CLEARONE COMMUNICATIONS INC
Form 10-Q
November 13, 2006

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 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 jurisdiction of incorporation or organization)	(I.R.S. employer identification number)

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

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

1825 Research Way, Salt Lake City, Utah 84119
(Former address of principal executive offices, if changed since last report)

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 x No ¨

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 x

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

Indicate the number of shares outstanding of each of the registrant’s classes of common stock, as of the latest practicable date. There were 12,145,068 shares of the Company’s Common Stock, par value $0.001, outstanding on November 13, 2006.

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CLEARONE COMMUNICATIONS, INC.
REPORT ON FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2006

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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 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.

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

	September 30, 2006	June 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,734	$ 1,240
Marketable securities	20,550	20,550
Accounts receivable	7,300	7,784
Note receivable	153	-
Inventories, net	6,179	6,614
Income tax receivable	2,548	2,607
Deferred income taxes, net	94	128
Prepaid expenses	188	255
Net Assets of Discontinued Operations	-	565
Total current assets	38,746	39,743
Property and equipment, net	1,473	1,647
Note receivable - long-term	166	-
Other assets	22	15
Total assets	$ 40,407	$ 41,405
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,643	$ 2,597
Accrued liabilities	2,136	2,397
Deferred product revenue	5,249	5,871
Total current liabilities	9,028	10,865
Deferred income taxes, net	94	128
Total liabilities	9,122	10,993
Commitments and contingencies (see Note 8)		
Shareholders' equity:		
Common stock, par value $0.001, 50,000,000 shares authorized, 12,185,427 and 12,184,727 shares issued and outstanding, respectively	12	12
Additional paid-in capital	52,997	52,764
Treasury stock	(37)	-
Accumulated deficit	(21,687)	(22,364)
Total shareholders' equity	31,285	30,412
Total liabilities and shareholders' equity	$ 40,407	$ 41,405

See accompanying notes to condensed consolidated financial statements

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

	Three Months Ended	
	September 30, 2006	September 30, 2005
Product Revenue:	$ 9,411	$ 8,778
Cost of goods sold:		
Product	4,205	3,921
Product inventory write-offs	111	93
Total cost of goods sold	4,316	4,014
Gross profit	5,095	4,764
Operating expenses:		
Marketing and selling	1,918	1,812
General and administrative	809	1,771
Settlement in shareholders' class action	-	(1,205)
Research and product development	2,079	1,799
Total operating expenses	4,806	4,177
Operating income (loss)	289	587
Other income (expense), net:		
Interest income	307	159
Other, net	25	7
Total other income (expense), net	332	166
Income (loss) from continuing operations before income taxes	621	753
Benefit from income taxes	19	222
Income (loss) from continuing operations	640	975
Discontinued operations:		
Income from discontinued operations	55	118
Gain on disposal of discontinued operations	3	1,496
Income tax provision	(21)	(602)
Income from discontinued operations	37	1,012
Net income	$ 677	$ 1,987

See accompanying notes to condensed consolidated financial statements

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

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005
Basic earnings (loss) per common share from continuing operations	$ 0.05	$ 0.09
Diluted earnings (loss) per common share from continuing operations	$ 0.05	$ 0.08
Basic earnings (loss) per common share from discontinued operations	$ 0.00	$ 0.09
Diluted earnings (loss) per common share from discontinued operations	$ 0.00	$ 0.08
Basic earnings (loss) per common share	$ 0.06	$ 0.18
Diluted earnings (loss) per common share	$ 0.06	$ 0.16
Basic weighted average shares	12,184,849	11,284,244
Diluted weighted average shares	12,231,744	12,278,664

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)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005
Cash flows from operating activities:		
Net income from continuing operations	$ 640	$ 975
Adjustments to reconcile net income (loss) from continuing operations		
to net cash provided by operations:		
Depreciation and amortization expense	268	326
Stock-based compensation	230	342
Write-off of inventory	111	93
(Gain) loss on disposal of assets and fixed assets write-offs	-	(40)
Provision for doubtful accounts	-	3
Changes in operating assets and liabilities:		
Accounts receivable	484	(414)
Note receivable - Ken-A-Vision	(319)	-
Inventories	324	661
Prepaid expenses and other assets	67	(280)
Accounts payable	(954)	(430)
Accrued liabilities	(261)	(1,357)
Income taxes	59	380
Deferred product revenue	(622)	(207)
Net change in other assets/liabilities	(6)	1
Net cash provided by continuing operating activities	21	53
Net cash provided by discontinued operating activities	35	527
Net cash provided by operating activities	56	580
Cash flows from investing activities:		
Purchase of property and equipment	(112)	(64)
Proceeds from the sale of property and equipment	18	43
Purchase of marketable securities	-	(3,000)
Sale of marketable securities	-	1,800
Net cash used in continuing investing activities	(94)	(1,221)
Net cash provided by discontinued investing activities	567	938
Net cash used in investing activities	473	(283)
Cash flows from financing activities:		
Proceeds from common stock	2	-
Common stock purchased and retired	(37)	-

Net cash used in continuing financing activities		(35)		-
Net cash used in discontinued financing activities		-		-
Net cash used in financing activities		(35)		-
Net increase in cash and cash equivalents		494		297
Cash and cash equivalents at the beginning of the period		1,240		1,892
Cash and cash equivalents at the end of the period	$	1,734	$	2,189

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)

	Three Months Ended			
	September 30, 2006		September 30, 2005	
Supplemental disclosure of cash flow information:				
Cash paid for interest	$	-	$	-
Cash paid (received) for income taxes		(57)		-
Supplemental disclosure of non-cash financing activities:				
Value of common shares issued in shareholder settlement	$	-	$	2,264

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 unaudited condensed consolidated financial statements, consisting of the condensed consolidated balance sheets as of September 30, 2006 and June 30, 2006, the condensed consolidated statements of operations for the three months ended September 30, 2006 and 2005 and the condensed consolidated statements of cash flows for the three months ended September 30, 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 of Regulation S-X. 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. Summary of Significant Accounting Policy Update

Pervasiveness 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 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 condensed consolidated financial statements include, among others, revenue recognition, allowances for doubtful accounts and product returns, provisions for obsolete inventory, valuation of long-lived assets including goodwill, and deferred income tax asset valuation allowances. Actual results could differ materially from these estimates.

Revenue Recognition - The Company evaluates, at each quarter-end, the inventory in the channel through information provided by certain of its distributors. The level of inventory in the channel will fluctuate up or down, each quarter, based upon these distributors’ individual operations. Accordingly, each quarter-end revenue deferral is calculated and recorded based upon the underlying, estimated channel inventory at quarter-end. The amounts of deferred cost of goods sold were included in consigned inventory. The following table details the amount of deferred revenue, cost of goods sold, and gross profit at each period end for the 21-month period ended September 30, 2006.

	Deferred Revenue	Deferred Cost of Goods Sold	Deferred Gross Profit
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

Share-Based Payment In December 2004, the Financial Accounting Standards Board ("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.

SFAS No. 123R 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, cumulatively.

Effective July 1, 2005, the Company 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. See Note 9 for information about the Company's various share-based compensation plans, the impact of adoption of SFAS No. 123R, and the assumptions used to calculate the fair value of share-based compensation.

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.

Recent Accounting Pronouncements

Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued Interpretation No. 48 ("FIN 48"), *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on recognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact of FIN 48 on our consolidated financial statements.

Inventory Costs

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs - an Amendment of ARB No. 43," which is the result of its efforts to converge U.S. accounting standards for inventories with International Accounting Standards. SFAS No. 151 requires idle facility expenses, freight, handling costs, and wasted material (spoilage) costs to be recognized as current-period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 was effective beginning with the Company's fiscal 2006 financial statements. There was not a significant impact on the Company's business, results of operations, financial position, or liquidity from the adoption of this standard.

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

Accounting Changes and Error Corrections

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections - a Replacement of APB Opinion No. 20 and FASB Statement No. 3," in order to converge U.S. accounting standards with International Accounting Standards. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition of a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, it does not change the transition provisions of any existing accounting pronouncements. The Company does not believe that the adoption of SFAS No. 154 will have a material effect on its business, results of operations, financial position, or liquidity.

3. Earnings Per Common Share

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

	Three Months Ended	
	September 30, 2006	September 30, 2005
	(in thousands of dollars, except per share amounts)	
Numerator:		
Income (loss) from continuing operations	$ 640	$ 975
Income (loss) from discontinued operations, net of tax	35	74
Gain (loss) on disposal of discontinued operations, net of tax	2	938
Net income (loss)	$ 677	$ 1,987
Denominator:		
Basic weighted average shares	12,184,849	11,284,244
Dilutive common stock equivalents using treasury stock method	46,895	994,420
Diluted weighted average shares	12,231,744	12,278,664
Basic earnings (loss) per common share:		
Continuing operations	$ 0.05	$ 0.09
Discontinued operations	0.00	0.01
Disposal of discontinued operations	0.00	0.08
Net income (loss)	0.06	0.18
Diluted earnings (loss) per common share:		
Continuing operations	$ 0.05	$ 0.08
Discontinued operations	0.00	0.01
Disposal of discontinued operations	0.00	0.08
Net income (loss)	0.06	0.16

Options that had an exercise price greater than the average market price of the common shares (“Out-of-the-Money Options”) during the respective period were not included in the computation of diluted earnings per share as the effect would be anti-dilutive. An average total of 1,231,591 and 1,454,061 Out-of-the-Money Options were not included during the three months ended September 30, 2006 and 2005, respectively. Warrants to purchase 150,000 shares of common stock were outstanding as of September 30, 2006 and 2005, but were not included in the computation of diluted earnings per share as the effect would be anti-dilutive. The Company issued 228,000 shares in November 2004 and 920,494 shares in September 2005.

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

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:

	Three Months Ended	
	September 30, 2006	September 30, 2005
Income from discontinued operations:		
Ken-A-Vision	$ 55	$ 118
Gain on disposal of discontinued operations:		
Ken-A-Vision	$ 3	$ -
OM Video	-	150
Burk	-	1,346
Total gain on disposal of discontinued operations	3	1,496
Income tax (provision) benefit:		
Ken-A-Vision	$ (21)	$ (44)
OM Video	-	(56)
Burk	-	(502)
Total income tax (provision) benefit	(21)	(602)
Total income from discontinued operations, net of income taxes:		
Ken-A-Vision	$ 37	$ 74
OM Video	-	94
Burk	-	844
Total income from discontinued operations, net of income taxes	$ 37	$ 1,012

Document and Camera Product Line

On August 23, 2006, the Company entered into an Asset Purchase Agreement with Ken-A-Vision Manufacturing Company, Inc. ("KAV"), a privately held manufacturer of camera solutions for education, audio visual, research, and manufacturing applications, to sell inventory, equipment, tools, and certain intellectual property pertaining to its document and education camera product line. KAV also agreed to assume certain warranty obligations with respect to historical Company camera product sales. The purchase price, which was subject to adjustment based upon the quantities of a mix of finished good inventory to be delivered to KAV, as defined in the agreement, was $635, payable in cash and a 24-month note receivable. The sale closed on August 30, 2006.

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

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). OM Video pre-tax income (loss), reported in discontinued operations, for the three months ended September 30, 2005 was $150. Through December 31, 2005, all payments required through such date had been received and $854 of the promissory note remained outstanding; 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 note receivable is in default and we are currently considering our collection options.

Burk

On August 22, 2005, the Company entered into a Mutual Release and Waiver Agreement with Burk pursuant to which Burk paid the Company $1,346 in full satisfaction of the promissory note, which included a discount of $119. As part of the Mutual Release and Waiver Agreement, the Company waived any right to future commission payments from Burk. Additionally, Burk and the Company granted mutual releases to one another with respect to future claims and liabilities. Accordingly, the total pre-tax gain on the disposal of discontinued operations, related to Burk, was approximately $2,419. The gain was recognized beginning in fiscal 2001. The Company realized pre-tax gain on the disposal of discontinued operations of $1,346 during the three months ended September 30, 2005.

5. Income Taxes

During the three months ended September 30, 2006, the Company recorded a benefit for income taxes from continuing operations of $19. This compares to a benefit for income taxes of $222 during the three months ended September 30, 2005. Taxes are based on the estimated annual effective tax rate.

SFAS No. 109, *"Accounting for Income Taxes,"* requires that a valuation allowance be established when it is more likely than not that all or a portion of a deferred tax asset will not be realized. As of September 30, 2006, the Company has recorded a valuation allowance against all of its net deferred tax assets due to the uncertainty of realization of the assets. Based on the Company's lack of cumulative profitability in recent years it is more likely than not that all of the net deferred tax assets will not be realized.

6. Inventory

Inventories, net of reserves, consist of the following as of September 30, 2006 and June 30, 2006:

	September 30, 2006	June 30, 2006
Raw materials	$ 188	$ 513
Finished goods	3,450	3,284
Consigned inventory	2,541	2,817
Total inventory	$ 6,179	$ 6,614

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

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

7. Accrued Liabilities

Accrued liabilities consist of the following as of September 30, 2006 and June 30, 2006:

	September 30, 2006	June 30, 2006
Accrued salaries and other compensation	$ 800	$ 1,150
Other accrued liabilities	1,336	1,247
Total	$ 2,136	$ 2,397

8. Commitments and Contingencies

The Company establishes contingent liabilities when a particular contingency is both probable and estimable. For the contingencies noted below, the Company has accrued amounts considered probable and estimable. The Company is not aware of pending claims or assessments, other than as described below, which may have a material adverse impact on the Company's business, results of operations, financial position, or liquidity.

Outsource Manufacturer. On August 11, 2003, the Company entered into a manufacturing agreement with an international outsource manufacturer related to the outsourced manufacturing of certain of its products. The manufacturing agreement established annual volume commitments. In the event annual volume commitments are not met, the Company will be subject to a tooling amortization charge for the difference between the Company's volume commitment and its actual product purchases. For the calendar year ended December 31, 2004, the Company was also responsible for prepayment of $274 in certain raw material inventory related to the annual volume commitment. As of September 30, 2006, $30 of the prepayment remained outstanding. The Company is also obligated to repurchase all raw materials sold to the international outsource manufacturer.

On August 1, 2005, the Company entered into a manufacturing agreement with a domestic outsource manufacturer related to the outsourced manufacturing of certain of its products. The raw materials owned by the Company were consigned to the manufacturer at August 1, 2005 in the amount of $2,285. The consigned raw material balance at September 30, 2006 was $175. The agreement established annual volume commitments and forecasting requirements. When the manufacturer procures materials for the forecast and actual orders do not meet the forecast, the Company is responsible to advance to the manufacturer the value of the inventory greater than a 90 day supply. The amount advanced to the domestic manufacturer at September 30, 2006 was $657. The consigned raw material balance and the amount advanced to the domestic manufacturer, net of estimated reserves, is included in raw materials.

Legal Proceedings. In addition to the legal proceedings described below, the Company is 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 the Company as of November 1, 2006 and after discussions with legal counsel, the Company does not believe any such other proceedings will have a material, adverse effect on its business, results of operations, financial position, or liquidity, except as described below.

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

The Shareholders' Class Action . On June 30, 2003, a consolidated complaint was filed against the Company, eight present or former officers and directors of the Company, and Ernst & Young LLP ("Ernst & Young"), the Company's former independent public accountants, by a class consisting of purchasers of the Company's common stock during the period from April 17, 2001 through January 15, 2003. The action followed the consolidation of several previously filed class action complaints and the appointment of lead counsel for the class. The allegations in the complaint were essentially the same as those contained in the SEC complaint described in the Company's Annual Report on Form 10-K for the year ended June 30, 2005. On December 4, 2003, the Company, on behalf of itself and all other defendants with the exception of Ernst & Young, entered into a settlement agreement with the class pursuant to which the Company agreed to pay the class $5,000 and to issue the class 1.2 million shares of its common stock. The cash payment was made in two equal installments, the first on November 10, 2003 and the second on January 14, 2005. On May 23, 2005, the court order was amended to require the Company to pay cash in lieu of stock to those members of the class who would otherwise have been entitled to receive fewer than 100 shares of stock. On September 29, 2005, the Company completed its obligations under the settlement agreement by issuing a total of 1,148,494 shares of the Company's common stock to the plaintiff class, including 228,000 shares previously issued in November 2004, and the Company paid an aggregate of $127 in cash in lieu of shares to those members of the class who would otherwise have been entitled to receive an odd-lot number of shares or who resided in states in which there was no exemption available for the issuance of shares. The cash payments were calculated on the basis of $2.46 per share which was equal to the higher of (i) the closing price for the Company's common stock as reported by the Pink Sheets on the business day prior to the date the shares were mailed, or (ii) the average closing price over the five trading days prior to such mailing date.

On a quarterly basis, the Company revalued the un-issued shares to the closing price of the stock on the later of the date the shares were mailed or the last day of the quarter. During fiscal 2006 and 2005, the Company received a benefit of approximately $1,205 and $2,046, respectively, while during fiscal 2004 the Company incurred an expense of approximately $4,080 related to the revaluation of the 1.2 million shares of the Company's common stock that were issued in November 2004 and September 2005.

The Shareholder Derivative Actions. Between March and August 2003, four shareholder derivative actions were filed by certain shareholders of the Company against various present and past officers and directors of the Company and against Ernst & Young. The complaints asserted allegations similar to those asserted in an SEC complaint described in the Company's Annual Report on Form 10-K for the year ended June 30, 2005 and the shareholders' class action described above and also alleged that the defendant directors and officers violated their fiduciary duties to the Company by causing or allowing the Company to recognize revenue in violation of generally accepted accounting principles ("GAAP") and to issue materially misstated financial statements and that Ernst & Young breached its professional responsibilities to the Company and acted in violation of GAAP by failing to identify or prevent the alleged revenue recognition violations and by issuing unqualified audit opinions with respect to the Company's fiscal 2002 and 2001 financial statements. One of these actions was dismissed without prejudice on June 13, 2003. As to the other three actions, the Company's Board of Directors appointed a special litigation committee of independent directors to evaluate the claims made by these shareholders. That committee determined that the maintenance of the derivative proceedings against the individual defendants was not in the best interest of the Company. Accordingly, on December 12, 2003, the Company moved to dismiss those claims. In March 2004, the Company's motions to dismiss those claims were granted and the derivative claims were dismissed with prejudice as to all defendants except Ernst & Young. The Company was substituted as the plaintiff in the action and is now pursuing in its own name the claims against Ernst & Young.

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The Insurance Coverage Action. On February 9, 2004, the Company and Edward Dallin Bagley, the Chairman of the Board of Directors and a significant shareholder of the Company, jointly filed an action against National Union Fire Insurance Company of Pittsburgh, Pennsylvania ("National Union") and Lumbermens Mutual Insurance Company of Berkeley Heights, New Jersey ("Lumbermens Mutual"), the carriers of certain prior period directors and officers' liability insurance policies, to recover the costs of defending and resolving claims against certain of the Company's present and former directors and officers in connection with the SEC complaint, the shareholders' class action, and the shareholder derivative actions described above, and seeking other damages resulting from the refusal of such carriers to timely pay the amounts owing under such liability insurance policies. This action has been consolidated into a declaratory relief action filed by one of the insurance carriers on February 6, 2004 against the Company and certain of its current and former directors. In this action, the insurers assert that they are entitled to rescind insurance coverage under our directors and officers liability insurance policies, $3,000 of which was provided by National Union and $2,000 of which was provided by Lumbermens Mutual, based on alleged misstatements in the Company's insurance applications. In February 2005, the Company entered into a confidential settlement agreement with Lumbermens Mutual pursuant to which the Company and Mr. Bagley received a lump-sum cash amount and the plaintiffs agreed to dismiss their claims against Lumbermens Mutual with prejudice. The cash settlement is held in a segregated account until the claims involving National Union have been resolved, at which time the amounts received in the action will be allocated between the Company and Mr. Bagley. The amount distributed to the Company and Mr. Bagley will be determined based on future negotiations between the Company and Mr. Bagley. The Company cannot currently estimate the amount of the settlement which it will ultimately receive. Upon determining the amount of the settlement which the Company will ultimately receive, the Company will record this as a contingent gain. None of the cash held in the segregated account is recorded as an asset at September 30, 2006. On October 21, 2005, the court granted summary judgment in favor of National Union on its rescission defense and accordingly entered a judgment dismissing all of the claims asserted by the Company and Mr. Bagley. In connection with the summary judgment, the Company has been ordered to pay approximately $59 in expenses. However, due to the Lumbermans Mutual cash proceeds discussed above and the appeal to the summary judgment discussed below, this potential liability has not been recorded in the balance sheet as of September 30, 2006. On February 2, 2006, the Company and Mr. Bagley filed an appeal to the summary judgment granted on October 21, 2005 and intend to vigorously pursue the appeal and any follow-up proceedings regarding their claims against National Union, although no assurances can be given that they will be successful. The Company and Mr. Bagley have entered into a Joint Prosecution and Defense Agreement in connection with the action and the Company is paying all litigation expenses except litigation expenses which are solely related to Mr. Bagley's claims in the litigation. The Company has recognized and continues to recognize the expenses incurred related to this action at the dates incurred.

9. Share-Based Payment

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

On September 30, 2006, the Company had two share-based compensation plans, one which expired on December 15, 2005, and one which remains active, which are described below.

The Company's 1990 Incentive Plan (the "1990 Plan") had shares of common stock available for issuance to employees and directors. Provisions of the 1990 Plan included the granting of stock options. Generally, stock options vested over a five-year period at 10 percent, 15 percent, 20 percent, 25 percent, and 30 percent per year. Certain other stock options vested in full after eight years. As of September 30, 2006, there were no options outstanding under the 1990 Plan and no additional options were available for grant under such plan.

The Company also has a 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 September 30, 2006, 22,500 and 150,500 of these options that cliff vest after 9.8 and 6.0 years, respectively, remain outstanding.

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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 all directors and officers' unvested options shall vest and become exercisable immediately prior to the event or closing of the transaction. All options outstanding as of September 30, 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 September 30, 2006, there were 1,251,921 options outstanding under the 1998 Plan, which includes the cliff vesting and 3 or 4-year vesting options discussed above, and 945,255 options available for grant in the future.

In addition to the two stock option plans, the Company 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 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.

In applying the Black-Scholes methodology to the options granted during the three months ended September 30, 2006 and 2005, the Company used the following assumptions:

	Three Months Ended	
	September 30, 2006	**September 30, 2005**
Risk-free interest rate, average	4.8%	4.1%
Expected option life, average	4.6 years	5.8 years

Expected price volatility, average	88.4%	88.3%
Expected dividend yield	0.0%	0.0%
Expected annual forfeiture rate	10.0%	10.0%

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. 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 Company determined the annual forfeiture rate for options that will cliff vest after 9.8 or 6.0 years to be 38.0 percent and the annual forfeiture rate for options that vest on 3 or 4-year vesting schedules to be 10.0 percent.

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In the three months ended September 30, 2006, the adoption of SFAS No. 123R resulted in incremental, pre-tax, stock-based compensation cost of $230. For the three months ended September 30, 2006, the Company expensed $10 in cost of goods sold, $25 in marketing and selling, $167 in general and administrative, and $28 in research and product development expense related to the transition to SFAS No. 123R. The stock-based compensation cost associated with adoption of SFAS No. 123R reduced net operating income for the three months ended September 30, 2006 by $230, decreased net income by $144, and reduced basic and diluted earnings per share by $0.01 per share. The total income tax provision (benefit) related to share-based compensation for the three months ended September 30, 2006 was ($86).

	Three Months Ended September 30, 2006	
	As Reported	**SFAS No. 123R Compensation Expense**
Revenue	$ 9,411	$ -
Cost of goods sold	4,316	10
Gross profit	5,095	(10)
Operating expenses:		
Marketing and selling	1,918	25
General and administrative	809	167
Research and product development	2,079	28
Total operating expenses	4,806	220
Operating (loss) income	289	(230)
Other income (expense), net	332	-
Income (loss) from continuing operations before income taxes	621	(230)
Benefit for income taxes	19	86
Income (loss) from continuing operations	640	(144)
Income from discontinued operations, net of tax	37	-
Net income	$ 677	$ (144)
Basic earnings (loss) per common share:		
Continuing operations	$ 0.05	$ 0.01
Discontinued operations	-	-
Net income	0.06	0.01
Diluted earnings (loss) per common share:		
Continuing operations	$ 0.05	$ 0.01

Discontinued operations	-	-
Net income	0.06	0.01

As of September 30, 2006, the total compensation cost related to unvested stock options not yet recognized was $1,414 which is expected to be recognized over the next 4.0 years on a straight-line basis. The weighted-average estimated fair value of the stock options granted during the three months ended September 30, 2006 and 2005 was $3.57 and $2.91, per share, respectively.

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The following table shows the stock option activity for the three months ended September 30, 2006.

Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Remaining Contractual Term (years)
Outstanding at June 30, 2006	1,237,920	$ 6.12	
Granted	321,000	3.57	
Expired and canceled	(275,720)	6.91	
Forfeited prior to vesting	(30,579)	3.90	
Exercised	(700)	2.88	
Outstanding at September 30, 2006	1,251,921	5.35	7.3 years
Exercisable	712,238	5.73	6.2 years

Non-vested Shares	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested at June 30, 2006	320,124	$ 4.39
Granted	321,000	2.47
Vested	(70,862)	3.33
Forfeited prior to vesting	(30,579)	2.95
Non-vested at September 30, 2006	539,683	$ 3.47

Due to the Company's failure to remain current in its filing of periodic reports with the SEC during fiscal 2004, 2005, and most of 2006, employees, executive officers, and directors were not allowed to exercise options under the 1998 Plan. Since December 2003, individual grants that had been affected by this situation were modified to extend the exercise period of the option through the date the Company became current in its filings with the SEC and options again became exercisable. Since July 1, 2003, modifications of stock option grants included (i) the extension of the post-service exercise period of vested options held by persons who have ceased to remain employed by the Company; (ii) the extension of the option exercise period for maturing options that were fully vested and unexercised; (iii) the acceleration of vesting schedule for certain key employees whose employment terminated due to the sale of the conferencing services business to Premiere; and (iv) the acceleration of vesting schedule for one former officer at termination. For the fiscal years ended June 30, 2006, 2005, and 2004, the Company modified stock options related to 8, 32, and 20 employees, respectively. Compensation cost is recognized immediately for options that are fully vested on the date of modification. During the fiscal years ended June 30, 2006, 2005, and 2004, the Company expensed $16, $41, and $200, respectively, in compensation cost associated with these modifications.

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10. Segment and Geographic Information

During the three months ended September 30, 2006 and 2005, all revenue and income (loss) from continuing operations was included in the product segment. Additionally, 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:

	Three Months Ended			
	September 30, 2006		September 30, 2005	
United States	$	6,938	$	6,824
All other countries		2,473		1,954
Total	$	9,411	$	8,778

11. Manufacturing Transition

In May 2005, the Company approved an impairment action and a restructuring action in connection with its decision to outsource its Salt Lake City manufacturing operations. These actions were intended to improve the overall cost structure for the product segment by focusing resources on other strategic areas of the business. The Company recorded an impairment charge of $180 and a restructuring charge of $110 during the fiscal year ended June 30, 2005 as a result of these actions. These charges were disclosed separately in the consolidated statements of operations. The impairment charge consisted of an immediate impairment of certain property and equipment of $180 that had value to the Company while it manufactured product but that was not purchased by Third Party Manufacturer (“TPM”) and at the time were not considered likely to be sold. These assets would have remained in service had the Company not outsourced its manufacturing operations. The restructuring charge also consisted of severance and other employee termination benefits of $70 related to a workforce reduction of approximately 20 employees who were transferred to an employment agency used by TPM to transition the workforce and a charge of $40 related to the operating lease for the Company’s manufacturing facilities that would no longer be used by the Company. All severance payments were paid by December 31, 2005.

The following table summarizes changes in the Company’s restructuring charges for the three months ended September 30, 2006 and 2005.

	Severance		Manufacturing Facilities Lease		Total	
Balance at June 30, 2005	$	70	$	40	$	110
Utilized		(30)		(8)		(38)
Balance at September 30, 2005	$	40	$	32	$	72

Balance at June 30, 2006	$	-	$	43	$	43
Utilized		0		(29)		(29)
Balance at September 30, 2006	$	-	$	14	$	14

12. Settlement Agreement and Release

The Company entered into a settlement agreement and release with its former Vice-President - Operations in connection with the cessation of his employment, which generally provided for his resignation from his position and employment with the Company, the payment of severance, and a general release of claims against the Company by him. On August 24, 2006, an agreement was entered into which generally provided for a severance payment of $9 and his surrender and delivery to the Company of 45,000 unexercised stock options in exchange for an additional $5 payment.

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13. Subsequent Events

On October 30, 2006, the Company announced a self-tender offer through which it intends to repurchase at a price of $4.25 per share up to 2,353,000 of its shares. If the offer is fully subscribed, the Company's outstanding shares would be reduced by approximately 19% at an aggregate cost of approximately $10,000. The tender offer commenced on November 6, and is scheduled to expire on December 6, 2006, unless extended.

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.

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 September 30, 2006, the Company deferred

$5.3 million in revenue and $2.5 million in cost of goods sold related to products sold where return rights had not lapsed. As of September 30, 2005, the Company deferred $4.8 million in revenue and $2.4 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, cost of goods sold, and gross profit at each period end for the 21-month period ended September 30, 2006 (in thousands).

	Deferred Revenue	Deferred Cost of Goods Sold	Deferred Gross Profit
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

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.

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 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. The reversal of a previously established valuation allowance results in a benefit for income taxes.

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