adjustments to reconcile net income to net cash provided by (used in) operations:		
Depreciation and amortization expense	1,422	1,917
Amortization of deferred rent	(110)	(41)
Stock-based compensation expense	296	241
Provision for doubtful accounts	69	25
Write-down of inventory to net realizable value	996	1,235
Loss on disposal of assets	49	—
Tax benefit from exercise of stock options	(104)	(2)
Changes in operating assets and liabilities:		
Receivables	(1,059)	44
Inventories	(998)	447
Deferred income taxes	(6)	(1,457)
Prepaid expenses and other assets	(1,251)	(652)
Accounts payable	428	(512)
Accrued liabilities	(408)	(130)
Income taxes payable	(14,782)	14,492
Deferred product revenue	565	189
Other long-term liabilities	(238)	1,481
Net cash provided by (used in) operating activities	(9,952)	43,924
Cash flows from investing activities:		
Purchase of property and equipment	(1,040)	(574)
Purchase of marketable securities	(25,502)	—
Payment towards business acquisitions	—	(4,632)
Net cash used in investing activities	(26,542)	(5,206)
Cash flows from financing activities:		
Proceeds from the exercise of stock options	489	490
Tax benefit from the exercise of stock options	104	2
Treasury stock purchased	(2,416)	(384)
Net cash provided by (used in) financing activities	(1,823)	108
Net increase (decrease) in cash and cash equivalents	(38,317)	38,826
Cash and cash equivalents at the beginning of the period	55,509	16,683
Cash and cash equivalents at the end of the period	\$ 17,192	\$ 55,509
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$ 18,021	\$ 1,393

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year ended December 31,	
	2013	2012
The Company acquired the business of VCON Video Conferencing, Ltd. in February 2012 for \$4,632 and recorded the following assets and liabilities:		
Inventory	\$ —	\$ 40
Property and equipment	—	34
Product warranty liability	—	(8)
Proprietary software	—	2,247
Goodwill	—	2,319
Cash paid	\$ —	\$ 4,632

See accompanying notes

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except share and 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 company that designs, develops and sells conferencing, collaboration, streaming and digital signage solutions for audio and visual communications. The performance and simplicity of its advanced comprehensive solutions offer unprecedented levels of functionality, reliability and scalability.

Basis of Presentation:

Fiscal Year – This report on Form 10-K includes financial statements for the years ended December 31, 2013 and 2012.

Consolidation – These consolidated financial statements include the financial statements of ClearOne, Inc. and its wholly owned subsidiaries. All inter-company accounts and transactions have been eliminated in consolidation. Certain prior year amounts have been reclassified to conform to the current year presentation.

Use of Estimates – The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and expenses during the reporting periods. Key estimates in the accompanying consolidated financial statements include, among others, revenue recognition, allowances for doubtful accounts and product returns, provisions for obsolete inventory, valuation of long-lived assets, and deferred income tax asset valuation allowances. Actual results could differ materially from these estimates.

Foreign Currency Translation – The U.S. Dollar is used as the functional currency for our subsidiaries in the United Kingdom, Hong Kong and Israel. However, the Company's foreign subsidiaries have certain assets, liabilities and cash flows that are subject to foreign currency risk. Gains or losses arising on re-measurement of foreign currency denominated assets and liabilities are not significant and are included in the Company's Statement of Operations under "Other income, net".

Concentration Risk – We depend on an outsourced manufacturing strategy for our products. We outsource the manufacture of all of our products to third-party manufacturers located in both the U.S. and Asia. If any of these manufacturers experience difficulties in obtaining sufficient supplies of components, component prices significantly exceeding the anticipated costs, an interruption in their operations, or otherwise suffer capacity constraints, we would experience a delay in production and shipping of these products which would have a negative impact on our revenues. Should there be any disruption in services due to natural disaster, economic or political difficulties, transportation restrictions, acts of terror, quarantine or other restrictions associated with infectious diseases, or other similar events, or any other reason, such disruption may have a material adverse effect on our business. Operating in the international environment exposes us to certain inherent risks, including unexpected changes in regulatory requirements and tariffs, and potentially adverse tax consequences, which could materially affect our results of operations. Currently, we have no second source of manufacturing for a portion of our products.

Significant Accounting Policies:

Cash Equivalents – The Company considers all highly-liquid investments with a maturity of three months or less, when purchased, to be cash equivalents. The Company places its temporary cash investments with high-quality financial institutions. At times, such investments may be in excess of the Federal Deposit Insurance Corporation insurance limits.

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.

A decline in the market value of any available-for-sale security below cost that is deemed other than temporary results in a charge to earnings and establishes a new cost basis for the security. Losses are charged against “Other income” when a decline in fair value is determined to be other than temporary. We review several factors to determine whether a loss is other than temporary. These factors include, but are not limited to: (i) the extent to which the fair value is less than cost and the cause for the fair value decline, (ii) the financial condition and near term prospects of the issuer, (iii) the length of time a security is in an unrealized loss position and (iv) our ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value. There were no other-than-temporary impairments recognized during the years ended December 31, 2013 and 2012.

Accounts Receivable – Accounts receivable are recorded at the invoiced amount. Generally, credit is granted to customers on a short-term basis without requiring collateral, and as such, these accounts receivable, do not bear interest, although a finance charge may be applied to such receivables that are past due. The Company extends credit to customers who it believes have the financial strength to pay. The Company has in place credit policies and procedures, an approval process for sales returns and credit memos, and processes for managing and monitoring channel inventory levels.

The allowance for doubtful accounts is the Company’s best estimate of the amount of probable credit losses in the Company’s existing accounts receivable. Management regularly analyzes accounts receivable including current aging, historical write-off experience, customer concentrations, customer creditworthiness, and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. We review customer accounts quarterly by first assessing accounts with aging over a specific duration and balance over a specific amount. We review all other balances on a pooled basis based on past collection experience. Accounts identified in our customer-level review as exceeding certain thresholds are assessed for potential allowance adjustment if we conclude the financial condition of that customer has deteriorated, adversely affecting their ability to make payments. Delinquent account balances are written off if the Company determines that the likelihood of collection is not probable. If the assumptions that are used to determine the allowance for doubtful accounts change, the Company may have to provide for a greater level of expense in future periods or reverse amounts provided in prior periods.

The Company’s allowance for doubtful accounts activity for the years ended December 31, 2013 and 2012 was as follows:

	Year ended December 31,	
	2013	2012
Balance at beginning of the year	\$ 60	\$ 149
Charged to costs and expenses	96	25
Write offs, net of recoveries	(27)	(114)
Balance at end of the year	<u>\$ 129</u>	<u>\$ 60</u>

Inventories – Inventories are valued at the lower of cost or market, with cost computed on a first-in, first-out (“FIFO”) basis. In addition to the price of the product purchased, the cost of inventory includes the Company’s internal manufacturing costs, including warehousing, engineering, material purchasing, quality and product planning expenses and applicable overhead, not

in excess of estimated realizable value. Consideration is given to obsolescence, excessive levels, deterioration, direct selling expenses, and other factors in evaluating net realizable value.

Distributor channel inventories include products that have been delivered to customers for which revenue recognition criteria have not been met.

The inventory also includes advance replacement units (valued at cost) provided by the Company to end-users to service defective products under warranty. The value of advance replacement units included in the inventory was \$45 and \$39, as of December 31, 2013 and 2012, respectively.

Property and Equipment – Property and equipment are stated at cost less accumulated depreciation and amortization. Expenditures that materially increase values or capacities or extend useful lives of property and equipment are capitalized. Routine maintenance, repairs, and renewal costs are expensed as incurred. Gains or losses from the sale, trade-in or retirement of property and equipment are recorded in current operations and the related book value of the property is removed from property and equipment accounts and the related accumulated depreciation and amortization accounts. Estimated useful lives are generally two to ten years. Depreciation and amortization are calculated over the estimated useful lives of the respective assets using the straight-line method. Leasehold improvement amortization is computed using the straight-line method over the shorter of the lease term or the estimated useful life of the related assets.

Goodwill and Intangible Assets – Intangible assets acquired in a purchase business combination are amortized over their useful lives unless these lives are determined to be indefinite. Intangible assets are carried at cost, less accumulated amortization. Amortization is computed over the estimated useful lives of the respective assets, which are generally three to ten years. Goodwill represents the excess of costs over the fair value of net assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized. In accordance with the provisions of FASB ASC Topic 350, *Intangibles – Goodwill and Other*, the Company tests goodwill and other intangible assets with indefinite lives for impairment at least annually at the beginning of the fourth quarter, or sooner if a triggering event occurs suggesting possible impairment of the values of these assets. Impairment testing for these assets involves a two-step process. In the first step, the fair value of the reporting unit holding the assets is compared to its carrying amount. If the carrying amount of the reporting unit exceeds its fair value, the second step of the impairment test is performed to measure the amount of the impairment loss, if any. In the second step, the fair value of the reporting unit is allocated to all of its assets and liabilities, including intangible assets and liabilities not recorded on the balance sheet. The excess, if any, of the fair value of the reporting unit over the sum of the fair values allocated to identified assets and liabilities is the value of goodwill to be compared to its carrying value (See Note 3 – Business Combinations, Goodwill and Intangibles). ClearOne and all of its subsidiaries are considered as one reporting unit for this purpose.

Impairment of Long-Lived Assets – Long-lived assets, such as property, equipment, and definite-lived intangibles subject to depreciation and amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset or asset group to estimated future undiscounted net cash flows of the related asset or group of assets over their remaining lives. If the carrying amount of an asset exceeds its estimated future undiscounted cash flows, an impairment charge is recognized for the amount by which the carrying amount exceeds the estimated fair value of the asset. Impairment of long-lived assets is assessed at the lowest levels for which there are identifiable cash flows that are independent of other groups of assets. The impairment of long-lived assets requires judgments and estimates. If circumstances change, such estimates could also change.

Revenue Recognition – Product revenue is recognized when (i) the products are shipped, (ii) persuasive evidence of an arrangement exists, (iii) the price is fixed and determinable, and (iv) collection is reasonably assured.

The Company provides a right of return on product sales to certain distributors and other resellers under a product rotation program. Under this seldom-used program, once a quarter, a distributor or reseller is allowed to return products purchased during the prior 180 days for a total value generally not exceeding 15% of the distributor's or reseller's net purchases during the preceding quarter. The distributor or reseller is, however, required to place a new purchase order for an amount not less than the value of products returned under the stock rotation program. When products are returned, the associated revenue, cost of goods sold, inventory and accounts receivable originally recorded are reversed. When the new order is fulfilled, the revenue, associated cost of goods sold, inventory and accounts receivable are recorded and the product revenue is subject to the deferral analysis described below. In a small number of cases, the distributors are also permitted to return products for other business reasons.

Revenue from product sales to distributors is not recognized until the return privilege has expired or until it can be determined with reasonable certainty that the return privilege has expired, which approximates when product is sold-through to customers of the Company's distributors (dealers, system integrators, value-added resellers, and end-users) rather than when the product is initially shipped to a distributor. At each quarter-end, the Company evaluates the inventory in the channel through information provided by our distributors. The level of inventory in the channel will fluctuate up-ward or down-ward each quarter, based upon our distributors' individual operations. Accordingly, at each quarter-end, the deferral for revenue and associated cost of goods sold are calculated and recorded based upon the actual channel inventory reported at quarter-end. Further, with respect to distributors and other channel partners not reporting the channel inventory, the revenue and associated cost of goods sold are deferred until the Company receives payment for the product sales made to such distributors or channel partners.

The amount of deferred cost of goods sold is included in distributor channel inventories.

The details of deferred revenue and associated cost of goods sold and gross profit are as follows:

	As of December 31,	
	2013	2012
Deferred revenue	\$ 4,158	\$ 3,593
Deferred cost of goods sold	1,520	1,289
Deferred gross profit	\$ 2,638	\$ 2,304

The Company offers rebates and market development funds to certain of its distributors, dealers/resellers, and end-users based upon the volume of product purchased by them. The Company records rebates as a reduction of revenue in accordance with GAAP.

The Company provides, at its discretion, advance replacement units to end-users on defective units of certain products under warranty. Since the purpose of these units is not revenue generating, the Company tracks the units due from the end-user, valued at retail price, until the defective unit has been returned, but no receivable balance is maintained on the Company's balance sheet.

Sales and Similar Taxes - Taxes collected from customers and remitted to government authorities are reported on a net basis and thus are excluded from revenues.

Shipping and Handling Costs – Shipping and handling billed to customers is recorded as revenue. Shipping and handling costs are included in cost of goods sold.

Warranty Costs – The Company accrues for warranty costs based on estimated warranty return rates and estimated costs to repair. Factors that affect the Company's warranty liability include the number of units sold, historical and anticipated rates of warranty returns, and repair cost. The Company reviews the adequacy of its recorded warranty accrual on a quarterly basis.

The details of changes in the Company’s warranty accrual are as follows:

	Year ended December 31,	
	2013	2012
Balance at the beginning of year	\$ 385	\$ 467
Accruals/additions	433	443
Usage/claims	(480)	(525)
Balance at end of year	<u>\$ 338</u>	<u>\$ 385</u>

Advertising – The Company expenses advertising costs as incurred. Advertising costs consist of trade shows, magazine advertisements, and other forms of media. Advertising expenses for the years ended December 31, 2013 and 2012 totaled \$472 and \$525, respectively, and are included under the caption “Sales and Marketing”.

Research and Product Development Costs – The Company expenses research and product development costs as incurred.

Income Taxes – The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carry-forwards. These temporary differences will result in deductible or taxable amounts in future years when the reported amounts of the assets or liabilities are recovered or settled. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided when it is more likely than not that some or all of the deferred tax assets may not be realized. The Company evaluates the realizability of its net deferred tax assets on a quarterly basis and valuation allowances are provided, as necessary. Adjustments to the valuation allowance increase or decrease the Company’s income tax provision or benefit. As of December 31, 2013 and 2012, the Company had a valuation allowance of \$378 and \$270 against capital loss carryovers, foreign net operating losses, and state research and development credits, respectively.

The Company follows the provisions contained in ASC Topic 740, *Income Taxes*. The Company recognizes the tax benefit from an uncertain tax position only if it is at least more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position.

Judgment is required in determining the provision for income taxes and related accruals, deferred tax assets and liabilities. In the ordinary course of business, there are transactions and calculations where the ultimate tax outcome is uncertain. Additionally, the Company’s tax returns are subject to audit by various tax authorities. Although the Company believes that its estimates are reasonable, actual results could differ from these estimates.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Earnings Per Share – The following table sets forth the computation of basic and diluted earnings per common share:

	Year ended December 31,	
	2013	2012
Numerator:		
Net income	\$ 5,179	\$ 26,647
Denominator:		
Basic weighted average shares	9,064,340	9,107,234
Dilutive common stock equivalents using treasury stock method	391,178	107,451
Diluted weighted average shares	9,455,518	9,214,685
Basic earnings per common share:	\$ 0.57	\$ 2.93
Diluted earnings per common share:	\$ 0.55	\$ 2.89
Weighted average options outstanding	1,128,045	1,197,487
Anti-dilutive options not included in the computation	149,773	681,820

Share-Based Payment – We estimate the fair value of stock options using the Black-Scholes option pricing model, which requires certain estimates, including an expected forfeiture rate and expected term of options granted. We also make decisions regarding the method of calculating expected volatilities and the risk-free interest rate used in the option-pricing model. The resulting calculated fair value of stock options is recognized as compensation expense over the requisite service period, which is generally the vesting period. When there are changes to the assumptions used in the option-pricing model, including fluctuations in the market price of our common stock, there will be variations in the calculated fair value of our future stock option awards, which results in variation in the compensation cost recognized.

Recent Accounting Pronouncements

After evaluating the recent accounting pronouncements through the date of this filing, the Company has concluded that their application will have no material impact on the Company's financial results.

2. 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 security at December 31, 2013 were as follows:

<i>(In thousands)</i>	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Estimated fair value
December 31, 2013				
Available-for-sale securities:				
Corporate bonds and notes	\$ 18,832	\$ 68	\$ (43)	\$ 18,857
Municipal bonds	6,658	22	(11)	6,669
Total available-for-sale securities	\$ 25,490	\$ 90	\$ (54)	\$ 25,526

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Maturities of marketable securities classified as available-for-sale securities were as follows at December 31, 2013:

<i>(In thousands)</i>	Amortized cost	Estimated fair value
Due within one year	\$ 3,198	\$ 3,200
Due after one year through five years	20,711	20,737
Due after five years through ten years	1,581	1,589
Total available-for-sale securities	\$ 25,490	\$ 25,526

Debt securities in an unrealized loss position as of December 31, 2013 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. The available-for-sale marketable securities in a gross unrealized loss position as of December 31, 2013 are summarized as follows:

<i>(In thousands)</i>	<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 December 31, 2013						
Corporate bonds and notes	\$ 204	\$ (1)	\$ 6,687	\$ (42)	\$ 6,891	\$ (43)
Municipal bonds	355	(1)	1,125	(10)	1,480	(11)
	<u>\$ 559</u>	<u>\$ (2)</u>	<u>\$ 7,812</u>	<u>\$ (52)</u>	<u>\$ 8,371</u>	<u>\$ (54)</u>

3. Business Combinations, Goodwill and Intangibles

Acquisition of video conferencing business

On February 16, 2012, the Company completed the acquisition of the video conferencing business of Israel-based VCON Video Conferencing, Ltd. ("VCON") through an asset purchase agreement. VCON was a pioneer in software-based video conferencing solutions with product offerings that include group video conferencing endpoints, desktop video conferencing endpoints, video conferencing infrastructure solutions and software development kits. This acquisition and the combination of streaming and digital signage technologies have provided us with complementary technology opportunities allowing us to enter new growth markets.

Pursuant to the asset purchase agreement, the Company paid consideration of \$4,632 in cash. The fair values of assets acquired and liabilities assumed are based on the information that was available during the measurement period of twelve months from the date of acquisition. The fair value of identified assets and liabilities acquired and goodwill is as follows:

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	<u>Fair Value</u>
Inventory	40
Property and equipment	34
Product warranty liability	(8)
Proprietary software	2,247
Goodwill	2,319
	<u>4,632</u>

The goodwill of \$2,319 is composed of expected synergies in utilizing VCON technology in ClearOne product offerings, reduction in future combined research and development expenses, and intangible assets including acquired workforce that do not qualify for separate recognition. This goodwill balance is not deductible for tax purposes.

Unaudited Supplemental Pro Forma information for the acquisition is as follows:

- 1) Revenue and net loss from the video conferencing business from February 16, 2012 to December 31, 2012 were \$1,319 and (\$1,170), respectively.
- 2) Revenue and earnings of the combined entity for the years ended December 31, 2013 and 2012 calculated as though the business combination occurred prior to the year ended December 31, 2012, were as follows:

	<u>Year ended December 31,</u>	
	<u>2013</u>	<u>2012</u>
Revenue	\$ 49,592	46,630
Net income	5,179	26,603

- 3) There were no material, nonrecurring pro forma adjustments directly attributable to the acquisition included in this supplemental Pro Forma information.

Goodwill

Changes in the carrying amount of the company's goodwill for the years ended December 31, 2013 and 2012 were as follows:

	<u>2013</u>	<u>2012</u>
Balance as of January 1,		
Goodwill	\$ 3,472	\$ 1,153
Accumulated impairment losses	—	—
	<u>3,472</u>	<u>1,153</u>
Goodwill acquired during the year	—	2,319
Balance as of December 31,		
Goodwill	3,472	3,472
Accumulated impairment losses	—	—
	<u>\$ 3,472</u>	<u>\$ 3,472</u>

Intangible Assets

Intangible assets as of December 31, 2013 and 2012 consisted of the following:

	Estimated useful lives	As of December 31,	
		2013	2012
Tradename	7 years	\$ 435	\$ 435
Patents and technological know-how	10 years	2,070	2,070
Proprietary software	3 to 15 years	2,961	2,961
In-process research and development	Indefinite	—	159
Other	5 years	208	49
		5,674	5,674
Accumulated amortization		(1,964)	(1,416)
		3,710	4,258

During the years ended December 31, 2013 and 2012, amortization of these intangible assets were \$548 and \$679, respectively.

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

Years ending December 31,	
2014	\$ 559
2015	515
2016	477
2017	389
2018	374
Thereafter	1,396
	\$ 3,710

4. Inventories

Inventories, net of reserves, consisted of the following:

	As of December 31,	
	2013	2012
Current:		
Raw materials	\$ 1,362	\$ 734
Finished goods (including distributor channel inventories)	10,916	10,139
	\$ 12,278	\$ 10,873
Long-term:		
Raw materials	\$ 227	\$ 891
Finished goods	324	1,064
	\$ 551	\$ 1,955

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 have developed programs to reduce the inventory to normal operating levels in the near future. 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.

Current finished goods include distributor channel inventories in the amounts of approximately \$1,520 and \$1,289 as of December 31, 2013 and 2012, respectively. Distributor channel inventories represent inventory at distributors and other customers where revenue recognition criteria have not been achieved.

The losses incurred on valuation of inventory at the lower of cost or market value and write-off of obsolete inventory amounted to \$996 and \$1,235 during the years ended December 31, 2013 and 2012, respectively.

5. Property and Equipment

Major classifications of property and equipment and estimated useful lives were as follows:

	Estimated useful lives	As of December 31,	
		2013	2012
Office furniture and equipment	3 to 10 years	\$ 6,676	\$ 9,552
Leasehold improvements	1 to 6 years	1,429	1,413
Manufacturing and test equipment	2 to 10 years	2,681	2,673
		10,786	13,638
Accumulated depreciation and amortization		(8,961)	(11,930)
Property and equipment, net		\$ 1,825	\$ 1,708

Depreciation and amortization expense on property and equipment for the years ended December 31, 2013 and 2012 was \$874 and \$1,238, respectively.

6. 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 was \$909 and \$973, including amortization of deferred rent of \$110 and \$42, for the years ended December 31, 2013 and 2012, respectively.

We currently occupy a 31,000 square-foot facility in Salt Lake City, Utah under the terms of an operating lease expiring in May 2016 which supports our principal administrative, sales, 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 December 2017, which serves as our primary inventory fulfillment and repair center and digital signage product assembly workshop. Our earlier lease of a 24,000 square-foot warehouse in Salt Lake City terminated in January 2012.

We leased a warehouse measuring approximately 5,600 square-feet in Hong Kong to support our partners and customers located in the Asia-Pacific region. This operating lease expired February 2014 and has not been renewed. This warehouse is maintained to support our partners and customers located in the Asia-Pacific region.

We occupy an 11,100 square-foot facility in Austin, Texas under the terms of an operating lease expiring in August 2016, which serves as an additional facility to support our administrative, sales, marketing, customer support, and research and development activities.

We currently lease a 4,700 square foot office facility in Hod Hasharon, Israel to primarily support our research and development activities. We previously leased a 1,000 square foot warehouse in Tzur Yigal. The Hod Hasharon lease expired in December 2013 and was renewed for an additional 24-month period. Upon expiration, we will have the option to extend the lease for two to four additional years. The Tzur Yigal lease expired in August 2013 and was not renewed.

We entered into a new lease agreement in March 2014 for a manufacturing and office facility in Alachua, Florida measuring approximately 46,000 square feet for a period of two years with an option to extend the lease by two more years. The Alachua facility will primarily be used to manufacture our wireless microphone products and to support this business.

Future minimum lease payments under non-cancellable operating leases with initial terms of one year or more are as follows:

Years ending December 31,		
2014	\$	914
2015		945
2016		581
2017		260
2018		91
Thereafter		91
Total minimum lease payments	\$	<u>2,882</u>

7. Accrued Liabilities

Accrued liabilities consist of the following:

	As of December 31,	
	2013	2012
Accrued salaries and other compensation	\$ 783	\$ 1,345
Other accrued liabilities	978	798
Total	\$ <u>1,761</u>	\$ <u>2,143</u>

8. Commitments and Contingencies

We establish contingent liabilities when a particular contingency is both probable and estimable. The Company is not aware of any pending claims or assessments, other than as described below, which may have a material adverse impact on the Company's financial position or results of operations.

Outsource Manufacturers. We have manufacturing agreements with electronics manufacturing service ("EMS") providers related to the outsourced manufacturing of our products. Certain manufacturing agreements establish annual volume commitments. We are also obligated to repurchase Company-forecasted but unused materials. The Company has non-cancellable, non-returnable, and long-lead time commitments with its EMS providers and certain suppliers for inventory components that will be used in production. The Company's purchase commitments under such agreements is approximately \$2,862 as of December 31, 2013.

Uncertain Tax Positions. As further discussed in Note 12 - Income Taxes of the Notes to Consolidated Financial Statements, we have adopted the provisions of Accounting Standards Codification ASC 740. We had \$1,901 of uncertain tax positions as of December 31, 2013. Due to the inherent uncertainty of the underlying tax positions, it is not possible to forecast the payment of this liability to any particular year.

Legal Proceedings. In addition to the legal proceedings described below, we are also involved from time to time in various claims and other legal proceedings which arise in the normal course of our business. Such matters are subject to many uncertainties and outcomes that are not predictable. However, based on the information available to us, we do not believe any such proceedings will have a material adverse effect on our business, results of operations, financial position, or liquidity, except as described below.

Former Officer Indemnification

In July 2007 and January 2008, the U.S. Attorney for the District of Utah indicted two of our former officers, Frances Flood (“Flood”) and Susie Strohm (“Strohm”), for allegedly causing us to issue materially misstated financial statements for our 2001 and 2002 fiscal years and for perjury in connection with the investigation by the SEC into the alleged misstatements. In December 2003, we entered into indemnification agreements with each former officer, requiring payment of all reasonable attorneys’ fees and costs incurred in defending against the charges in certain circumstances consistent with and subject to limitations imposed by our bylaws and applicable law. To date, we have paid approximately \$3,630 in attorneys’ fees and costs to defend against the charges. In February 2009, Flood was convicted on nine counts and Strohm was convicted on one count. In June 2010, Flood was sentenced to four years in prison and three years of probation and Strohm was sentenced to two years of probation plus 150 hours of community service. In April 2011, the Tenth Circuit Court of Appeals in Denver affirmed Flood’s conviction, but has allowed her to assert in a collateral proceeding her claim that she received ineffective assistance of counsel. In November 2011, the Tenth Circuit affirmed Strohm’s perjury conviction as well.

Flood: In August 2008, Flood filed a lawsuit in Federal District Court for the District of Utah, seeking to compel us to pay her attorneys’ fees and costs to defend against the criminal charges. The District Court issued a preliminary injunction in January 2009 requiring us to pay Flood’s criminal legal fees and costs through trial. Pursuant to the Court’s order, ClearOne paid approximately \$373 to Flood’s attorneys and approximately \$248 into the Court’s escrow. In July 2009, ClearOne asserted counterclaims against Flood and sought to recover \$3,390 plus interest, costs and attorneys’ fees.

The Tenth Circuit Court of Appeals issued a ruling in August 2010 vacating the District Court’s preliminary injunction on the grounds that it rested on a legally erroneous interpretation of Flood’s Employment Separation Agreement. ClearOne filed a motion in the United States District Court for the District of Utah seeking a return of the monies paid by ClearOne pursuant to the Court’s order. The District Court granted ClearOne’s motion in January 2012 for return of the \$248 held in the Court’s escrow, but denied ClearOne’s motion with respect to the \$373 paid to Flood’s attorneys.

ClearOne filed a motion for summary judgment in August 2012 seeking dismissal of Flood’s claims and judgment on our own claims against Flood. On or about March 1, 2013, Flood filed for bankruptcy in the U.S. Bankruptcy Court for the Eastern District of Virginia. On March 19, 2013, the US District Court for the District of Utah issued an order staying this case.

Strohm: Strohm and her counsel (“Dorsey”) filed a lawsuit in August 2008 in the Third Judicial District Court in Salt Lake City, Utah seeking to compel us to pay Strohm’s attorneys’ fees and costs to defend her against the criminal charges, plus interest, and for attorneys’ fees in connection with the civil action. ClearOne asserted counterclaims against Strohm in August 2009 seeking to recover \$3,296 plus interest, costs and attorneys’ fees.

The District Court entered Judgment against ClearOne in June 2011 for \$973 in fees and expenses in the criminal case, plus \$362 in interest at 18% through February 1, 2011, which amounts were paid by ClearOne under protest to Dorsey on February 1, 2011. The Judgment also included \$865 in civil case fees and expenses plus interest. ClearOne has posted a cash bond to cover the civil case fees and interest pending ClearOne’s appeal. ClearOne as well as Dorsey appealed against the judgment. The Utah Supreme Court heard oral arguments in September 2012.

On April 9, 2013, the Utah Supreme Court issued its Opinion declaring that Strohm’s attorney, Dorsey, is not entitled to recover any attorneys’ fees or expenses in connection with its civil action against ClearOne but that Dorsey is entitled to recover post-verdict criminal fees incurred in connection with Strohm’s sentencing and appeal. On April 23, 2013, Dorsey filed a petition for rehearing with the Utah Supreme Court seeking to recover its attorneys’ fees and expenses incurred in obtaining court-ordered indemnification for Strohm. Dorsey has further requested that the Court reverse its public policy ruling that Dorsey is not entitled to attorneys’ fees and expenses in connection with its civil action against ClearOne. In early August 2013, the Utah Supreme Court denied Dorsey’s petitions for rehearing.

Theft of Intellectual Property and Related Cases

In January 2007, we filed a lawsuit in the Third Judicial District Court, Salt Lake County, Utah against WideBand Solutions, Inc. (“WideBand”) and two of its principals, Dr. Jun Yang, and Andrew Chiang for misappropriation of our trade secrets (the “Trade Secret Case”). We also brought claims against Biamp Systems Corporation, Inc. (“Biamp”). The litigation eventually included other defendants, namely Lonny Bowers, Donald Bowers, David Sullivan, Dial HD and Versatile DSP. The matter was subsequently removed to federal court. The United States District Court, District of Utah, Central Division.

The litigation involved various appeals filed by all parties extended to various state courts, federal courts and the federal appeal court. The court found the defendants guilty of willfully and maliciously misappropriating our trade secrets. Various awards were made in ClearOne's favor and against the defendants. Biamp settled with us and paid \$3,860 after we won the appeal in the Tenth Circuit court. We also settled with one of the defendants and received \$250 in February 2012. We have various awards against other defendants amounting to approximately \$7,658 owed jointly and severally by them. While we intend to vigorously pursue collection of these outstanding awards, there can be no assurance that we will ultimately collect on all or a portion of these awards.

ARS Special Arbitration

We filed separate arbitration proceedings against UBS Financial Services, Inc. (“UBS”) and Morgan Stanley & Co., Inc. (“Morgan Stanley”) with the Financial Industry Regulatory Authority (“FINRA”) pursuant to the Auction Rate Securities (“ARS”) Special Arbitration Procedures established by FINRA. At the relevant time, we held an aggregate of \$12,200 in ARS from UBS and Morgan Stanley, which turned out to be illiquid. In October 2008, we accepted offers to repurchase our \$12,200 of ARS, at par value, from these two investment banks that sold them to us pursuant to the settlement agreements, but did not waive any claims for consequential damages. In both arbitration proceedings, we sought consequential damages as a result of our inability to access funds invested in ARS that UBS and Morgan Stanley sold to us, including losses with respect to a planned strategic business acquisition and related due diligence costs. No claims were asserted against us by UBS or Morgan Stanley.

With respect to the Morgan Stanley arbitration, the arbitration panel denied our claims in their entirety. With respect to the UBS arbitration under a different panel, we settled the dispute for a total amount of \$45 million in December 2012. The settlement award was subject to a 15% contingency legal fee of \$6.75 million which was also paid in December 2012 to our litigation counsel.

Conclusion

These legal proceedings are subject to all of the risks and uncertainties of legal proceedings and there can be no assurance as to the probable result of the legal proceedings.

The Company believes it is adequately accrued for the aforementioned contingent liabilities. While we intend to defend ourselves in the above matters vigorously and diligently, there exists the possibility of adverse outcomes that we estimate could be up to \$1,000 over and above amounts already provided for. If these adverse outcomes were to occur, our financial position, results of operations and cash flows could be negatively affected materially for the period in which the adverse outcomes are known.

9. Share-Based Payments

The Company's share-based compensation primarily consists of two share-based compensation plans, one which was replaced on November 20, 2007, and one which became active on the same date. The plans are described below.

The Company's 1998 Incentive Plan (the "1998 Plan") had shares of common stock available for issuance to employees and directors. Through December 1999, 1,066,000 options were granted that would cliff vest after 9.8 years; however, such vesting was accelerated for 637,089 of these options upon meeting certain earnings per share goals through the fiscal year ended June 30, 2003. Subsequent to December 1999 and through June 2002, 1,248,250 options were granted that would cliff vest after 6.0 years; however, such vesting was accelerated for 300,494 of these options upon meeting certain earnings per share goals through the fiscal year ended June 30, 2005.

The Company also has a 2007 Equity Incentive Plan (the "2007 Plan"). Provisions of the 2007 Plan include the granting of up to 1,000,000 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. Under both plans, one new share is issued for each stock option exercised.

Of the options granted subsequent to June 2002, all vesting schedules are based on 3 or 4-year vesting schedules, with either one-third or one-fourth vesting on the first anniversary and the remaining options vesting ratably over the remainder of the vesting term. Generally, directors and officers have 3-year vesting schedules and all other employees have 4-year vesting schedules. Additionally, in the event of a change in control or the occurrence of a corporate transaction, the Company's Board of Directors has the authority to elect that all unvested options shall vest and become exercisable immediately prior to the event or closing of the transaction. All options outstanding as of December 31, 2013 had contractual lives of ten years. Under the 1998 Plan, 2,500,000 shares were authorized for grant. As of December 31, 2013, there were 550,000 options outstanding under the 1998 Plan, which includes the cliff vesting and 3 or 4-year vesting options discussed above. As of December 31, 2013, there were 561,274 options outstanding under the 2007 Plan. As of December 31, 2013, the 2007 Plan had 259,154 authorized unissued options, while there were no options remaining that could be granted under the 1998 Plan.

The Company also has an Employee Stock Purchase Plan ("ESPP"). Employees can purchase common stock through payroll deductions of up to 10 percent of their base pay. Amounts deducted and accumulated by the employees are used to purchase shares of common stock on or about the first day of each month. The Company contributes to the account of the employee one share of common stock for every nine shares purchased by the employee under the ESPP.

The Company uses judgment in determining the fair value of the share-based payments on the date of grant using an option-pricing model with assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the risk-free interest rate of the awards, the expected life of the awards, the expected volatility over the term of the awards, and the expected dividends of the awards. The Company uses the Black-Scholes option pricing model to determine the fair value of share-based payments granted under the guidelines of ASC Topic 718.

In applying the Black-Scholes methodology to the options granted, the Company used the following assumptions:

	Year ended December 31,	
	2013	2012
Risk-free interest rate, average	1.8%	1.3%
Expected option life, average	6.8 years	7.2 years
Expected price volatility, average	49.8%	51.4%
Expected dividend yield	—%	—%

The risk-free interest rate is determined using the U.S. Treasury rate in effect as of the date of the grant, based on the expected life of the stock option. The expected life of the stock option is determined using historical data.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The expected price volatility is determined using a weighted average of daily historical volatility of the Company's stock price over the corresponding expected option life. The Company does not currently intend to distribute any dividend payments to shareholders.

Under guidelines of ASC Topic 718, the Company recognizes compensation cost net of an expected forfeiture rate and recognized the associated compensation cost for only those awards expected to vest on a straight-line basis over the underlying requisite service period. The Company estimated the forfeiture rates based on its historical experience and expectations about future forfeitures.

The following table shows the stock option activity:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
As of December 31, 2012	1,137,283	\$ 4.63		
Granted	127,500	8.52		
Expired and canceled	(4,323)	4.03		
Forfeited prior to vesting	(26,536)	4.73		
Exercised	(122,650)	3.99		
As of December 31, 2013	1,111,274	\$ 5.15	4.86	\$ 4,016
Vested and Expected to Vest at December 31, 2013	1,111,274	\$ 5.15	4.86	\$ 4,016
Vested at December 31, 2013	850,159	\$ 4.76	3.62	\$ 3,395

The weighted average per share fair value of options granted during the years ending December 31, 2013 and 2012 was \$4.38 and \$2.16 respectively. The total intrinsic value of options exercised during the years ended December 31, 2013 and 2012 was \$448 and \$152, respectively.

The total pre-tax compensation cost related to stock options recognized during the years ended December 31, 2013 and 2012 was \$296 and \$241, respectively. Tax benefit from compensation cost related to stock options during the years ended December 31, 2013 and 2012 was \$86 and \$18, respectively. As of December 31, 2013, the total compensation cost related to stock options not yet recognized and before the effect of any forfeitures was \$784, which is expected to be recognized over approximately the next 2.6 years on a straight-line basis.

Stock Repurchase Program

In May 2012, our Board of Directors authorized a stock repurchase program to purchase the Company's common stock in the open market. A total of 300,087 and 94,744 shares costing \$2,416 and \$384 were purchased under this program during the years ended December 31, 2013 and 2012. The cost of shares purchased is recorded as a reduction to shareholders' equity. As of December 31, 2013, the Company was authorized to purchase approximately \$7.2 million worth of additional shares in the open market.

10. Significant Customers

Sales to significant customers that represented more than 10 percent of total revenues are as follows:

	Year ended December 31,	
	2013	2012
Customer A	18.2 %	17.5 %
Customer B	10.8 %	*
Total	29.0 %	17.5 %

* Sales didn't exceed 10% of the revenue.

The following table summarizes the percentage of total gross accounts receivable from significant customers:

	As of December 31,	
	2013	2012
Customer A	24.9 %	20.3 %
Customer B	12.4 %	*
Total	37.3 %	20.3 %

These customers facilitate product sales to a large number of end-users, none of which is known to account for more than 10 percent of the Company's revenue from product sales. Nevertheless, the loss of one or more of these customers could reduce revenue and have a material adverse effect on the Company's business and results of operations.

11. 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 quoted prices in active markets or based on other observable inputs. The following table sets forth the fair value of the financial instruments re-measured by the Company as of December 31, 2013:

	Level 1	Level 2	Level 3	Total
<i>(In thousands)</i>				
December 31, 2013				
Corporate bonds and notes	\$ —	\$ 18,857	\$ —	\$ 18,857
Municipal bonds	—	6,669	—	6,669
Total	\$ —	\$ 25,526	\$ —	\$ 25,526

12. Income Taxes

Consolidated income before taxes for domestic and foreign operations consisted of the following:

	Year ended December 31,	
	2013	2012
Domestic	8,714	42,990
Foreign	(945)	(435)
Total	7,769	42,555

The Company's (provision) for income taxes consisted of the following:

	Year ended December 31,	
	2013	2012
Current:		
Federal	\$ (1,993)	\$ (16,910)
State	(765)	(381)
Foreign	144	(74)
Total current	(2,614)	(17,365)
Deferred:		
Federal	202	455
State	(234)	46
Foreign	165	160
	133	661
Change in valuation allowance	(109)	796
Total deferred	24	1,457
(Provision) for income taxes	\$ (2,590)	\$ (15,908)

The income tax (provision) differs from that computed at the federal statutory corporate income tax rate as follows:

	Year ended December 31,	
	2013	2012
Tax (provision) at Federal statutory rate	\$ (2,642)	\$ (14,894)
State income tax (provision), net of federal benefit	(293)	(1,476)
Research and development tax credits	616	357
Foreign earnings or losses taxed at different rates	(170)	(136)
Other	8	(555)
Change in valuation allowance	(109)	796
Tax (provision)	\$ (2,590)	\$ (15,908)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The tax effects of significant temporary differences representing net deferred tax assets and liabilities consisted of the following:

	As of December 31, 2013		As of December 31, 2012	
	Current	Long-term	Current	Long-term
Deferred revenue	\$ 971	\$ —	\$ 856	\$ —
Basis difference in intangible assets	—	82	—	159
Inventory reserve	1,955	—	1,871	—
Net operating loss carryforwards	—	682	—	667
Research and development tax credits	—	31	—	248
Accrued expenses	159	—	140	—
Stock-based compensation	—	679	—	684
Allowance for sales returns and doubtful accounts	47	—	20	—
Difference in property and equipment basis	—	(388)	—	(475)
Other	458	51	462	(19)
Total net deferred income tax asset	3,590	1,137	3,349	1,264
Less: Valuation allowance	(265)	(113)	(201)	(69)
Net deferred income tax asset (liability)	\$ 3,325	\$ 1,024	\$ 3,148	\$ 1,195

The Company has not provided for U.S. deferred income taxes or foreign withholding taxes on undistributed earnings of its non-U.S. subsidiaries since these earnings are intended to be reinvested indefinitely, in accordance with guidelines contained in ASC Topic 740, *Accounting for Income Taxes*. It is not practical to estimate the amount of additional taxes that might be payable on such undistributed earnings.

In accordance with ASC Topic 740, the Company analyzed its valuation allowance at December 31, 2013 and determined that, based upon available evidence, it is more likely than not that certain of its deferred tax assets may not be realized and, as such, has established a valuation allowance against certain deferred tax assets. These deferred tax assets include capital loss carryovers, state research and development credits, and Hong Kong net operating loss carryforwards.

The statute allowing a federal research and development credit (the "R&D Credit") expired for years beginning after December 31, 2011. Congress renewed the R&D Credit for the years 2012 and 2013 with the American Taxpayer Relief Act of 2012 (the "Act"). Accounting guidance requires that the effects of a change in tax law be recognized in the period that includes the enactment date. For U.S. federal tax purposes, the enactment date of the Act is the date the President signs the bill into law. The President did not sign the Act into law until January 2, 2013. Therefore, the benefit for the 2012 R&D credit was recognized in the first quarter of 2013 as a discrete tax benefit. The total amount of 2012 federal R&D credit benefit recognized in 2013 was \$277.

As of December 31, 2013, the Company had state research credit carryforwards of \$34, which will begin to expire in 2027 if not utilized. The Company has federal net operating loss ("NOL") carryforwards of approximately \$1,118 (pre-tax) and Hong Kong NOL carryforwards of approximately \$1,827 (pre-tax). The federal NOL carryforwards will begin to expire in 2025. The Hong Kong NOL carryforwards do not expire.

Effective July 1, 2007, the Company adopted the accounting standards related to uncertain tax positions. This standard requires that tax positions be assessed using a two-step process. A tax position is recognized if it meets a "more likely than not" threshold, and is measured at the largest amount of benefit that is greater than 50 percent likely of being realized. Uncertain tax positions must be reviewed at each balance sheet date. Liabilities recorded as a result of this analysis must generally be recorded separately from any current or deferred income tax accounts.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The total amount of unrecognized tax benefits at December 31, 2013 and 2012, that would favorably impact our effective tax rate if recognized was \$623 and \$802, respectively. As of December 31, 2013 and 2012, we accrued \$51 and \$56, respectively, in interest and penalties related to unrecognized tax benefits. We account for interest expense and penalties for unrecognized tax benefits as part of our income tax provision.

Although we believe our estimates are reasonable, we can make no assurance that the final tax outcome of these matters will not be different from that which we have reflected in our historical income tax provisions and accruals. Such difference could have a material impact on our income tax provision and operating results in the period in which we make such determination.

A reconciliation of the beginning and ending amount of liabilities associated with uncertain tax positions is as follows:

	Year ended December 31,	
	2013	2012
Balance - beginning of year	\$ 2,384	\$ 523
Additions based on tax positions related to the current year	84	795
Additions for tax positions of prior years	45	1,082
Reductions for tax positions of prior years	(518)	—
Settlements	—	—
Lapse in statutes of limitations	(94)	(16)
Uncertain tax positions, ending balance	\$ 1,901	\$ 2,384

The Company's U.S. federal income tax returns for 2010 through 2013 are subject to examination. The Company also files in various state and foreign jurisdictions. With few exceptions, the Company is no longer subject to federal, state, or non-U.S. income tax examinations by tax authorities for years prior to 2010. The Company completed its audit by the Internal Revenue Service ("IRS") for its 2006 tax return in 2010. As a result of the audit by the IRS, there were no material adjustments made to the Company's tax return.

The Inland Revenue Department of Hong Kong, a Special Administrative Region (the "IRD"), commenced an examination of the Company's Hong Kong profits tax returns for 2009 through 2011 in the fourth quarter of 2012 that is anticipated to be completed by the end of 2014. The Company does not anticipate the examination will result in a material change to its financial position. During the next twelve months, it is reasonably possible that the amount of the Company's unrecognized income tax benefits could change significantly. These changes could be the result of our ongoing tax audits or the settlement of outstanding audit issues. However, due to the issues being examined, at the current time, an estimate of the range of reasonably possible outcomes cannot be made, beyond amounts currently accrued.

13. Geographic Sales Information

The United States was the only country to contribute more than 10 percent of total revenues in each fiscal year. The Company's revenues are substantially denominated in U.S. dollars and are summarized geographically as follows:

	Year ended December 31,	
	2013	2012
United States	\$ 32,292	\$ 30,312
All other countries	17,300	16,105
Total	\$ 49,592	\$ 46,417

13. Subsequent Events

Agreement to Acquire Spontania:

On January 7, 2014, we entered into an agreement to acquire Spontania from Spain-based Dialcom Networks, S.L. in an all-cash deal for €3.65 million (approximately US \$5.00 million). Spontania is a software-based cloud collaboration solution which combines the benefits of video conferencing and web conferencing into a unique, effective and powerful enterprise solution that can scale to tens of thousands of users.

The addition of Spontania is expected to make ClearOne the only company offering an entirely software-based video conferencing product line that provides on-premise and cloud-based Software-as-a-Service (SaaS) and Platform-as-a-Service (PaaS) solutions and is expected to complement ClearOne's existing premise-based, enterprise video conferencing offering, COLLABORATE® obtained from the VCON acquisition. ClearOne plans to fund the acquisition of substantially all of the assets of the Spontania business with available cash and will not assume any debt or cash. The acquisition is expected to close by the end of the first quarter of 2014, subject to customary closing conditions, including applicable regulatory approvals.

Acquisition of Sabine, Inc.:

On March 7, 2014, we completed the acquisition of Sabine, Inc. which will provide the company with reliable and exclusive access to the wireless microphones that are a critical component of ClearOne's complete microphone portfolio. Under the terms of the transaction, ClearOne paid approximately \$7.20 million in cash and approximately \$1.50 million in ClearOne shares. In addition, ClearOne paid off Sabine debt of \$1.25 million and may be required to make earn-out payments over the next three years, based on achievement of certain performance criteria. ClearOne expects to maintain Sabine operations at its current headquarters in Alachua, Florida.

CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), is recorded, processed, summarized, and reported within the required time periods, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Principal Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. As required by Rule 13a-15 under the Exchange Act, we have completed an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and the Principal Financial Officer, of the effectiveness and the design and operation of our disclosure controls and procedures as of December 31, 2013. Our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives and, based upon this evaluation, our Chief Executive Officer and Principal Financial Officer concluded that, as of the end of the period covered by this Annual Report, our disclosure controls and procedures are effective at a reasonable assurance level.

The effectiveness of any system of disclosure controls and procedures is subject to certain limitations, including the exercise of judgment in designing, implementing, and evaluating the controls and procedures, the assumptions used in identifying the likelihood of future events, and the inability to eliminate improper conduct completely. A controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. As a result, there can be no assurance that our disclosure controls and procedures will detect all errors or fraud.

Management’s Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with United States generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2013 based on the framework set forth in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our assessment using that criteria, management concluded that the design and operation of our internal control over financial reporting were effective as of December 31, 2013.

This annual report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial reporting. Management’s report was not subject to attestation by our independent registered public accounting firm pursuant to the rules of the SEC applicable to smaller reporting companies.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the fourth fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of ClearOne, Inc.

We have audited the accompanying consolidated balances sheets of ClearOne, Inc. and subsidiaries (the Company) as of December 31, 2013 and 2012, and the related consolidated statements of income and comprehensive income, shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ClearOne, Inc. and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

/s/ MCGLADREY LLP

Irvine, California
March 19, 2014

CORPORATE INFORMATION

BOARD OF DIRECTORS

Zeynep Hakimoglu
Chairman
President and CEO
ClearOne

Brad R. Baldwin
President and CEO
First Utah Bank

Larry R. Hendricks
Formerly VP of Finance and GM
Daily Foods, Inc.

Scott M. Huntsman
CEO
Martin Doors

CORPORATE OFFICERS

Zeynep Hakimoglu
Chairman
President and CEO

Narsi Narayanan
Senior Vice President of Finance
and Corporate Secretary

Michael J. Braithwaite
Senior Vice President of
Multimedia Streaming Business

CORPORATE HEADQUARTERS

Edgewater Corporate Park
South Tower
5225 Wiley Post Way
Suite 500
Salt Lake City, UT 84116
801.975.7200

CORPORATE COUNSEL

Seyfarth Shaw, LLP
700 Louisiana St.
Suite 3700
Houston, TX 77002
713.225.1337

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

McGladrey LLP
18401 Von Karman Avenue
5th Floor
Irvine, CA 92612
949.255.6500

TRANSFER AGENT

Broadridge Corporate
Issuer Solutions
1717 Arch Street
Suite 1300
Philadelphia, PA 19103

SECURITIES LISTING

The company's common stock trades on the NASDAQ Capital Market under the symbol of CLRO

NASDAQ
L I S T E D

INVESTOR RELATIONS

PondelWilkinson Inc.
1880 Century Park East
Suite 700
Los Angeles, CA 90067
310.279.5980
investor@pondel.com

FORWARD-LOOKING INFORMATION Statements contained in this Annual Report, which are not historical facts, are forward-looking statements, as defined in the Private Securities Litigation Reform Act of 1995, and as such, are subject to risk and uncertainties which can cause actual results to differ materially from those currently anticipated. Readers are referred to the documents filed by ClearOne Communications with the Securities and Exchange Commission, specifically the most recent reports on forms 10-K and 10-Q, including amendments thereto, which identify important risk factors that could cause actual results to differ from those contained in the forward-looking statements.



Great ideas need to be heard

and [^]seen

ClearOne

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South Tower
Suite 500
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Salt Lake City, UT 84116

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