

CLEARONE COMMUNICATIONS INC  
Form 10-Q  
February 08, 2007

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

FORM 10-Q

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended December 31, 2006

OR

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-17219

**CLEARONE COMMUNICATIONS, INC.**

(Exact name of registrant as specified in its charter)

**Utah**      **87-0398877**  
(State or other      (I.R.S.  
jurisdiction of      employer  
incorporation      identification  
or      number)  
organization)

**5225 Wiley Post**  
**Way, Suite 500**      **84116**  
**Salt Lake City,**  
**Utah**  
(Address of      (Zip  
principal executive      Code)  
offices)

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

Indicate by check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and larger accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Larger Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. There were 11,068,649 shares of the Company's Common Stock, par value \$0.001, outstanding on February 8, 2007.

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**REPORT ON FORM 10-Q  
FOR THE QUARTER ENDED DECEMBER 31, 2007**

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## DISCLOSURE 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 or expressions; however, not all forward-looking statements contain these words. 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 in Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” Item 3, “Quantitative and Qualitative Disclosures About Market Risk,” and Item 4, “Controls and Procedures” included in this Quarterly Report on Form 10-Q. 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 Part II - Other Information, Item 1A, “Risk Factors” and the application of “Critical Accounting Policies” as discussed in Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” 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 ClearOne assumes no obligation to update forward-looking statements to reflect subsequent events, changes in circumstances, or changes in estimates.

**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements**

**CLEARONE COMMUNICATIONS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands of dollars, except per share amounts)

	<b>Unaudited December 31, 2006</b>	<b>June 30, 2006</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,840	\$ 1,240
Marketable securities	16,500	20,550
Accounts receivable	7,682	7,784
Note receivable	156	-
Inventories, net	5,909	6,614
Income tax receivable	2,392	2,607
Deferred income taxes, net	87	128
Prepaid expenses	322	255
Net assets of discontinued operations	-	565
<b>Total current assets</b>	<b>34,888</b>	<b>39,743</b>
Property and equipment, net	2,817	1,647
Note receivable - long-term	126	-
Other assets	22	15
<b>Total assets</b>	<b>\$ 37,853</b>	<b>\$ 41,405</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,083	\$ 2,597
Accrued liabilities	2,152	2,397
Deferred product revenue	4,711	5,871
<b>Total current liabilities</b>	<b>8,946</b>	<b>10,865</b>
Deferred rent	933	-
Deferred income taxes, net	87	128
<b>Total liabilities</b>	<b>9,966</b>	<b>10,993</b>
Shareholders' equity:		
Common stock, par value \$0.001, 50,000,000 shares authorized, 11,072,349 and 12,184,727 shares issued and outstanding, respectively	11	12
Additional paid-in capital	48,479	52,764
Accumulated deficit	(20,603)	(22,364)
<b>Total shareholders' equity</b>	<b>27,887</b>	<b>30,412</b>

Total liabilities and shareholders' equity	\$	37,853	\$	41,405
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See accompanying notes to condensed consolidated financial statements

**CLEARONE COMMUNICATIONS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(Unaudited)  
(in thousands of dollars, except per share amounts)

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>December</b>	<b>December</b>	<b>December</b>	<b>December</b>
	<b>31,</b>	<b>31,</b>	<b>31,</b>	<b>31,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Product Revenue:	\$ 10,107	\$ 9,102	\$ 19,518	\$ 17,879
Cost of goods sold:				
Product	4,690	4,286	8,895	8,206
Product inventory write-offs	170	184	281	277
Cost of goods sold:	4,860	4,470	9,176	8,483
Gross profit	5,247	4,632	10,342	9,396
Operating expenses:				
Marketing and selling	1,789	1,810	3,707	3,622
General and administrative	688	1,457	1,497	3,228
Settlement in shareholders' class action	-	-	-	(1,205)
Research and product development	1,855	1,778	3,934	3,577
Total operating expenses	4,332	5,045	9,138	9,222
Operating income (loss)	915	(413)	1,204	174
Other income (expense), net:				
Interest income	283	186	590	345
Other, net	37	5	62	12
Other income (expense), net:	320	191	652	357
Income (loss) from continuing operations before income taxes	1,235	(222)	1,856	531
(Provision) benefit from income taxes	(155)	146	(136)	368
Income (loss) from continuing operations	1,080	(76)	1,720	899
Discontinued operations:				
Income from discontinued operations	20	100	75	218
	(13)	150	(10)	1,646

Gain (loss) on disposal of discontinued operations				
Income tax provision	(3)	(93)	(24)	(695)
Income from discontinued operations:	4	157	41	1,169
Net income	\$ 1,084	\$ 81	\$ 1,761	\$ 2,068

See accompanying notes to condensed consolidated financial statements



**CLEARONE COMMUNICATIONS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME (CONTINUED)**  
**(Unaudited)**  
**(in thousands of dollars, except per share amounts)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>December 31,</b>	<b>December 31,</b>	<b>December 31,</b>	<b>December 31,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
Basic earnings per common share from continuing operations	\$ 0.09	\$ (0.01)	\$ 0.14	\$ 0.08
Diluted earnings per common share from continuing operations	\$ 0.09	\$ (0.01)	\$ 0.14	\$ 0.07
Basic earnings per common share from discontinued operations	\$ 0.00	\$ 0.01	\$ 0.00	\$ 0.10
Diluted earnings per common share from discontinued operations	\$ 0.00	\$ 0.01	\$ 0.00	\$ 0.10
Basic earnings per common share	\$ 0.09	\$ 0.01	\$ 0.15	\$ 0.18
Diluted earnings per common share	\$ 0.09	\$ 0.01	\$ 0.15	\$ 0.17
Basic weighted average shares	11,922,641	12,184,727	12,053,745	11,734,485
Diluted weighted average shares	11,957,706	12,195,466	12,100,794	12,230,035

See accompanying notes to condensed consolidated financial statements

**CLEARONE COMMUNICATIONS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(in thousands of dollars, except per share amounts)**

	<b>Six Months Ended</b>	
	<b>December 31,</b>	<b>December</b>
	<b>2006</b>	<b>31,</b>
		<b>2005</b>
Cash flows from operating activities:		
Net income from continuing operations	\$ 1,720	\$ 899
Adjustments to reconcile net income from continuing operations to net cash provided by (used in) operations:		
Depreciation and amortization expense	479	690
Stock-based compensation	453	613
Write-off of inventory	281	277
(Gain) loss on disposal of assets and fixed assets write-offs	-	(48)
Provision for doubtful accounts	-	3
Changes in operating assets and liabilities:		
Accounts receivable	102	(662)
Note receivable - Ken-A-Vision	(282)	-
Inventories	424	746
Prepaid expenses	(67)	(221)
Other assets	(7)	-
Accounts payable	(514)	(626)
Accrued liabilities	(400)	(1,222)
Income taxes	215	326
Deferred product revenue	(1,160)	(119)
Net cash provided by continuing operating activities	1,244	656
Net cash provided by discontinued operating activities	47	208
Net cash provided by operating activities	1,291	864
Cash flows from investing activities:		
Purchase of property and equipment	(616)	(134)
Proceeds from the sale of property and equipment	55	55
Purchase of marketable securities	(6,900)	(3,600)
Sale of marketable securities	10,950	2,400
Net cash provided by (used in) continuing investing activities	3,489	(1,279)

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Net cash provided by discontinued investing activities	559	1,032
Net cash provided by (used in) investing activities	4,048	(247)
Cash flows from financing activities:		
Proceeds from common stock	6	-
Purchase and retirement of stock	(4,745)	-
Net cash used in continuing financing activities	(4,739)	-
Net cash used in discontinued financing activities	-	-
Net cash used in financing activities	(4,739)	-
Net increase in cash and cash equivalents		
	600	617
Cash and cash equivalents at the beginning of the period	1,240	1,892
Cash and cash equivalents at the end of the period	\$ 1,840	\$ 2,509

See accompanying notes to condensed consolidated financial statements

**CLEARONE COMMUNICATIONS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)**  
**(Unaudited)**  
**(in thousands of dollars, except per share amounts)**

	<b>Six Months Ended</b>	
	<b>December 31,</b>	<b>December 31,</b>
	<b>2006</b>	<b>2005</b>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 1	\$ -
Cash paid (received) for income taxes	(55)	-
Supplemental disclosure of non-cash financing activities:		
Value of common shares issued in shareholder settlement	\$ -	\$ 2,264
Lease incentive for Edgewater leasehold improvements	1,088	-

See accompanying notes to condensed consolidated financial statements

**CLEARONE COMMUNICATIONS, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**  
**(in thousands of dollars, except per share amounts)**

### 1. Basis of Presentation

The accompanying condensed consolidated financial statements, consisting of the condensed consolidated balance sheets as of December 31, 2006 and June 30, 2006, the condensed consolidated statements of income for the three months and six months ended December 31, 2006 and 2005, and the condensed consolidated statements of cash flows for the six months ended December 31, 2006 and 2005, have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q. Accordingly, certain information and footnote disclosures normally included in complete financial statements have been condensed or omitted. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended June 30, 2006.

In management's opinion, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for interim periods are not necessarily indicative of the results of operations to be expected for the entire year or for any future period.

### 2. Inventory

Inventories, net of reserves, consisted of the following as of December 31, 2006 and June 30, 2006 (in thousands):

	<b>December</b>	
	<b>31,</b>	<b>June 30,</b>
	<b>2006</b>	<b>2006</b>
Raw materials	\$ 313	\$ 513
Finished goods	3,430	3,284
Consigned inventory	2,166	2,817
Total inventory	\$ 5,909	\$ 6,614

Consigned inventory represents inventory at distributors and other customers where revenue recognition criteria have not been achieved.

### 3. Share-Based Payment

The Company's share-based compensation primarily consists of the following plans:

On December 31, 2006, the Company had one active share-based compensation plan, the 1998 Stock Option Plan (the "1998 Plan"). Provisions of the 1998 Plan include the granting of 2,500,000 incentive and non-qualified stock options. Options may be granted to directors, officers, and key employees and may be granted upon such terms as the Board of Directors, in their sole discretion, determine. 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.

As of December 31, 2006, 22,500 and 150,335 of these options that cliff vest after 9.8 and 6.0 years, respectively, remain outstanding.

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 have 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, 2006 had contractual lives of ten years. Under the 1998 Plan, 2,500,000 shares were authorized for grant. The 1998 Plan expires June 10, 2008, or when all the shares available under the plan have been issued if this occurs earlier. As of December 31, 2006, there were 1,271,335 options outstanding under the 1998 Plan, which includes the cliff vesting and 3 or 4-year vesting options discussed above.

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 program was suspended during the period the Company failed to remain current in its filing of periodic reports with the SEC and reinstated in fiscal year 2007 after the Company became current.

Effective July 1, 2005, the Company adopted SFAS No. 123R, "Share-Based Payment." The Company adopted the fair value recognition provisions of SFAS No. 123R using the modified prospective transition method. Under this transition method, stock-based compensation cost recognized beginning July 1, 2005 includes the straight-line 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 in the pro-forma disclosures under the original SFAS No. 123 and (b) all share-based payments granted on or after July 1, 2005, in accordance with the provisions of SFAS No. 123R.

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, the expected dividends of the awards, and an estimate of the amount of awards that are expected to be forfeited. The Company uses the Black-Scholes option pricing model to determine the fair value of share-based payments granted under SFAS No. 123R and the original SFAS No. 123.

#### 4. Discontinued Operations

During the first fiscal quarter of 2007, the Company completed the sales of its document and educational camera product line to Ken-A-Vision Manufacturing. Additionally, during fiscal 2005, the Company sold its Canadian audiovisual integration services, OM Video, to 6351352 Canada Inc, a Canada corporation (the "OM Purchaser"). Accordingly, the results of operations and the financial position have been reclassified in the accompanying condensed consolidated financial statements as discontinued operations. Finally, during fiscal 2001, the Company sold certain assets to Burk Technology, Inc. ("Burk") whose sales proceeds are included with discontinued operations. Summary operating results of the discontinued operations are as follows (in thousands of dollars):

	Three Months Ended		Six Months Ended	
	December	December	December	December
	31,	31,	31,	31,
	2006	2005	2006	2005
Income from discontinued operations:				
Ken-A-Vision	\$ 20	\$ 100	\$ 75	\$ 218
Gain (loss) on disposal of discontinued operations:				
Ken-A-Vision	\$ (13)	\$ -	\$ (10)	\$ -
OM Video	-	150	-	300
Burk	-	-	-	1,346
Total gain (loss) on disposal of discontinued operations	(13)	150	(10)	1,646
Income tax benefit (provision):				
Ken-A-Vision	\$ (3)	\$ (37)	\$ (24)	\$ (81)
OM Video	-	(56)	-	(112)
Burk	-	-	-	(502)
Total income tax benefit (provision)	(3)	(93)	(24)	(695)
Total income (loss) from discontinued operations, net of income taxes:				
Ken-A-Vision	\$ 4	\$ 63	\$ 41	\$ 137
OM Video	-	94	-	188
Burk	-	-	-	844
Total income (loss) from discontinued operations, net of income taxes	\$ 4	\$ 157	\$ 41	\$ 1,169

#### OM Video

On March 4, 2005, the Company sold all of the issued and outstanding stock of its Canadian subsidiary, ClearOne Communications of Canada, Inc. ("ClearOne Canada") to 6351352 Canada Inc., a Canada corporation. ClearOne Canada owned all the issued and outstanding stock of Stechyson Electronics, Ltd., which conducts business under the name OM Video. The Company agreed to sell the stock of ClearOne Canada for \$200 in cash; a \$1,256 note



receivable over a 15-month period, with interest accruing on the unpaid balance at the rate of 5.3 percent per year; and contingent consideration ranging from 3.0 percent to 4.0 percent of related gross revenues over a five-year period. In June 2005, the Company was advised that the OM Purchaser had settled an action brought by the former employer of certain of OM Purchaser's owners and employees alleging violation of non-competition agreements. The settlement reportedly involved a cash payment and an agreement not to sell certain products for a period of one year. Based on an analysis of the facts and circumstances that existed at the end of fiscal 2005, and considering the guidance from Topic 5U of the SEC Rules and Regulations, "Gain Recognition on the Sale of a Business or Operating Assets to a Highly Leveraged Entity," the gain is being recognized as cash is collected (as collection was not reasonably assured). Through December 31, 2005, all required payments had been made however, 6351352 Canada Inc. failed to make any subsequent, required payments under the note receivable until June 30, 2006, when we received a payment of \$50. The Company recently reevaluated its options and concluded that its best course of action is to enforce its security and appoint a receiver over the assets of OM Video. As of December 31, 2006 the amount of the promissory note and contingent earn-out provision was approximately \$1,200. The Company expects to collect approximately \$400 to \$600, which is net of associated fees, over the next several periods through this receivership.

## **5. Shareholders' Equity**

The Company's shareholders' equity of \$27.89 million at December 31, 2006 declined approximately \$2.5 million from June 30, 2006. As previously announced, the Company completed a tender offer in Fiscal 2Q 2007 in which a total of approximately 1.1 million shares of its stock were repurchased for \$4.6 million. The cost of the tender offer, offset by \$1.8 million in net income in addition to the expensing of stock options for the six months ended December 31, 2006 explains the decline in total shareholders' equity.

## **6. Subsequent Events**

On January 8, 2007 the Company announced that it had filed a lawsuit in the Third Judicial District Court, Salt Lake County, State of Utah against Wideband Solutions, Inc., Biamp Systems Corporation, Inc. and two individuals; one a former employee and one previously affiliated with ClearOne. The Complaint brings claims against different combinations of the defendants for, among other things, misappropriation of certain trade secrets, breach of contract, conversion, unjust enrichment and intentional interference with business and contractual relations.

On January 22, 2007, the Company filed a form 8-K disclosing that, after exploring several collection options for its receivable in default from OM Video, elected to appoint a receiver over the assets of OM Video. Through receivership, the Company expects to collect a net of approximately \$400 to \$600 of the approximate \$1.2 million receivable balance.

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

*The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and related notes to condensed consolidated financial statements included in this Form 10-Q and our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended June 30, 2006 filed with the SEC and management's discussion and analysis contained therein. This discussion contains forward-looking statements based on current expectations that involve risks and uncertainties, such as our plans, objectives, expectations, and intentions, as set forth under "Disclosure Regarding Forward-Looking Statements." Our actual results and the timing of events could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth in the following discussion and under the caption "Risk Factors" in Part II, Item 1A, as well as other information found in the documents we file from time to time with the SEC. Unless otherwise indicated, all references to a year reflect our fiscal year that ends on June 30.*

**BUSINESS OVERVIEW**

We are an audio conferencing products company. We develop, manufacture, market, and service a comprehensive line of audio conferencing products, which range from tabletop conferencing phones to professionally installed audio systems. We believe we have a strong history of product innovation and plan to continue to apply our expertise in audio engineering to developing innovative new products. The performance and reliability of our high-quality solutions create a natural communication environment, which saves organizations of all sizes time and money by enabling more effective and efficient communication between geographically separated businesses, employees, and customers.

**CRITICAL ACCOUNTING POLICIES**

Our discussion and analysis of our results of operations and financial condition are based upon our condensed 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 management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues 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. We believe the following critical accounting policies affect our more significant assumptions and estimates that we used to prepare our condensed consolidated financial statements.

**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 distributors. Currently, we do not have sufficient historical return experience with our distributors that is predictive of future events given historical excess levels of inventory in the distribution channel. Accordingly, revenue from product sales to distributors is not recognized until 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. We evaluate, at each quarter-end, the inventory in the channel through information provided by certain of 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 revenue deferral is calculated and recorded based upon the underlying, estimated channel inventory at quarter-end. Although, certain distributors provide certain channel inventory amounts, we make judgments and estimates with regard to the amount of inventory in the entire channel, for all customers and for all channel inventory items, and the appropriate revenue and cost of goods sold associated with those channel products. Although these assumptions and judgments regarding total channel inventory revenue and cost of goods sold could differ from actual amounts, we believe that our calculations are indicative of actual levels of inventory in the distribution channel. As of December 31, 2006, the Company deferred

\$4.7 million in revenue and \$2.2 million in cost of goods sold related to products sold where return rights had not lapsed. The amounts of deferred cost of goods sold were included in consigned inventory. The following table details the amount of deferred revenue and cost of goods sold at each period end for the 18-month period ended December 31, 2006 (in thousands).

	<b>Deferred Revenue</b>	<b>Deferred Cost of Goods Sold</b>	<b>Deferred Gross Profit</b>
December 31, 2006	\$ 4,711	\$ 2,166	\$ 2,545
September 30, 2006	5,249	2,541	2,708
June 30, 2006	5,871	2,817	3,054
March 31, 2006	5,355	2,443	2,912
December 31, 2005	4,936	2,199	2,737
September 30, 2005	4,848	2,373	2,475
June 30, 2005	5,055	2,297	2,758
March 31, 2005	5,456	2,321	3,135
December 31, 2004	4,742	1,765	2,977
September 30, 2004	5,617	1,920	3,697
June 30, 2004	6,107	2,381	3,726

We offer rebates and market development funds to certain of our distributors and direct dealers/resellers based upon volume of product purchased by them. We record rebates as a reduction of revenue in accordance with Emerging Issues Task Force (“EITF”) Issue No. 00-22, “Accounting for Points and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future.” Beginning January 1, 2002, we adopted EITF Issue No. 01-9, “Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor’s Products).” We continue to record rebates as a reduction of revenue in the period revenue is recognized.

We offer credit terms on the sale of our products to a majority of our customers 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 customers to make required payments based upon our historical collection experience and expected collectibility 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.

### **Goodwill and Purchased Intangibles**

We assess the impairment of goodwill and other identifiable intangibles annually or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Some factors we consider important which could trigger an impairment review include the following:

- Significant underperformance relative to projected future operating results;
- Significant changes in the manner of our use of the acquired assets or the strategy for our overall business; and
  - Significant negative industry or economic trends.

If we determine that the carrying value of goodwill and other identified intangibles may not be recoverable based upon the existence of one or more of the above indicators of impairment, we would typically measure any impairment based on a projected discounted cash flow method using a discount rate determined by us to be commensurate with

the risk inherent in our current business model. We evaluate goodwill for impairment at least annually.

We plan to conduct our annual impairment tests in the fourth quarter of every fiscal year, unless impairment indicators exist sooner. Screening for and assessing whether impairment indicators exist or if events or changes in circumstances have occurred, including market conditions, operating fundamentals, competition, and general economic conditions, requires significant judgment. Additionally, changes in the high-technology industry occur frequently and quickly. Therefore, there can be no assurance that a charge to operations will not occur as a result of future purchased intangible impairment tests.

### **Impairment of Long-Lived Asset**

We assess the impairment of long-lived assets, such as property, 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 management 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 an expense for the allowance within the tax provision in the condensed consolidated statement of operations.

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

We account for our inventory on a first-in, first-out (“FIFO”) basis, and make appropriate adjustments on a quarterly basis to write down the value of inventory to the lower-of-cost or market.

In order to determine what, if any, inventory needs to be written down, we perform a quarterly analysis of obsolete and slow-moving inventory. 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, or market conditions. Those items that are found to have a supply in excess of our estimated demand are considered to be slow-moving or obsolete and the appropriate reserve is made to write down the value of that inventory to its realizable value. These charges are recorded in cost of goods sold. At the point of the loss recognition, a new, lower-cost basis for that inventory is established and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis. 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 rapidly changing technology and customer requirements, we could be required to increase our inventory allowances, and our gross profit could be adversely affected.

### **Share-Based Payment**

Prior to June 30, 2005 and as permitted under the original SFAS No. 123, 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 SFAS No. 123R, "Share-Based Payment." SFAS No. 123R is a revision of SFAS No. 123. SFAS No. 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. Primarily, SFAS No. 123R 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 SFAS No. 123R, 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 SFAS No. 123R 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 SFAS No. 123R.

Under SFAS No. 123R, 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 expected life of the awards, the expected volatility over the term of the awards, the expected dividends of the awards, the risk-free interest rate of the awards, and an estimate of the amount of awards that are expected to be forfeited. If assumptions change in the application of SFAS No. 123R in future periods, the stock-based compensation cost ultimately recorded under SFAS No. 123R may differ significantly from what was recorded in the current period.

## SEASONALITY

Our audio conferencing products revenue has historically been strongest during our second and fourth 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.

## ANALYSIS OF RESULTS OF OPERATIONS

### **Results of Operations for the three months or the second fiscal quarter ("2Q") and six months or the first half of the fiscal year ("1H") ended December 31, 2006 and 2005**

The following table sets forth certain items from our unaudited condensed consolidated statements of operations (in thousands) for the three and six months ended December 31, 2006 and 2005, together with the percentage of total revenue which each such item represents:

**CLEARONE COMMUNICATIONS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)  
(in thousands of dollars, except per share amounts)

	Three Months Ended				Six Months Ended			
	December 31, 2006		December 31, 2005		December 31, 2006		December 31, 2005	
	% of Revenue		% of Revenue		% of Revenue		% of Revenue	
Product Revenue:	\$ 10,107	100%	\$ 9,102	100%	\$ 19,518	100%	\$ 17,879	100%
Cost of goods sold:	4,860	48%	4,470	49%	9,176	47%	8,483	47%
Gross profit	5,247	52%	4,632	51%	10,342	53%	9,396	53%
Operating expenses:								
Marketing and selling	1,789	18%	1,810	20%	3,707	19%	3,622	20%
General and administrative	688	7%	1,457	16%	1,497	8%	3,228	18%
Settlement in shareholders' class action	-	0%	-	0%	-	0%	(1,205)	-7%
Research and product development	1,855	18%	1,778	20%	3,934	20%	3,577	20%
Total operating expenses	4,332	43%	5,045	55%	9,138	47%	9,222	52%

## Revenue

Revenue for 2Q 2007 increased by 11%, or approximately \$1 million, compared to 2Q 2006. The 2Q 2007 increase was due mainly to continued growth in the Company's professional audio and tabletop conferencing products which collectively increased approximately \$760,000 over 2Q 2006. The Company also realized growth in 2Q 2007 in its personal conferencing and accessories which collectively increased about \$310,000 over the same period of 2006.

1H 2007 revenue increased by 9%, or approximately \$1.6 million compared to 1H 2006. The 1H 2007 revenue increase was led by growth in professional audio and table products sales which increased \$1.4 million over 1H 2006. The Company also realized gains in its personal conferencing, OEM and accessories products which collectively increased about \$450,000. These increases were offset by reduced premium conferencing, conferencing furniture and other product sales which together declined about \$150,000 in 1H2007.

We evaluate, at each quarter-end, the inventory in the channel through information provided by certain of 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 revenue deferral is calculated and recorded based upon the

underlying, estimated channel inventory at quarter-end. During 2Q 2007 and 2006, the net change in deferred revenue based on the net movement of inventory in the channel was a net recognition (deferral) of \$538,000 and (\$88,000) in revenue, respectively. In the 1H 2007 and 2006, the net change in deferred revenue based on the net movement of inventory in the channel was a net recognition of \$1.2 million and \$119,000 in revenue, respectively.

Total revenues from sales outside of the United States accounted for 31% and 29% of total revenue for the three and six months ended December 31, 2006, respectively and 24% and 23% of total revenue for the three and six months ended December 31, 2005, respectively.

### **Costs of Goods Sold and Gross Profit**

Costs of goods sold (“COGS”) from the product segment 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.

The following table shows our COGS and gross profit together with each item’s amount as a percentage of total revenue:

	Three Months Ended December				Six Months Ended December 31,			
	31,		31,		(in thousands)		(in thousands)	
	(in thousands)		(in thousands)		(in thousands)		(in thousands)	
	2006	2005	2006	2005	2006	2005	2006	2005
	% of Revenue		% of Revenue		% of Revenue		% of Revenue	
Cost of goods sold	\$ 4,860	48.1%	\$ 4,470	49.1%	\$ 9,176	47.0%	\$ 8,483	47.4%
Gross profit	\$ 5,247	51.9%	\$ 4,632	50.9%	\$ 10,342	53.0%	\$ 9,396	52.6%

COGS increased \$390,000, or 9%, to \$4.9 million during 2Q 2007 compared with \$4.5 million in 2Q 2006. The 2Q 2007 increase in COGS was primarily due to the \$1 million or 11% increase in total revenue. In 1H 2007, COGS increased \$693,000, or 8%, to \$9.2 million compared with \$8.5 million for 1H 2006. The 1H 2007 increase in COGS was also primarily due to the \$1.6 million or 9% increase in total revenue.

Our gross profit from continuing operations was \$5.2 million, or 51.9% of revenue, for 2Q 2007 compared to \$4.6 million, or 50.9% of revenue, during 2Q 2006. Despite the gross profit percentage being slightly higher, the Company's 2Q 2007 gross profit was negatively impacted by material cost increases, rework and product write-offs which collectively totaled about \$340,000. The Company is actively seeking ways to mitigate increases to the manufacturing costs of its products. 1H 2007 and 2006 gross profit was \$10.3 million and \$9.4 million, respectively. The gross profit percentages were nearly identical in each comparative period as a result of the net revenue increase being nearly proportional on a product mix basis in each respective period.

### Operating Expenses

2Q 2007 operating expenses were \$4.3 million, a decrease of \$713,000, or 14.0%, from \$5.0 million for 2Q 2006. 1H 2007 operating expenses of \$9.1 million were slightly lower than the 1H 2006 total of \$9.2 million. The 1H 2006 figure included a \$1.2 million benefit related to the settlement in the shareholders' class action. Without the 1H 2006 settlement benefit, 1H 2006 operating expenses were \$10.4 million, or 14% higher than 1H 2007. The 2Q 2007 and 1H 2007 reductions were mainly attributable to lower general & administrative costs. The following is a more detailed discussion of expenses related to marketing and selling, general and administrative, and research and product development.

**Marketing and selling expenses.** Marketing and selling expenses include selling, customer service, and marketing expenses such as employee-related costs, allocations of overhead expenses, trade shows, and other advertising and selling expenses. 2Q 2007 and 2006 marketing and selling expenses were about the same at \$1.8 million. However, as a percentage of revenues, 2Q 2007 and 2006 marketing and selling expenses were 17.7% and 19.9%, respectively. The lower 2Q 2007 percentage can be attributed to the 11% higher revenues over 2Q 2006 without an associated increase in marketing and selling expenses. 1H 2007 and 2006 marketing and selling expenses were also about the same at \$3.7 million and 3.6 million, respectively. As a percentage of revenues, 1H 2007 and 2006 marketing and selling expenses were 19.0% and 20.3%, respectively.

**General and administrative expenses.** G&A expenses include employee-related costs, professional service fees, allocations of overhead expenses, litigation costs, including costs associated with the SEC investigation and subsequent litigation, and corporate administrative costs, including finance and human resources. 2Q 2007 G&A expenses decreased \$769,000, or 53%, to \$688,000 compared to 2Q 2006 expenses of \$1.5 million. 2Q 2007 and 2006 G&A expenses were 6.8% and 16.0% of sales, respectively. The significant 2Q 2007 decrease was largely due to

lower audit fees of \$436,000 as higher fees were required in much of fiscal 2006 to bring the Company's financial statements current, lower depreciation of \$180,000 related to much of the Company's computer equipment becoming fully depreciated and lower payroll and related expenses of \$110,000 associated with lower G&A headcount. 1H 2007 G&A expenses decreased \$1.7 million, or 54%, to \$1.5 million compared to 1H 2006 expenses of \$3.2 million. 1H 2007 and 2006 G&A expenses were 7.7% and 18.1% of sales, respectively. The \$1.7 million decrease in 1H 2007 was due mainly to lower audit fees of \$930,000, lower payroll and related expenses of \$285,000 and lower depreciation expense of \$264,000, each of which decreased for the same reasons discussed in the 2Q change discussed above.

**Research and product development expenses.** Research and product development expenses include research and development, product management, and engineering services, and test and application expenses, including employee-related costs, outside services, expensed materials, depreciation, and an allocation of overhead expenses. 2Q 2007 research and product development expenses increased slightly to \$1.9 million from \$1.8 million in 2Q 2006. As a percentage of revenues, 2Q 2007 and 2006 research and product development expenses were 18.0% and 19.5%, respectively; the 2Q 2007 percentage decrease was due to the 11% increase in revenues. 1H 2007 research and product development expenses increased \$357,000, or 10.0%, to \$3.9 million compared with 1H 2006 expenses of \$3.6 million. The 1H 2007 increase in product development expenses was due to ongoing research and product development efforts. As a percentage of revenues, 1H 2007 and 2006 research and product development expenses were about the same at 20% during each period.

**Operating income.** 2Q 2007 operating income was \$915,000 compared to an operating loss of (\$413,000) in 2Q 2006. The 2Q 2007 operating profit increase of \$1.3 million was due mainly to the \$615,000 increase in gross profit combined with the \$769,000 decrease in G&A expenses. 1H 2007 and 2006 operating income was \$1.2 million and \$174,000 respectively. As previously discussed, 1H 2006 included a \$1.2 million benefit related to a settlement in the shareholders' class action. Without the 1H 2006 settlement benefit, 1H 2007 operating income would have been \$2.2 million higher than 1H 2006 reflecting the \$946,000 gross profit increase and \$1.7 million decrease in G&A expenses slightly offset by the \$357,000 increase in research and product development expenses.

**Other income (expense), net.** Other income (expense), net, includes interest income, interest expense, capital gains, gain (loss) on the disposal of assets, and currency gain (loss). 2Q 2007 other income was \$320,000, an increase of \$129,000 from other income of \$191,000 in 2Q 2006. 1H 2007 other income was \$652,000, an increase of \$295,000 from other income of \$357,000 in 1H 2006. The increases in both 2Q and 1H 2007 were primarily due to an increase in interest income associated with our marketable securities.

**Income (loss) from continuing operations before income taxes.** 2Q 2007 income from continuing operations was \$1.1 million compared to a (loss) in 2Q 2006 of (\$76,000). As a percentage of revenues, 2Q 2007 and 2006 income (loss) from continuing operations was 10.7% and (0.8%), respectively. 1H 2007 income from continuing operations was \$1.7 million compared to \$899,000 in 1H 2006. As a percentage of revenues, 1H 2007 and 2006 income from continuing operations was 8.8% and 5.0%, respectively. We attribute the fiscal 2007 improvement in income to the results of operations described above.

**Income (loss) from discontinued operations, net of tax.** During 2Q 2007 and 2006 we recorded income from discontinued operations, net of tax of \$4,000 and \$157,000, respectively. The 2Q 2007 income was exclusively related to the sale of our document and educational camera product line to Ken-A-Vision. The 2Q 2006 income of \$157,000 was related to receipt of payments on our OM Video promissory note in addition to income from the discontinued operations of the document and educational camera product line. For 1H 2007 and 2006 income from discontinued operations, net of tax was \$41,000 and \$1.2 million, respectively. The significant decrease in 1H 2007 can be attributed mainly to the 1H 2006 realized gain, net of tax, of \$844,000 related to a Mutual Release and Waiver with Burk Technology, Inc. previously discussed. Additionally, we recognized \$137,000 in income from discontinued operations from the document and educational camera product line and \$188,000 of payments on our OM Video promissory note.

## **LIQUIDITY AND CAPITAL RESOURCES**

As of December 31, 2006, our cash and cash equivalents were approximately \$1.8 million and our marketable securities were approximately \$16.5 million, which represented an overall decrease of \$3.5 million in our balances from June 30, 2006 which had cash and cash equivalents of approximately \$1.2 million and marketable securities of approximately \$20.6 million. The significant decrease in cash and cash equivalents during 1H 2007 can be attributed to the Company's 2Q 2007 repurchase of 1.1 million shares of common stock for approximately \$4.7 million offset by other net increases in cash provided by operating and investing activities.

Net cash flows provided by operating activities were \$1.3 million for the six months ended December 31, 2006, an increase of \$427,000 from the net cash flows provided by operating activities of \$864,000 for the six months ended December 31, 2005. The year-over-year increase can be attributed to an increase in net income from continuing operations of \$821,000 offset by depreciation and amortization which decreased \$211,000 and stock-based compensation which decreased \$160,000.

Net cash flows provided by investing activities were \$4.0 million for the six months ended December 31, 2006, an increase of \$4.3 million from the net cash flows (used in) investing activities of (\$247,000) for the six months ended December 31, 2005. The change was primarily attributable to the sale of \$4.0 million in marketable securities used to fund the repurchase of the tendered shares of common stock.

Net cash (used in) financing activities for the six months ended December 31, 2006 totaled (\$4.7 million) and was largely related to the Company's repurchase of 1.1 million shares of common stock. We did not use nor receive cash from financing activities during the same period ending December 31, 2005.

Additionally, we recorded \$1.1 million in non-cash financing activities related to leasehold improvements to our new headquarters, the majority of which was paid as an incentive by the lessor as part of the lease agreement. These improvements are being accounted for in accordance with FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*, which states among other things that landlord incentives which fund leasehold improvements should be recorded as deferred rent and amortized as reductions to lease expense over the term of the lease.

Management believes that future income from operations and effective management of working capital will provide the liquidity needed to finance growth plans. In addition to capital expenditures, the Company plans to use cash during the remainder of fiscal 2007 for selective infusions of technological, marketing or product manufacturing rights to broaden the Company's product offerings; for continued share repurchases; and if available for a reasonable price, acquisitions that may strategically fit the Company's business and are accretive to performance.

### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our exposure to market risk has not changed materially since June 30, 2006.

### **Item 4. 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 Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. 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.



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 Chief Financial Officer, of the effectiveness and the design and operation of our disclosure controls and procedures as of December 31, 2006. Based upon this evaluation, our management, including the Chief Executive Officer and the Chief Financial Officer, has concluded that our disclosure controls and procedures were effective as of December 31, 2006.

There were no changes in the company's internal controls over financial reporting that occurred during the quarter ended December 31, 2006, that have materially affected, or are reasonably likely to materially affect, the company's internal controls over financial reporting.

## PART II - OTHER INFORMATION

### Item 1. LEGAL PROCEEDINGS

*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 business. Such matters are subject to many uncertainties and outcomes that are not predictable. However, based on the information available to us as of February 8, 2007 and after discussions with legal counsel, we do not believe any such other proceedings will have a material, adverse effect on our business, results of operations, financial position, or liquidity, except as described below.

*Theft of Trade Secrets Complaint.* On January 3, 2007, the Company filed a lawsuit in the Third Judicial District Court, Salt Lake County, State of Utah against WideBand Solutions, Inc., Biamp Systems Corporation, Inc. and two individuals; one a former employee and one previously affiliated with the Company. The Complaint brings claims against different combinations of the defendants for, among other things, misappropriation of certain trade secrets, breach of contract, conversion, unjust enrichment and intentional interference with business and contractual relations. The relief being sought by the Company includes an order enjoining the defendants from further use of the Company's trade secrets and an award consisting of, among other things, compensation and damages related the unjust enrichment of the defendants. The litigation is in the early stages, is subject to all of the risks and uncertainties of litigation and there can be no assurance as to the probable result of this litigation.

## **Item 1A. RISK FACTORS**

*Investors should carefully consider the risks described below. The risks described below are not the only ones we face, and there are risks that we are not presently aware of or that we currently believe are immaterial that may also impair our business operations. Any of these risks could harm our business. The trading price of our common stock could decline significantly due to any of these risks and investors may lose all or part of their investment. In assessing these risks, investors should also refer to the other information contained or incorporated by reference in this Quarterly Report on Form 10-Q, including our December 31, 2006 unaudited condensed consolidated financial statements and related notes.*

### ***Risks Relating to Our Business***

*We face intense competition in all of the markets for our products and services; our operating results will be adversely affected if we cannot compete effectively against other companies.*

As described in more detail in the section entitled “Competition,” in our Annual Report on Form 10-K for the year ended June 30, 2006, the markets for our products and services are characterized by intense competition and pricing pressures and rapid technological change. We compete with businesses having substantially greater financial, research and development, manufacturing, marketing, and other resources. If we are not able to continually design, manufacture, and successfully introduce 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, profits, and market share, each of which could have a materially adverse effect on our business.

*Difficulties in estimating customer demand in our products segment could harm our profit margins.*

Orders from our distributors and other distribution participants are based on demand from end-users. Prospective end-user demand is difficult to measure. This means that our revenues in any fiscal quarter could be adversely impacted by low end-user demand, which could in turn negatively affect orders we receive from distributors and dealers. Our expectations for both short- and long-term future net revenues are based on our own estimates of future demand.

Revenues for any particular time period are difficult to predict with any degree of certainty. We usually ship products within a short time after we receive an order; so consequently, unshipped backlog has not been a good indicator of future revenues. We believe that the current level of backlog will fluctuate dependent in part on our ability to forecast revenue mix and plan our manufacturing accordingly. A significant portion of our customers’ orders are received in the last month of the quarter. We budget the amount of our expenses based on our revenue estimates. If our estimates of sales are not accurate and we experience unforeseen variability in our revenues and operating results, we may be unable to adjust our expense levels accordingly and our gross profit and results of operations will be adversely affected. Higher inventory levels or stock shortages may also result from difficulties in estimating customer demand.

*Our sales depend to a certain extent on government funding and regulation.*

In the audio conferencing products market, the revenues generated from sales of our audio conferencing products for distance learning and courtroom facilities are dependent on government funding. In the event government funding for such initiatives was reduced or became unavailable, our sales could be negatively impacted. Additionally, many of our products are subject to governmental regulations. New regulations could significantly impact sales in an adverse manner.

*Environmental laws and regulations subject us to a number of risks and could result in significant costs and impact on revenue*

New regulations regarding the materials used in manufacturing, the process of disposing of electronic equipment, and the efficient use of energy have emerged in the last few years. The first implementations of these regulations have taken place in Europe and have required significant effort from ClearOne to comply. Other countries and U.S. states are currently considering similar regulations, which could require additional resources and effort from ClearOne to comply.

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The European Parliament has published the RoHS Directive, which restricts the use of certain hazardous substances in electrical and electronic equipment beginning July 1, 2006. In order to comply with this directive, it has become necessary to re-design the majority of our products and switch over to components that do not contain the restricted substances, such as lead, mercury, and cadmium. This process involves procurement of the new compliant components, engineering effort to design, develop, test, and validate them, and re-submitting these re-designed products for multiple country emissions, safety, and telephone line interface compliance testing and approvals. This effort has consumed resources and time that would otherwise have been spent on new product development, which will continue until the products have been updated.

To date, we have completed the re-design of our products and begun shipping the majority to the European market. Certain of the re-designed product have yet to launch into the European market although we anticipate that most of these products will be ready for launch during fiscal 2007. Additionally, certain of our products will not be re-designed. Accordingly, sales into the European market may be negatively impacted and our results of operations could suffer. Our outsourced manufacturers may hold us responsible for the cost of purchased components that have become obsolete as a result of our re-design efforts. To the extent that we cannot manage these potential exposures to our current estimates, our results of operations could be negatively impacted. In addition, because this has essentially become a worldwide issue for all electronics manufacturers who wish to sell into the European market, we have seen increased lead times for compliant components because of the increased demand. This is an issue that is not unique to ClearOne, but also applies to many manufacturers exporting products to the European Union.

The European Parliament has also published the WEEE Directive, which makes producers of certain electrical and electronic equipment financially responsible for collection, reuse, recycling, treatment, and disposal of equipment placed on the European Union market after August 13, 2005. We are currently compliant in terms of the labeling requirements and have finalized the recycling processes with the appropriate entities within Europe. According to our understanding of the directive, distributors of our product are deemed producers and must comply with this directive by contracting with a recycler for the recovery, recycling, and reuse of product.

The California law regarding efficient use of energy goes into effect in July 2007 and will require re-design of power supplies in order to comply. ClearOne has already begun this effort.

*Product development delays or defects could harm our competitive position and reduce our revenues.*

We have, in the past, and may again experience, technical difficulties and delays with the development and introduction of new products. Many of the products we develop contain sophisticated and complicated circuitry and components, and utilize manufacturing techniques involving new technologies. Potential difficulties in the development process that could be experienced by us include difficulty in:

- meeting required specifications and regulatory standards;
- meeting market expectations for performance;
- hiring and keeping a sufficient number of skilled developers;
- obtaining prototype products at anticipated cost levels;
- having the ability to identify problems or product defects in the development cycle; and
- achieving necessary manufacturing efficiencies.

Once new products reach the market, they may have defects, or may be met by unanticipated new competitive products, which could adversely affect market acceptance of these products and our reputation. If we are not able to manage and minimize such potential difficulties, our business and results of operations could be negatively affected.

*Our profitability may be adversely affected by our continuing dependence on our distribution channels.*

We market our products primarily through a network of distributors who in turn sell our products to systems integrators, dealers, and value-added resellers. All of our agreements with such distributors and other distribution participants are non-exclusive, terminable at will by either party and generally short-term. No assurances can be given that any or all such distributors or other distribution participants will continue their relationship with us. Distributors and to a lesser extent systems integrators, dealers, and value-added resellers cannot easily be replaced and the loss of revenues and our inability to reduce expenses to compensate for the loss of revenues could adversely affect our net revenues and profit margins.

Although we rely on our distribution channels to sell our products, our distributors and other distribution participants are not obligated to devote any specified amount of time, resources, or efforts to the marketing of our products or to sell a specified number of our products. There are no prohibitions on distributors or other resellers offering products that are competitive with our products and most do offer competitive products. The support of our products by distributors and other distribution participants may depend on the competitive strength of our products and the price incentives we offer for their support. If our distributors and other distribution participants are not committed to our products, our revenues and profit margins may be adversely affected.

*Reporting of channel inventory by certain distributors.*

We defer recognition of revenue from product sales to distributors until the return privilege has expired, which approximates when product is sold-through to customers of our distributors. We evaluate, at each quarter-end, the inventory in the channel through information provided by certain of our distributors. We use this information along with our judgment and estimates to determine the amount of inventory in the entire channel, for all customers and for all inventory items, and the appropriate revenue and cost of goods sold associated with those channel products. We cannot guarantee that the third party data, as reported, or that our assumptions and judgments regarding total channel inventory revenue and cost of goods sold will be accurate.

*We depend on an outsourced manufacturing strategy.*

In August 2005, we entered into a manufacturing agreement with a manufacturing services provider, to be the exclusive manufacturer of substantially all the products that were previously manufactured at our Salt Lake City, Utah manufacturing facility. This manufacturer is currently the primary manufacturer of many of our products. We also have an agreement with offshore manufacturers for the manufacture of other product lines. Additionally, in July 2006, we outsourced the manufacturing of our furniture product lines to two manufacturers. If these manufacturers experience difficulties in obtaining sufficient supplies of components, component prices significantly exceed 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, quarantines, transportation restrictions, acts of terror, 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 substantially all of our products.

The cost of delivered product from our contract manufacturers is a direct function of their ability to buy components at a competitive price and to realize efficiencies and economies of scale within their overall business structure. If they are unsuccessful in driving efficient cost models, our delivered costs could rise, affecting our profitability and ability to compete. In addition, if the contract manufacturers are unable to achieve greater operational efficiencies, delivery schedules for new product development and current product delivery could be negatively impacted.

*We depend on a single source for certain components.*

Certain of our products have been qualified to utilize components for which we rely upon a consistent supply from a single source. Our reliance on a single source puts us at risk if, for whatever reason, we are unable to receive these single-sourced components to meet demand which could have a material adverse effect on our business.

*Product obsolescence could harm demand for our products and could adversely affect our revenues and our results of operations.*

Our industry is subject to rapid and frequent technological innovations that could render existing technologies in our products obsolete and thereby decrease market demand for such products. If any of our products become slow-moving or obsolete and the recorded value of our inventory is greater than its market value, we will be required to write down the value of our inventory to its fair market value, which would adversely affect our results of operations. In limited circumstances, we are required to purchase components that our outsourced manufacturers use to produce and assemble our products. Should technological innovations render these components obsolete, we will be required to write down the value of this inventory, which could adversely affect our results of operations.



*If we are unable to protect our intellectual property rights or have insufficient proprietary rights, our business would be materially impaired.*

We currently rely primarily on a combination of trade secrets, copyrights, trademarks, patents, patents pending, and nondisclosure agreements to establish and protect our proprietary rights in our products. No assurances can be given that others will not independently develop similar technologies, or duplicate or design around aspects of our technology. In addition, we cannot assure that any patent or registered trademark owned by us will not be invalidated, circumvented or challenged, or that the rights granted thereunder will provide competitive advantages to us. Litigation may be necessary to enforce our intellectual property rights. We believe our products and other proprietary rights do not infringe upon any proprietary rights of third parties; however, we cannot assure that third parties will not assert infringement claims in the future. Our industry is characterized by vigorous protection of intellectual property rights. Such claims and the resulting litigation are expensive and could divert management's attention, regardless of their merit. In the event of a claim, we might be required to license third-party technology or redesign our products, which may not be possible or economically feasible.

We currently hold only a limited number of patents. To the extent that we have patentable technology for which we have not filed patent applications, others may be able to use such technology or even gain priority over us by patenting such technology themselves.

*International sales account for a significant portion of our net revenue and risks inherent in international sales could harm our business.*

International sales represent a significant portion of our total product sales. We anticipate that the portion of our total product revenue from international sales will continue to increase as we further enhance our focus on developing new products, establishing new distribution partners, strengthening our presence in key growth areas, and improving product localization with country-specific product documentation and marketing materials. Our international business is subject to the financial and operating risks of conducting business internationally, including:

- unexpected changes in, or the imposition of, additional legislative or regulatory requirements;
- unique environmental regulations;
- fluctuating exchange rates;
- tariffs and other barriers;
- difficulties in staffing and managing foreign sales operations;
- import and export restrictions;
- greater difficulties in accounts receivable collection and longer payment cycles;
- potentially adverse tax consequences;
- potential hostilities and changes in diplomatic and trade relationships;
- disruption in services due to natural disaster, economic or political difficulties, quarantines, transportation, or other restrictions associated with infectious diseases.

*We may not be able to hire and retain qualified key and highly-skilled technical employees, which could affect our ability to compete effectively and may cause our revenue and profitability to decline.*

We depend on our ability to hire and retain qualified key and highly-skilled employees to manage, research and develop, market, and service new and existing products. Competition for such key and highly-skilled employees is intense, and we may not be successful in attracting or retaining such personnel. To succeed, we must hire and retain employees who are highly skilled in the rapidly changing communications and Internet technologies. Individuals who have the skills and can perform the services we need to provide our products and services are in great demand. Because the competition for qualified employees in our industry is intense, hiring and retaining employees with the skills we need is both time-consuming and expensive. We might not be able to hire enough skilled employees or retain

the employees we do hire. In addition, provisions of the Sarbanes-Oxley Act of 2002 and related rules of the SEC impose heightened personal liability on some of our key employees. The threat of such liability could make it more difficult to identify, hire and retain qualified key and highly-skilled employees. We have relied on our ability to grant stock options as a means of recruiting and retaining key employees. Recent accounting regulations requiring the expensing of stock options will impair our future ability to provide these incentives without incurring associated compensation costs. Our inability to hire and retain employees with the skills we seek could hinder our ability to sell our existing products, systems, or services or to develop new products, systems, or services with a consequent adverse effect on our business, results of operations, financial position, or liquidity.

*Our reliance on third-party technology or license agreements.*

We have licensing agreements with various suppliers for software and hardware incorporated into our products. These third-party licenses may not continue to be available to us on commercially reasonable terms, if at all. The termination or impairment of these licenses could result in delays of current product shipments or delays or reductions in new product introductions until equivalent designs could be developed, licensed, and integrated, if at all possible, which would have a material adverse effect on our business.

*We may have difficulty in collecting outstanding receivables.*

We grant credit without requiring collateral to substantially all of our customers. In times of economic uncertainty, the risks relating to the granting of such credit would typically increase. Although we monitor and mitigate the risks associated with our credit policies, we cannot ensure that such mitigation will be effective. We have experienced losses due to customers failing to meet their obligations. Future losses could be significant and, if incurred, could harm our business and have a material adverse effect on our operating results and financial position.

*Interruptions to our business could adversely affect our operations.*

As with any company, our operations are at risk of being interrupted by earthquake, fire, flood, and other natural and human-caused disasters, including disease and terrorist attacks. Our operations are also at risk of power loss, telecommunications failure, and other infrastructure and technology based problems. To help guard against such risks, we carry business interruption loss insurance to help compensate us for losses that may occur.

***Risks Relating to Our Company***

*Our stock price fluctuates as a result of the conduct of our business and stock market fluctuations.*

The market price of our common stock has experienced significant fluctuations and may continue to fluctuate significantly. The market price of our common stock may be significantly affected by a variety of factors, including:

- statements or changes in opinions, ratings, or earnings estimates made by brokerage firms or industry analysts relating to the market in which we do business or relating to us specifically;
- disparity between our reported results and the projections of analysts;
- the shift in sales mix of products that we currently sell to a sales mix of lower-gross profit product offerings;
- the level and mix of inventory levels held by our distributors;
- the announcement of new products or product enhancements by us or our competitors;
- technological innovations by us or our competitors;
- success in meeting targeted availability dates for new or redesigned products;
- the ability to profitably and efficiently manage our supplies of products and key components;
- the ability to maintain profitable relationships with our customers;
- the ability to maintain an appropriate cost structure;
- quarterly variations in our results of operations;
- general consumer confidence or general market conditions or market conditions specific to technology industries;
- domestic and international economic conditions;

the adoption of the new accounting standard, SFAS No. 123R, "Share-Based Payments," which requires us to record compensation expense for certain options issued before July 1, 2005 and for all options issued or modified after June 30, 2005;

- our ability to report financial information in a timely manner; and
- the markets in which our stock is traded.

*We have previously identified material weaknesses in our internal controls.*

In our Form 10-K for the fiscal year ending June 30, 2006, we reported and identified a material weakness in our internal controls. Although we believe we have remedied this weakness through the commitment of considerable resources, we are always at risk that any future failure of our own internal controls or the internal control at any of our outsourced manufacturers or service providers could result in additional reported material weaknesses. Any future failures of our internal controls could have a material impact on our market capitalization, results of operations, or financial position, or have other adverse consequences.

*Our directors and officers own a significant percentage of the Company, and may exert significant influence over us.*

Our officers and directors together have beneficial ownership in excess of 20% percent of our common stock. With this significant holding in the aggregate, the officers and directors, acting together, could exert a significant degree of influence over us and may be able to delay or prevent a change in control.

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

Items 2(a) and (b) are not applicable

(c) Stock Repurchases

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May be Purchased Under the Plans or Programs (2)
October 1, 2006- October 31, 2006	29,859	\$3.53	29,859	\$1,857,000
November 1, 2006 - November 30, 2006	0	\$0	0	\$1,857,000
December 1, 2006 - December 31, 2006 (1)	1,073,552	\$4.25	1,073,552	\$1,857,000
Total	1,103,411		1,103,411	

- (1) On October 30, 2006 the Company announced that its Board of Directors authorized a \$10 million tender offer which was completed on December 6, 2006. Under the tender offer the Company repurchased 1,073,552 shares, or approximately 9% of shares outstanding, for approximately \$4.6 million at a price per share of \$4.25.
- (2) On August 31, 2006, the Company announced that its Board of Directors had approved a stock buy-back program to purchase up \$2,000,000 of the Company's common stock over the next 12 months on the open market. All repurchased shares will be immediately retired. The stock buy-back program will expire in August 2007.

**Item 3. DEFAULTS UPON SENIOR SECURITIES**

Not Applicable.

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

On November 20, 2006 at the annual meeting, shareholders of the Company approved the following matters submitted to them for consideration:

Elected the following as directors of the Company:

	FOR	WITHHELD
Edward	10,198,899	811,055
Dallin Bagley		
Brad R. Baldwin	10,818,093	191,851
Zeynep "Zee" Hakimoglu	10,849,800	160,144

Larry R. Hendricks	10,840,096	169,848
Scott M. Huntsman	10,838,796	171,148
Harry Spielberg	10,848,871	161,073

**Item 5. OTHER INFORMATION**

Not Applicable.

