# 2012 ANNUAL REPORT

ClearOne's COLLABORATE® soft-codec-based video conferencing is a complete portfolio featuring desktop video applications, room systems, infrastructure, and management solutions coupled with our industry-leading audio processing to enable natural collaboration— as if everyone were face-to-face.

Soft-Codec-Based Video Conferencing

ClearOne's newest VIEW® Pro multimedia streaming system delivers the ultimate in high-quality, 4:4:4 true-color media distribution on existing IP networks and is unmatched in scalability and ease of deployment. MagicBox Digital signage players and software packages provide both on-premise and cloud solutions for SMBs— delivering the right message to the right people at the right time.

Multimedia Streaming and Signage

ClearOne's CHAT® and INTERACT® AT series are full lines of USB-based voice-conferencing products for PCs, while MAX® tabletop speakerphones are designed for more traditional analog and VoIP conferencing. Our broad portfolio of award-winning UC voice products covers applications from the desktop to the small working conference room— each solution boasting ClearOne's unmatched, rich audio performance.

UC Voice and Telephony

Professional Audio

ClearOne's CONVERGE® Pro and INTERACT® Pro systems provide state-of-the-art technology for large-scale audio conferencing such as boardrooms, auditoriums, telemedicine theaters, courtrooms and distance-learning. Our products enable flexibility, scalability and best-in-class legacy voice quality for any audio conferencing application.

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:

Your company continues to grow, creating value for you. We have taken significant steps to accelerate our growth thanks to the vision of our management team, the support of the board of directors, the enthusiasm of our partners, the creative energy of our employees and the trust of our shareholders.

Our vision and strategy are working. By managing our business with a relentless focus on operational excellence, growth through innovation and sensible use of hard-earned growth capital, we have been able to deliver profitable performance and solid returns. In the nine years since I became CEO, we have turned around our fortunes:

Growing Shareholder Wealth

- Of the $45 million damages award received in the first quarter of 2013 related to the auction rate securities sold to ClearOne, we have retained approximately $24.4 million after paying legal fees and taxes.
- Following the above mentioned settlement, the Board voted to repurchase up to $10 million of ClearOne stock, of which we have repurchased $2.8 million already. Since relisting in 2006, we have repurchased nearly $20 million or about 30 percent of the company's outstanding stock.

Generating Revenue Growth and Maintaining Profitability

- We grew revenues from $35.7 million in 2009 (twelve months ended December 31, 2009) to $48.4 million in 2013 (twelve months ended September 30, 2013), while maintaining gross margins of about 60% and consistently generating positive cash flow.
- With a debt-free balance sheet and a demonstrated ability to generate growth, we are constantly evaluating prudent options to invest capital to grow revenue and expand our footprint in the audio/visual industry either through strategic acquisitions or internal investments.

Our ability to post this strong performance is a testament to our core strategy, which relies on a strategically-built portfolio of innovative and profitable products to drive long-term returns. We will continue to allocate a portion of our resources to drive these new growth opportunities.

Our performance is also a testament to the strength of the market in which we operate. We have worked to intercept the needs of a changing market place with smart products and new technology. We recognized that there would always be a global appetite for smart solutions to evolving business challenges, and we aligned our company to meet those needs head on. Today, we see the global demand for our new and innovative products growing.

We have entered new markets with one of the best sales channels in our industry. We continue to enhance our sales channels to capture greater market share by focusing on emerging geographies and building new partnerships with many of the largest global and regional information technology distributors. Our new product offerings give our sales partners new opportunities to increase their revenue by selling more products to their existing customers.

Technology Leadership

ClearOne began with a focus on the niche installed audio conferencing market where we have been quite successful. In fact most Fortune 500 companies use ClearOne installed audio products, and we have about a 50% share of the nearly $65 million plus installed audio market.

We grew to play a key role in the unified communications, audio end points market, expanding the market for our audio products to about $450 million. Building on this success and our financial strength, we have expanded our focus to include other related audio visual markets through three acquisitions, VCON, NetStreams and MagicBox. These acquisitions provided video and network technologies that are highly complementary to and fortify our flagship voice conferencing solutions and are being integrated with our existing technologies to expand the breadth and depth of our solutions.

As the paradigm shift from hardware to cost-effective software-based video communication gains momentum, these acquired technologies are poised to play a key role in our growth and provide ClearOne access to a growing $5 billion plus market.

Today, ClearOne holds more than 90 issued and pending patents, up from fewer than 10 in 2004. This intellectual property is a very valuable part of the company and we are committed to our ongoing R&D investments to enhance our product line and to continue to defend our proprietary technologies.

Putting Legacy Problems Behind Us

Since I became CEO in 2004, our management team, board of directors and all of our talented employees have worked diligently to eliminate the legacy problems that once threatened ClearOne's viability. The following is a sample of our success in overcoming these challenges:

- During 2004 and 2005, we reconstructed and filed 3 years of audited financial results.
- In August 2007, we completed the arduous, multi-year task of earning back our NASDAQ listing.
- We defended and prevailed in litigation related to the theft of our trade secrets and recovered nearly $4.0 million out of an $11.6 million judgment awarded to us.
- ClearOne, with our legal team, implemented an aggressive strategy to halt the payment of unnecessary criminal defense fees claimed by two former officers, saving the company hundreds of thousands of dollars. We secured an arbitration settlement of $45 million for damages resulting from the freezing of auction rate securities.

We believe that ClearOne is at the forefront of a very unique moment in our markets. We are confident that we have positioned our company with the right technologies, product mix, human capital and sales channel to maximize our shareholder value and to continue to growth shareholder wealth.

Milestones Ahead

When I look back at where ClearOne was when I became CEO – delisted from NASDAQ and with an ongoing SEC investigation, among other complications – compared to where we are today, I am grateful for the support of my management team, employees, board of directors and shareholders. The initiatives described above are a direct result of the growth strategies we put in place together. Today, we see our remarkable performance as a validation of those strategies and as an exciting preview of what's to come. We will continue to forge ahead, and in 2014, we expect to see our newest video solutions fortify our growth plans and help ensure a continuation of our strong financial performance.

We invite you to join us in this exciting growth opportunity and to closely watch our progress during the year ahead. As a team, we look forward to executing our strategies to continue to drive the growth and value of the company. We appreciate your support.

Zee Hakimoglu
President and Chief Executive Officer
ClearOne, Inc.

## SELECTED FINANCIAL DATA

(Dollars in thousands, except per share data)

| Year ended December 31, | 2012 | 2011 | 2010 |
|---|---|---|---|
| Revenue | $ 46,417 | $ 46,067 | $ 41,284 |
| Operating income | $ 42,521 | $ 10,572 | $ 1,797 |
| Net income | $ 26,647 | $ 6,929 | $ 2,374 |
| Diluted earnings per share | $ 2.89 | $ 0.75 | $ 0.27 |
| Cash and cash equivalents | $ 55,509 | $ 16,683 | $ 11,431 |
| Total Assets | $ 91,939 | $ 49,559 | $ 43,981 |
| Shareholders' equity | $ 66,668 | $ 39,664 | $ 31,735 |

## QUARTERLY STOCK PRICE

Our common stock has been 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.

| Year ended December 31, | 2012 | | 2011 | |
|---|---|---|---|---|
| | High | Low | High | Low |
| Q1 - Jan 1 to Mar 31 | $ 5.20 | $ 4.14 | $ 7.49 | $ 3.75 |
| Q2 - Apr 1 to Jun 30 | 4.72 | 3.70 | 9.20 | 5.91 |
| Q3 - Jul 1 to Sep 30 | 4.26 | 3.70 | 7.73 | 4.90 |
| Q4 - Oct 1 to Dec 31 | 4.76 | 3.76 | 5.51 | 3.95 |

On March 21, 2013, the closing price for our common stock as reported on the NASDAQ Capital Market was $6.88.

As of March 21, 2013, there were 9,121,314 shares of our common stock issued and outstanding and held by approximately 369 shareholders of record. This number includes each broker dealer and clearing corporation that holds shares for customers as a single shareholder.

We have not paid a cash dividend on our common stock and do not anticipate doing so in the foreseeable future. We intend to retain earnings to fund future working capital requirements, infrastructure needs, growth, product development, and our stock repurchase program.

## SHARE REPURCHASES

In May 2012, our Board of Directors authorized a stock repurchase program. Under the program, we were authorized to repurchase up to $3 million of our outstanding common stock. In February of 2013, the Board updated the program by authorizing an increase in the amount available for the stock repurchase program from $3 million to $10 million. 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. We may suspend or discontinue the stock repurchase program 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 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 both large 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 September 6, 2011, ClearOne acquired the business of MagicBox, Inc. (MagicBox), a manufacturer of hardware and software solutions delivering digital content and information to digital displays. Under the terms of an asset purchase agreement with MagicBox, an Oregon corporation, ClearOne paid approximately $980 thousand in cash consideration for all the assets, including intellectual property, fixed assets and current assets of MagicBox and assumed no debt.

MagicBox was a manufacturer of small-scale digital signage and video messaging systems for public or private broadcast. As a result of this acquisition, we now design digital signage and video messaging systems that emphasize ease-of-use with the flexibility and power to take on any task. Custom hardware and software packages allow customers to design and deliver solutions online.

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 in consideration for all the assets, including intellectual property, fixed assets and inventory, and assumed no debt.

**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” set forth in our Annual Report on Form 10-K for the year ended December 31, 2012.

**STRATEGY**

We currently participate in the following markets:

- Professional audio visual, including audio conferencing and video conferencing;
- 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, 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 and control distribution;
- 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 include (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 70% and 73% of our consolidated revenue in 2012 and 2011, 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 840, Converge Pro 8i, Converge Pro TH20 and Converge Pro VH20, 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 communicate on systems for enhanced collaboration.

### *Professional Microphones*

The ClearOne Ceiling Microphone Array introduced in November 2011 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 22% of our consolidated revenue in both 2012 and 2011.

### *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 speaker phones, but features 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 speaker phones 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 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. Unique features of our software-based video endpoint solutions include:

- Embedded multipoint video conferencing;
- Embedded SIP/H.323 bridging interoperability with all leading standards-based hardware and software video conferencing endpoints;
- Built-in recording and streaming;
- Built-in remote content and data sharing; and
- Built-in interactive multicast.

We believe the video-conferencing industry is moving towards software-based solutions for a variety of reasons as software-based solutions:

- Offer higher scalability and capacity at lower cost than hardware-based solutions;
- Enable faster implementation time for new, latest or custom features;
- Allow easy customization for different needs of vertical markets;
- Offer easy upgrades and seamless feature additions after the initial investment;
- Offer more flexibility to expand with business growth;
- Are more highly secured for IT infrastructure requirements;
- Allow the use of existing equipment and infrastructure with easier installation and maintenance;
- Achieve a higher return on investment with multiple capabilities and applications in a single-box solution; and
- Facilitate easier migration to user-friendly devices (e.g. tablets, phones, MAC, PC, etc.).

*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, its 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. Using the Composer software application 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, 2012, approximately $30.3 million, or 65% of our total product sales, were generated in the United States and product sales of approximately $16.1 million, or 35% of our total product sales, were generated outside the United States. Revenue from product sales to customers outside of the United States accounted for approximately 37% of our total product sales for the year ended December 31, 2011. 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 600 distributors and direct resellers throughout the world during 2012. 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, that represented approximately 17.5% of consolidated revenue during the year ended December 31, 2012. During the year ended December 31, 2011, revenues included sales to two distributors, Starin Marketing and VSO Marketing, that represented 30% of our consolidated revenue, with each of these distributors accounting for more than 10 percent of the consolidated revenue during that period. As discussed above, these 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. As of December 31, 2012, our shipped orders on which we had not recognized revenue were $3.6 million and our backlog of unshipped orders was approximately $621,000.

**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.

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 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 $8.3 million during the year ended December 31, 2012 and $7.1 million during the year ended December 31, 2011.

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, 2012, we had 145 full-time employees. Of these employees, 88 were located in our Salt Lake City office, 37 in other U.S. locations, and 20 outside the U.S. None of our employees is 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 "Special Note 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 in our Annual Report on Form 10-K for the year ended December 31, 2012 and elsewhere in this report.

### OVERVIEW

Throughout this discussion, we compare results of operations for the year ended December 31, 2012 ("2012") to the year ended December 31, 2011 ("2011" or "the comparable period").

Despite a poor start in the first quarter of 2012 and very little revenue growth in the second and third quarters of 2012, we attained higher revenue in 2012 when compared to 2011 due to a strong finish in the fourth quarter of 2012.

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 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.

Overall revenue increased marginally in 2012 due to the contribution of additional revenue from the businesses acquired in 2011 and 2012 and due to growth in revenue from unified communications audio end points. Revenue from our professional audio communication products declined slightly in 2012. Our gross profit during 2012 declined marginally while our net income surged to $26.6 million from $6.9 million in 2011. Net income in 2012 and 2011 benefited by credits of $38.5 million and $3.7 million, respectively, from litigation proceeds.

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 higher in 2012 when compared to 2011.

The audio visual products market is characterized by intense competition and rapidly evolving technology. Our competitors vary within each product category. The professional audio communication products, which contribute the most to our revenue, despite a small decline in revenues in 2012, continues to perform strongly largely due to our professional microphone products and our popular mid-tier premium conferencing products. Despite our strong leadership position in the professional audio communications products market, we face challenges to revenue growth due to continuing popularity of mid-tier premium conferencing products within the product mix in opposition to higher cost professional conferencing products. Revenue from unified communications audio end points grew in 2012 despite increasing competition in the personal conferencing products market. The additional revenue from visual communication products through acquisitions in 2011 and 2012 contributed to our overall growth.

We expect the recently introduced professional microphone products will complement our professional conferencing products and drive our revenue growth. We intend to increase our penetration of the unified communications audio end points market through deepening and expanding our partnerships with large IT distributors. 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 the momentum derived from the strong fourth quarter in 2012 will continue into 2013 if the underlying global economic conditions do not weaken. Even though our cash position has increased due to the recent receipt of settlement proceeds, recent 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' future against the need to maintain the profitability of the company.

**DISCUSSION OF RESULTS OF OPERATIONS - YEAR ENDED DECEMBER 31, 2012 COMPARED TO YEAR ENDED DECEMBER 31, 2011**

The following table sets forth certain items from our consolidated statements of operations for the years ended December 31, 2012 and 2011, together with the percentage of total revenue which each item represents.

| | Year ended December 31, | | | | Variance Favorable (Unfavorable) | |
|---|---|---|---|---|---|---|
| | 2012 | | 2011 | | | |
| | Amount | % of Revenue | Amount | % of Revenue | Amount | % |
| Revenue | $ 46,417 | 100.0% | $ 46,067 | 100.0% | $ 350 | 0.8% |
| Cost of goods sold | 19,089 | 41.1% | 18,522 | 40.2% | (567) | (3.1)% |
| Gross profit | 27,328 | 58.9% | 27,545 | 59.8% | (217) | (0.8)% |
| Sales and marketing | 8,112 | 17.5% | 8,120 | 17.6% | 8 | 0.1% |
| Research and product development | 8,261 | 17.8% | 7,128 | 15.5% | (1,133) | (15.9)% |
| General and administrative | 6,934 | 14.9% | 5,427 | 11.8% | (1,507) | (27.8)% |
| Proceeds from litigation | (38,500) | (82.9)% | (3,702) | (8.0)% | 34,798 | (940.0)% |
| Operating income | 42,521 | 91.6% | 10,572 | 22.9% | 31,949 | 302.2% |
| Other income, net | 34 | 0.1% | 24 | 0.1% | 10 | 41.7% |
| Income before income taxes | 42,555 | 91.7% | 10,596 | 23.0% | 31,959 | 301.6% |
| Provision for income taxes | (15,908) | (34.3)% | (3,667) | (8.0)% | (12,241) | 333.8% |
| Net income | $ 26,647 | 57.4% | $ 6,929 | 15.0% | $ 19,718 | 284.6% |

**Revenue**

Our revenue was $46.4 million for the year ended December 31, 2012 compared to $46.1 million for the comparable period. Revenue during 2012 increased by approximately $350 thousand, or 0.8%, from the comparable period. The additional revenue in 2012 from visual audio products resulting from our acquisitions and the increase in revenue by 3% from unified communications audio end points contributed to the marginal increase in revenue in 2012. The above increases were partially offset by a decline of 3% in revenue from professional audio communications products. The share of professional audio communications products in our mix decreased from approximately 73% in 2011 to approximately 70% in 2012. During 2012 revenue from Europe, Middle East and Africa grew by 13% while revenue from the Americas declined by 1%.

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 2012 and 2011, the change in deferred revenue based on the movement of inventory in the channel was a deferral of revenue of $190 thousand and a recognition of revenue of $902 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 2012 was approximately $27.3 million compared to approximately $27.5 million in the comparable period, a decrease of 0.8%. The decrease in gross profit was primarily due to increased obsolescence costs associated with inventory. Gross profit margins ("GPM"), or gross profit as a percentage of sales, declined to 59% in 2012 from 60% in 2011.

Our profitability in the near-term continues to depend significantly on our revenues from professional audio communications products. We hold considerable amounts of 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 after excluding net litigation proceeds were $23.3 million in 2012 compared to $20.7 million during the comparable period. Net litigation proceeds were $38.5 million in 2012 compared to $3.7 million in 2011. Following is 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 expense such as employee-related costs, allocations of overhead expenses, trade shows, and other advertising and selling expenses. Total S&M expenses were approximately $8.1 million in both 2012 and 2011. S&M expenses as a percentage of revenue also remained the same in both 2012 and 2011.

**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 $8.3 million in 2012 compared to $7.1 million during the comparable period. As a percentage of revenue, R&D expenses increased to 17.8% in 2012 compared to 15.5% in 2011. The increase in R&D expenses was primarily due to increases in employee-related costs due to recent acquisitions and increased headcount, increase in consulting fees and accelerated amortization of certain R&D assets.

**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 $6.9 million in 2012 compared with approximately $5.4 million in 2011. The increase in G&A expenses was primarily due to special bonuses awarded to key contributors to litigation settlement, increased costs associated with the recently acquired operations of video conferencing business, an increase in amortization of intangibles, an increase in legal expenses. These increases were partially offset by a reduction in bad debts.

**Proceeds from litigation.** 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). We recognized in 2011 income of approximately $3.7 million received from one of our competitors upon our successful litigation in the matter related to the theft of our intellectual property. (See section titled "Theft of our Intellectual Property and Related Cases" under Note 8 - Commitments and Contingencies to our Consolidated Financial Statements).

### (Provision) for income taxes

The tax expense of $15.9 million during 2012 was primarily the result of tax on current year income. This compared to a tax expense of $3.7 million during 2011.

## LIQUIDITY, CAPITAL RESOURCES AND FINANCIAL POSITION

As of December 31, 2012, our cash and cash equivalents were approximately $55.5 million compared to $16.7 million as of December 31, 2011. Our working capital was $56.5 million and $32.7 million as of December 31, 2012 and December 31, 2011, respectively.

Net cash flows provided by operating activities were approximately $43.9 million during 2012, an increase of approximately $38.1 million, compared to $5.8 million in 2011. The increase was primarily due to higher net income resulting from net litigation proceeds, an increase in deferred revenue and increased cash inflows on inventory. These increases in cash inflows were partially offset by outflows on reduced accounts payable.

Net cash flows used in investing activities were $5.2 million during 2012 compared to net cash flows used in investing activities of $1.4 million during 2011. During 2012, the cash outflows on investing activities consisted of the acquisition of VCON's business for $4.6 million and the purchase of property and equipment. During 2011, the cash outflows on investing activities consisted of the acquisition of MagicBox's business for $980 thousand and the purchase of property and equipment. Please refer to Note 3 - Business Combinations, Goodwill and Intangible Assets in the Notes to Consolidated Financial Statements (Part II, Item 8) for details on the acquisitions in 2012 and 2011.

Net cash provided by financing activities in 2012 consisted of proceeds received from the exercise of stock options amounting to $490 thousand and associated tax benefits of $2 thousand, offset by the acquisition of outstanding stock totaling $384 thousand under the stock repurchase program. Net cash provided by financing activities in 2011 consisted of proceeds from the exercise of stock options totaling $747 thousand and associated tax benefits totaling $66 thousand.

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, 2012, we had open purchase orders related to our electronics manufacturing service providers and other contractual obligations of approximately $4.0 million, primarily related to inventory purchases.

At December 31, 2012, we had inventory totaling $12.8 million out of which non-current inventory accounted for $2.0 million. This compares to total inventories of $14.5 million and non-current inventory of $1.9 million as of December 31, 2011. 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 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 major 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 or down 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.

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

| | As of December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Deferred Revenue | $ 3,593 | $ 3,404 |
| Deferred Cost of Goods Sold | 1,289 | 1,199 |
| Deferred Gross Profit | $ 2,304 | $ 2,205 |

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 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. Goodwill of $2.3 million was recorded in connection with the VCON acquisition. There were no impairments recorded in 2012 or 2011 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, 2012 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 $270 thousand. Please refer to Note 11 - 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**

Prior to June 30, 2005, and as permitted under the then existing FASB guidelines under SFAS No. 123, "Accounting for Stock-Based Compensation," we accounted for our share-based payments following the recognition and measurement principles of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," as interpreted. Accordingly, no share-based compensation expense had been reflected in our statements of operations for unmodified option grants since (1) the exercise price equaled the market value of the underlying common stock on the grant date, and (2) the related number of shares to be granted upon exercise of the stock option was fixed on the grant date.

In December 2004, the FASB issued guidelines now contained under FASB ASC Topic 718, "Compensation – Stock Compensation". ASC Topic 718 establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. Primarily, this Topic focuses on accounting for transactions in which an entity obtains employee services in share-based payment transactions. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.

Under ASC Topic 718, we measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the awards – the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service. Therefore, if an employee does not ultimately render the requisite service, the costs associated with the unvested options will not be recognized cumulatively.

Effective July 1, 2005, we adopted the guidelines contained in ASC Topic 718 and its fair value recognition provisions using the modified prospective transition method. Under this transition method, stock-based compensation cost recognized after July 1, 2005 includes the straight-line basis compensation cost for (a) all share-based payments granted prior to July 1, 2005, but not yet vested, based on the grant date fair values used for the pro-forma disclosures under the original SFAS No. 123 and (b) all share-based payments granted or modified on or after July 1, 2005, in accordance with the provisions of ASC Topic 718.

Under ASC Topic 718, we recognize compensation cost net of an anticipated forfeiture rate and recognize the associated compensation cost for those awards expected to vest on a straight-line basis over the requisite service period. We use 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, the expected dividends of the awards, and an estimate of the amount of awards that are expected to be forfeited. If assumptions change in the application of ASC Topic 718 and its fair value recognition provisions in future periods, the stock-based compensation cost ultimately recorded under the guidelines of ASC Topic 718 may differ significantly from what was recorded in the current period.

## IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

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

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

| | December 31, 2012 | December 31, 2011 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 55,509 | $ 16,683 |
| Receivables, net of allowance for doubtful accounts of $60 and $149, as of December 31, 2012 and 2011 respectively | 8,388 | 8,457 |
| Inventories | 10,873 | 12,565 |
| Deferred income taxes | 3,148 | 2,987 |
| Prepaid expenses and other assets | 1,369 | 740 |
| Total current assets | 79,287 | 41,432 |
| Long-term inventories, net | 1,955 | 1,905 |
| Property and equipment, net | 1,708 | 2,338 |
| Intangibles, net | 4,258 | 2,690 |
| Goodwill | 3,472 | 1,153 |
| Deferred income taxes | 1,195 | — |
| Other assets | 64 | 41 |
| Total assets | $ 91,939 | $ 49,559 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 2,302 | $ 2,814 |
| Accrued liabilities | 2,143 | 2,234 |
| Income taxes payable | 14,782 | 300 |
| Deferred product revenue | 3,593 | 3,404 |
| Total current liabilities | 22,820 | 8,752 |
| Deferred income taxes | — | 101 |
| Deferred rent | 422 | 494 |
| Other long-term liabilities | 2,029 | 548 |
| Total liabilities | 25,271 | 9,895 |
| Shareholders' equity: | | |
| Common stock, par value $0.001, 50,000,000 shares authorized, 9,163,462 and 9,098,152 shares issued and outstanding as of December 31, 2012 and 2011, respectively | 9 | 9 |
| Additional paid-in capital | 40,430 | 40,073 |
| Retained earnings (accumulated deficit) | 26,229 | (418) |
| Total shareholders' equity | 66,668 | 39,664 |
| Total liabilities and shareholders' equity | $ 91,939 | $ 49,559 |

*See accompanying notes*

**CONSOLIDATED STATEMENTS OF OPERATIONS**
**(Dollars in thousands, except per share amounts)**

| | Year ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Revenue | $ 46,417 | $ 46,067 |
| Cost of goods sold | 19,089 | 18,522 |
| Gross profit | 27,328 | 27,545 |
| | | |
| Operating expenses: | | |
| Sales and marketing | 8,112 | 8,120 |
| Research and product development | 8,261 | 7,128 |
| General and administrative | 6,934 | 5,427 |
| Proceeds from litigation, net | (38,500 ) | (3,702) |
| Total operating expenses | (15,193 ) | 16,973 |
| | | |
| Operating income | 42,521 | 10,572 |
| Other income, net | 34 | 24 |
| Income before income taxes | 42,555 | 10,596 |
| Provision for income taxes | (15,908 ) | (3,667) |
| Net income | $ 26,647 | $ 6,929 |
| | | |
| Basic earnings per common share | $ 2.93 | $ 0.77 |
| Diluted earnings per common share | $ 2.89 | $ 0.75 |
| | | |
| Basic weighted average shares outstanding | 9,107,234 | 9,027,934 |
| Diluted weighted average shares outstanding | 9,214,685 | 9,271,811 |

*See accompanying notes*

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
## (Dollars in thousands)

| | Common Stock | | Additional Paid-in Capital | Retained Earnings (Accumulated Deficit) | Total Shareholders' Equity |
|---|---|---|---|---|---|
| | Shares | Amount | | | |
| Balances at December 31, 2010 | 8,929,439 | $ 9 | $ 39,073 | $ (7,347 ) | $ 31,735 |
| Exercise of stock options | 168,514 | — | 746 | — | 746 |
| Tax benefit - stock option exercises | — | — | 66 | — | 66 |
| Stock-based compensation expense | — | — | 187 | — | 187 |
| Employee stock purchase plan | 199 | — | 1 | — | 1 |
| Net income | — | — | — | 6,929 | 6,929 |
| Balances at 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 exercises | — | — | 10 | — | 10 |
| Stock-based compensation expense | — | — | 241 | — | 241 |
| Employee stock purchase plan | 185 | — | 1 | — | 1 |
| Net income | — | — | — | 26,647 | 26,647 |
| Balances at December 31, 2012 | 9,163,462 | $ 9 | $ 40,430 | $ 26,229 | $ 66,668 |

*See accompanying notes*

**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Dollars in thousands)**

| | Year ended December 31, | |
|---|---|---|
| | **2012** | **2011** |
| Cash flows from operating activities: | | |
| Net income | $ 26,647 | $ 6,929 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Depreciation and amortization expense | 1,917 | 1,243 |
| Amortization of deferred rent | (41 ) | (23 ) |
| Stock-based compensation expense | 241 | 187 |
| Provision for doubtful accounts | 25 | 312 |
| Write-down of inventory to net realizable value | 1,235 | 188 |
| Loss on disposal of assets | — | 5 |
| Tax benefit from exercise of stock options | (2 ) | — |
| Changes in operating assets and liabilities: | | |
| Receivables | 44 | 1,081 |
| Inventories | 447 | (3,066 ) |
| Deferred income taxes | (1,457 ) | 1,416 |
| Prepaid expenses and other assets | (652 ) | (305 ) |
| Accounts payable | (512 ) | 634 |
| Accrued liabilities | (130 ) | (2,277 ) |
| Income taxes payable | 14,492 | 250 |
| Deferred product revenue | 189 | (902 ) |
| Other long-term liabilities | 1,481 | 127 |
| Net cash provided by operating activities | 43,924 | 5,799 |
| | | |
| Cash flows from investing activities: | | |
| Payment towards business acquisitions | (4,632 ) | (980 ) |
| Purchase of property and equipment | (574 ) | (380 ) |
| Net cash used in investing activities | (5,206 ) | (1,360 ) |
| | | |
| Cash flows from financing activities: | | |
| Proceeds from the exercise of stock options | 490 | 747 |
| Tax benefit from the exercise of stock options | 2 | 66 |
| Treasury stock purchased | (384 ) | — |
| Net cash provided by financing activities | 108 | 813 |
| | | |
| Net increase in cash and cash equivalents | 38,826 | 5,252 |
| Cash and cash equivalents at the beginning of the period | 16,683 | 11,431 |
| Cash and cash equivalents at the end of the period | $ 55,509 | $ 16,683 |
| | | |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for income taxes | $ 1,393 | $ 1,705 |

## CONSOLIDATED STATEMENTS OF CASH FLOWS
## (Dollars in thousands)

| | Year ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Supplemental disclosure of non-cash activities: | | |
| Exchanged accounts receivable from a vendor with accounts payable to the same vendor | $ — | $ 182 |
| Transfer from property and equipment to inventory | — | 78 |
| | | |
| 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 | $ — |
| | | |
| The Company acquired the business of MagicBox, in September 2011, for $980 and recorded the following assets and liabilities: | | |
| Accounts receivable | $ — | $ 81 |
| Inventories | — | 117 |
| Other current assets | — | 12 |
| Accrued expenses | — | (4 ) |
| Property and equipment | — | 9 |
| Intangibles | — | 338 |
| Goodwill | — | 427 |
| Cash paid | $ — | $ 980 |

*See accompanying notes*

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
## (Dollars in thousands, except share and per share amounts)

### 1. Organization – Nature of Operations

ClearOne, Inc., a Utah corporation, and its subsidiaries (collectively, the "Company") develop, manufacture, market, and service a comprehensive line of audio visual products including audio conferencing, video conferencing, streaming and digital signage products. The Company's solutions create a natural communication environment, designed to save organizations time and money by enabling more effective and efficient communication between geographically separated businesses, employees, and customers.

### 2. Summary of Significant Accounting Policies

*Fiscal Year* – This report on Form 10-K includes financial statements for the years ended December 31, 2012 and 2011.

*Consolidation* – These consolidated financial statements include the financial statements of ClearOne, Inc. and its wholly owned subsidiaries. All intercompany 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 remeasurement 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 shipping 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 would 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.

*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.

*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, 2012 and 2011 was as follows:

| | Year ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Balance at beginning of the year | $ 149 | $ 206 |
| Charged to costs and expenses | 25 | 312 |
| Deductions | (114) | (369) |
| Balance at end of the year | $ 60 | $ 149 |

*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.

Consigned inventory includes 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 $39 and $43, as of December 31, 2012 and 2011, 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 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 major 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 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 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 or down 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 consigned inventory.

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

| | As of December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Deferred revenue | $ 3,593 | $ 3,404 |
| Deferred cost of goods sold | 1,289 | 1,199 |
| Deferred gross profit | $ 2,304 | $ 2,205 |

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, | |
|---|---|---|
| | 2012 | 2011 |
| Balance at the beginning of year | $ 467 | $ 363 |
| Accruals/additions | 443 | 439 |
| Usage/claims | (525) | (335) |
| Balance at end of year | $ 385 | $ 467 |

*Advertising* – The Company expenses advertising costs as incurred. Advertising expenses consist of trade shows, magazine advertisements, and other forms of media. Advertising expenses for the years ended December 31, 2012 and 2011, totaled $525 and $482, 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, 2012, the Company had a valuation allowance of $270 against capital loss carryovers, and state research and development credits.

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.

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

| | Year ended December 31, | |
|---|---|---|
| | **2012** | **2011** |
| Numerator: | | |
| Net income | $ 26,647 | $ 6,929 |
| Denominator: | | |
| Basic weighted average shares | 9,107,234 | 9,027,934 |
| Dilutive common stock equivalents using treasury stock method | 107,451 | 243,877 |
| Diluted weighted average shares | 9,214,685 | 9,271,811 |
| Basic earnings per common share: | $ 2.93 | $ 0.77 |
| Diluted earnings per common share: | $ 2.89 | $ 0.75 |
| | | |
| Weighted average options outstanding | 1,197,487 | 1,137,219 |
| Anti-dilutive options not included in the computation | 681,820 | 893,343 |

*Share-Based Payment* – The Company applies FASB ASC Topic 718, *Compensation – Stock Compensation*. ASC Topic 718 establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services. Primarily, ASC Topic 718 focuses on accounting for transactions in which an entity obtains employee services in share-based payment transactions. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.

ASC Topic 718 requires the Company to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the awards – the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service. Therefore, if an employee does not ultimately render the requisite service, the costs associated with the unvested options will not be recognized.

Effective July 1, 2005, the Company adopted guidelines included in ASC Topic 718 and its fair value recognition provisions using the modified prospective transition method. Under this transition method, stock-based compensation cost recognized after July 1, 2005 includes the straight-line basis compensation cost for (a) all share-based payments granted prior to July 1, 2005, but not yet vested, based on the grant date fair values used for the pro-forma disclosures under the original SFAS No. 123, and (b) all share-based payments granted or modified on or after July 1, 2005, in accordance with the provisions of ASC Topic 718. See Note 9 – Share-Based

Payments for information about the Company's various share-based compensation plans, the impact of adoption of ASC Topic 718, and the assumptions used to calculate the fair value of share-based compensation.

If assumptions change in the application of ASC Topic 718 in future periods, the stock-based compensation cost ultimately recorded under ASC Topic 718 may differ significantly from what was recorded in the current period.

*Recent Accounting Pronouncements*

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

**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 will provide 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:

| | | |
|---|---|---|
| Inventory | $ | 40 |
| Property and equipment | | 34 |
| Product warranty liability | | (8) |
| Proprietary software | | 2,247 |
| Goodwill | | 2,319 |
| | $ | 4,632 |

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.

Adjustments were made to the initial purchase price allocation and higher allocation to goodwill was made retroactive to the date of acquisition. The final fair value differed from the initial allocation as follows:

| | Final Fair Value | | Initial Allocation | | Difference | |
|---|---|---|---|---|---|---|
| Inventory | $ | 40 | $ | 320 | $ | (280) |
| Tradename | | — | | 500 | | (500) |
| Patents and technology | | — | | 2,300 | | (2,300) |
| Proprietary software | | 2,247 | | 500 | | 1,747 |
| In-process research and development | | — | | 200 | | (200) |
| Goodwill | | 2,319 | | 786 | | 1,533 |

The decrease in purchase price allocation to intangible assets also resulted in a decrease in amortization charges retrospectively starting with the first quarter of 2012. The decrease in amortization charges in the three month periods ended March 31, June 30 and September 30, 2012, were $25, $75 and $75, respectively.

### *Unaudited Supplemental Pro Forma information*

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 as though the business combination occurred as of January 1, 2011 were as follows:

| | Year ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Revenue | $ 46,630 | $ 47,583 |
| Net income | 26,603 | 6,046 |

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

### *Acquisition of digital signage business*

On September 6, 2011, the Company acquired substantially all the assets of MagicBox, Inc. through an asset purchase agreement.

MagicBox's content management and control technology, along with its industry-leading database integration software complemented ClearOne's StreamNet systems. MagicBox had complementary products to ClearOne for a broad spectrum of applications. StreamNet technology delivers low-latency HD distribution over IP which to ClearOne fits well with MagicBox's content creation, scheduling, database integration and digital signage domain expertise.

Pursuant to the asset purchase agreement, the Company paid Magic Box, Inc. $980 in cash.

The fair value of identified assets and liabilities acquired and goodwill was as follows:

| | |
|---|---|
| Accounts receivable | $ 81 |
| Inventory | 117 |
| Other current assets | 12 |
| Accrued expenses | (4) |
| Property and equipment | 9 |
| Proprietary software | 179 |
| In-process research and development | 159 |
| Goodwill | 427 |
| | $ 980 |

The goodwill of $427 is composed of expected synergies in utilizing MagicBox 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. The goodwill balance of $427 related to the MagicBox acquisition is deductible for tax purposes.

The Company incurred $327 and $167 towards acquisition related expenses, all of which are categorized under General and Administrative expenses in the Consolidated Statements of Operations for years ended December 31, 2012 and 2011, respectively.

Changes in the carrying amount of goodwill for the years ended December 31, 2012 and 2011 are as follows:

| | 2012 | 2011 |
|---|---|---|
| Balance as of January 1, | | |
| Goodwill | $ 1,153 | $ 726 |
| Accumulated impairment losses | — | — |
| | 1,153 | 726 |
| Goodwill acquired during the year | 2,319 | 427 |
| Balance as of December 31, | | |
| Goodwill | 3,472 | 1,153 |
| Accumulated impairment losses | — | — |
| | $ 3,472 | $ 1,153 |

***Intangible Assets***

Intangible assets as of December 31, 2012 and 2011 consisted of the following:

| | Estimated | As of December 31, | |
|---|---|---|---|
| | useful lives | 2012 | 2011 |
| Tradename | 7 years | $ 435 | $ 435 |
| Patents and technological know-how | 10 years | 2,070 | 2,070 |
| Proprietary software | 3 to 15 years | 2,961 | 394 |
| In-process research and development | Indefinite | 159 | 559 |
| Other | 5 years | 49 | 49 |
| | | 5,674 | 3,507 |
| Accumulated amortization | | (1,416) | (817) |
| | | $ 4,258 | $ 2,690 |

During the years ended December 31, 2012 and 2011, amortization of these intangible assets were $679 and $393, respectively.

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

| Years ending December 31, | |
|---|---|
| 2013 | $ 533 |
| 2014 | 528 |
| 2015 | 483 |
| 2016 | 446 |
| 2017 | 357 |
| Thereafter | 1,752 |
| | $ 4,099 |

### 4. Inventories

Inventories, net of reserves, consisted of the following:

| | As of December 31, 2012 | As of December 31, 2011 |
|---|---|---|
| Current: | | |
| Raw materials | $ 734 | $ 1,091 |
| Finished goods | 10,139 | 11,474 |
| | $ 10,873 | $ 12,565 |
| Long-term: | | |
| Raw materials | $ 891 | $ 444 |
| Finished goods | 1,064 | 1,461 |
| | $ 1,955 | $ 1,905 |

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 consigned inventory in the amounts of approximately $1,289 and $1,199 as of December 31, 2012 and 2011, respectively. Consigned inventory represents 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 $1,235 and $188 during the years ended December 31, 2012 and 2011, 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, 2012 | As of December 31, 2011 |
|---|---|---|---|
| Office furniture and equipment | 3 to 10 years | $ 9,552 | $ 9,627 |
| Leasehold improvements | 1 to 6 years | 1,413 | 1,392 |
| Manufacturing and test equipment | 2 to 10 years | 2,673 | 2,590 |
| | | 13,638 | 13,609 |
| Accumulated depreciation and amortization | | (11,930) | (11,271) |
| Property and equipment, net | | $ 1,708 | $ 2,338 |

Depreciation expense for the years ended December 31, 2012 and 2011 was $1,238 and $892, 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 $973 and $762 for the years ended December 31, 2012 and 2011, 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 facility.

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. Our earlier lease for the 24,000 square-foot warehouse in Salt Lake City terminated in January 2012.

We currently lease a warehouse measuring approximately 5,600 square-feet in Hong Kong under an operating lease that expires in February 2014. This warehouse is maintained to support our partners and customers located in the Asia-Pacific region.

We also occupy a 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 two facilities in Israel - a 4,700 square foot office facility in Hod Hasharon to primarily support our research and development activities and a 1,000 square foot warehouse in Tzur Yigal. The Hod Hasharon lease expires in December 2013, with options to extend from two to six years. The Tzur Yigal lease expires in August 2013.

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

| **Years ending December, 31,** | | |
|---|---|---|
| 2013 | $ | 942 |
| 2014 | | 909 |
| 2015 | | 939 |
| 2016 | | 575 |
| 2017 | | 254 |
| Thereafter | | 170 |
| Total minimum lease payments | $ | 3,789 |

**7. Accrued Liabilities**

Accrued liabilities consist of the following:

| | As of December 31, | | | |
|---|---|---|---|---|
| | | 2012 | | 2011 |
| Accrued salaries and other compensation | $ | 1,345 | $ | 987 |
| Other accrued liabilities | | 798 | | 1,247 |
| Total | $ | 2,143 | $ | 2,234 |

**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 $3,980 as of December 31, 2012.

*Unrecognized Tax Benefits.* As further discussed in "Note 11 - Income taxes" of Notes to Consolidated Financial Statements, we have adopted the provisions of Accounting Standards Codification ("ASC") 740. We had $2,384 of unrecognized tax benefits as of December 31, 2012. Due to the inherent uncertainty of the underlying tax positions, it is not possible to assign the liability as of December 31, 2012 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 $3,390 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.

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.

We 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 and has yet to express its decision.

### *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 involving 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, 2012 had contractual lives of ten years. Under the 1998 Plan, 2,500,000 shares were authorized for grant. As of December 31, 2012, there were 578,615 options outstanding under the 1998 Plan, which includes the cliff vesting and 3 or 4-year vesting options discussed above. As of December 31, 2012, there were 558,668 options outstanding under the 2007 Plan. As of December 31, 2012, the 2007 Plan had 357,410 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, | |
|---|---|---|
| | **2012** | **2011** |
| Risk-free interest rate, average | 1.3% | 1.6% |
| Expected option life, average | 7.2 years | 7.15 years |
| Expected price volatility, average | 51.4% | 51.9% |
| 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.

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 |
|---|---|---|---|---|
| Outstanding at December 31, 2011 | 1,160,933 | $ 4.50 | | |
| Granted | 187,000 | 4.06 | | |
| Expired and canceled | (12,440) | 4.93 | | |
| Forfeited prior to vesting | (38,341) | 4.23 | | |
| Exercised | (159,869) | 3.07 | | |
| Outstanding at December 31, 2012 | 1,137,283 | $ 4.63 | 5.47 | $ 256 |
| Vested and expected to vest at December 31, 2012 | 1,137,283 | $ 4.63 | 5.47 | $ 256 |
| Vested at December 31, 2012 | 853,350 | $ 4.71 | 4.26 | $ 232 |

The weighted average per share fair value of options granted during the years ending December 31, 2012 and 2011 was $2.16 and $2.85 respectively. The total intrinsic value of options exercised during the years ended December 31, 2012 and 2011 was $152 and $411, respectively.

The total pre-tax compensation cost related to stock options recognized during the years ended December 31, 2012 and 2011 was $241 and $187, respectively. Tax benefit from compensation cost related to stock options during the years ended December 31, 2012 and 2011 was $18 and $27, respectively. As of December 31, 2012, the total compensation cost related to stock options not yet recognized and before the effect of any forfeitures was $593, which is expected to be recognized over approximately the next 2.8 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 94,744 shares costing $384 have been purchased under this program during the year ended December 31, 2012. No shares were purchased during the year ended December 31, 2011. The cost of shares purchased is recorded as a reduction to shareholders' equity. As of December 31, 2012, the Company was authorized to purchase additional $2,616 worth of 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, | |
|---|---|---|
| | 2012 | 2011 |
| Customer A | 17.5% | 19.2% |
| Customer B | * | 10.9% |
| Total | 17.5% | 30.1% |

* 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, | |
|---|---|---|
| | 2012 | 2011 |
| Customer A | 20.3% | 25.0% |
| Customer B | * | 14.4% |
| Total | 20.3% | 39.4% |

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. Income Taxes

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

| | Year ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Domestic | $ 42,990 | $ 10,318 |
| Foreign | (435) | 278 |
| Total | $ 42,555 | $ 10,596 |

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

| | Year ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Current: | | |
| Federal | $ (16,910) | $ (2,106) |
| State | (381) | (99) |
| Foreign | (74) | (46) |
| Total current | (17,365) | (2,251) |
| Deferred: | | |
| Federal | 455 | (1,271) |
| State | 46 | (23) |
| Foreign | 160 | — |
| | 661 | (1,294) |
| Change in valuation allowance | 796 | (122) |
| Total deferred | 1,457 | (1,416) |
| (Provision) for income taxes | $ (15,908) | $ (3,667) |

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

| | Year ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Tax (provision) at Federal statutory rate | $ (14,894) | $ (3,603) |
| State income tax (provision), net of federal benefit | (1,476) | (162) |
| Research and development tax credits | 357 | 316 |
| Foreign earnings or losses taxed at different rates | (136) | 48 |
| Other | (555) | (266) |
| Change in valuation allowance | 796 | — |
| Tax (provision) | $ (15,908) | $ (3,667) |

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

| | As of December 31, 2012 | | As of December 31, 2011 | |
|---|---|---|---|---|
| | Current | Long-term | Current | Long-term |
| Deferred revenue | $ 856 | $ — | $ 860 | $ — |
| Basis difference in intangible assets | — | 159 | — | (580) |
| Inventory reserve | 1,871 | — | 1,598 | — |
| Net operating loss carryforwards | — | 667 | — | 364 |
| Research and development tax credits | — | 248 | — | 1,033 |
| Accrued expenses | 140 | — | 182 | — |
| Stock-based compensation | — | 684 | — | 742 |
| Allowance for sales returns and doubtful accounts | 20 | — | 56 | — |
| Difference in property and equipment basis | — | (475) | — | (646) |
| Other | 462 | (19) | 291 | 52 |
| Total net deferred income tax asset | 3,349 | 1,264 | 2,987 | 965 |
| Less: Valuation allowance | (201) | (69) | — | (1,066) |
| Net deferred income tax asset (liability) | $ 3,148 | $ 1,195 | $ 2,987 | $ (101) |

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, 2012 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 and state research and development credits.

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 entire benefit of the R&D credit for 2012 will be recognized in the first quarter of 2013, the reporting period that includes the enactment date. The benefit for the 2013 R&D Credit will be recognized for

interim reporting as a part of the forecasted annual effective tax rate. In prior years, the benefit from the R&D Credit has ranged from $288 to $316.

As of December 31, 2012, the Company had state research credit carryforwards of $304, which will begin to expire in 2024 if not utilized. The Company has federal net operating loss ("NOL") carryforwards of approximately $1,489 (pre-tax) and Hong Kong NOL carryforwards of approximately $3,464 (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.

The total amount of unrecognized tax benefits at December 31, 2012 and 2011, that would favorably impact our effective tax rate if recognized was $802 and $523, respectively. As of December 31, 2012 and 2011, we accrued $56 and $24, 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, | |
|---|---|---|
| | 2012 | 2011 |
| Balance - beginning of year | $ 523 | $ 404 |
| Additions based on tax positions related to the current year | 795 | 229 |
| Additions for tax positions of prior years | 1,082 | — |
| Reductions for tax positions of prior years | — | (88) |
| Settlements | — | — |
| Lapse in statutes of limitations | (16) | (22) |
| Unrecognized tax benefits, ending balance | $ 2,384 | $ 523 |

The Company's U.S. federal income tax returns for 2007 through 2012 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 2009. 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 2013. The Company does not anticipate the examination will result in a material change to its financial position. During the next twelve months, the Company anticipates that the Act may result in an increase to its unrecognized tax benefits. No significant reduction from the lapse of statutes of limitations is expected to result.

### 12. 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, | |
|---|---|---|
| | 2012 | 2011 |
| United States | $ 30,312 | $ 29,220 |
| All other countries | 16,105 | 16,847 |
| Total | $ 46,417 | $ 46,067 |

### 13. Subsequent Events

The Company evaluated its Consolidated Financial Statements as of and for the year ended December 31, 2012 for subsequent events through the date the financial statements were issued. The Company is not aware of any other subsequent events which would require recognition or disclosure in the financial statements.

## 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, 2012. 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, 2012 based on the framework 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, 2012.

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 significant 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 balance sheet of ClearOne, Inc. and subsidiaries (the Company) as of December 31, 2012, and the related consolidated statements of operations, shareholders' equity, and cash flows for the year ended December 31, 2012. 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 audit.

We conducted our audit 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 audit 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 audit provides 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, 2012, and the results of their operations and their cash flows for the year ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America.

/s/ MCGLADREY LLP

Irvine, California
March 22, 2013

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

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

We have audited the accompanying consolidated balance sheet of ClearOne Communications, Inc. and subsidiaries (the Company) as of December 31, 2011, and the related consolidated statements of operations, shareholders' equity, and cash flows for the year ended December 31, 2011. The Company's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 audit 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 audit provides 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 Communications, Inc. and subsidiaries as of December 31, 2011, and the results of its operations and its cash flows for the year ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America.

/s/ *JONES SIMKINS, P.C.*

JONES SIMKINS, P.C.
Logan, Utah
March 30, 2012

## CORPORATE INFORMATION

### BOARD OF DIRECTORS

**Zeynep Hakimoglu**
Chairman
President and CEO
ClearOne

**Brad R. Baldwin**
General Counsel
Wasatch Front
Regional MLS Inc.

**Larry R. Hendricks**
Retired, formerly VP
of Finance and GM
Daily Foods, Inc.

**Scott M. Huntsman**
President and CEO
GlobalSim

### CORPORATE OFFICERS

**Zeynep Hakimoglu**
Chairman
President and CEO

**Narsi Narayanan**
Vice President of Finance and
Corporate Secretary

**Michael J. Braithwaite**
Chief Strategy Officer

### 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
LISTED

### 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**
Edgewater Corporate Park
South Tower
Suite 500
5225 Wiley Post Way
Salt Lake City, UT 84116
**clearone.com**