

SMITH MICRO SOFTWARE INC  
Form 10-K  
March 07, 2014

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2013

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 01-35525

**SMITH MICRO SOFTWARE, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**33-0029027**

(I.R.S. Employer Identification Number)

**51 Columbia, Aliso Viejo, CA**

(Address of principal executive offices)

**92656**

(Zip Code)

Registrant's telephone number, including area code: **(949) 362-5800**

**Common Stock, \$.001 par value**

(Title of each class)

**The NASDAQ Stock Market LLC**

(NASDAQ Global Market)

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(Name of each exchange on which registered)

**Securities registered pursuant to Section 12(b) of the Act: Common Stock, \$.001 par value**

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

YES  NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
YES  NO

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

As of June 30, 2013, the last business day of the registrant's most recently completed second quarter, the aggregate market value of the common stock of the registrant held by non-affiliates was \$34,675,588 based upon the closing sale price of such stock as reported on the Nasdaq Global Market on that date. For purposes of such calculation, only executive officers, board members, and beneficial owners of more than 10% of the registrant's outstanding common stock are deemed to be affiliates.

As of February 18, 2014, there were 38,609,318 shares of common stock outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's Proxy Statement for the 2014 Annual Meeting of Stockholders to be filed under the Securities Exchange Act of 1934 are incorporated by reference in Part III of this report.

SMITH MICRO SOFTWARE, INC.

2013 ANNUAL REPORT ON FORM 10-K

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**SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS**

*In this document, the terms Smith Micro, Company, we, us, and our refer to Smith Micro Software, Inc. and, where appropriate, its subsidiaries.*

*This report contains forward-looking statements regarding Smith Micro which include, but are not limited to, statements concerning projected revenues, expenses, gross profit and income, the competitive factors affecting our business, market acceptance of products, customer concentration, the success and timing of new product introductions and the protection of our intellectual property. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and certain assumptions made by us. Words such as anticipates, expects, intends, plans, predicts, potential, believes, seeks, estimates, should, may, will and variations of these words or similar expressions are intended to identify forward-looking statements. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed or implied in any forward-looking statements as a result of various factors. Such factors include, but are not limited to, the following:*

*changes in demand for our products from our key customers and their end-users;*  
*our business and stock price may decline further which could cause an additional impairment of long-lived assets or restructuring charges resulting in a material adverse effect on our financial condition and results of operations;*  
*our ability to successfully execute our business and restructuring plan and control costs and expenses;*  
*we risk being delisted from NASDAQ if our stock trades below \$1.00 per share for 30 straight business days;*  
*our quarterly revenues and operating results are difficult to predict and could fall below analyst or investor expectations, which could cause the price of our common stock to fall;*  
*the pace at which the market for new products develop;*  
*the intensity of the competition and our ability to successfully compete;*  
*our ability to hire and retain key personnel;*  
*the availability of third party intellectual property and licenses which may not be on commercially reasonable terms, or not at all;*  
*our ability to protect our intellectual property and our ability to not infringe on the rights of others;*  
*the ongoing uncertainty and volatility in U.S. and worldwide economic conditions may adversely affect our operating results;*  
*our ability to raise additional capital through the issuance of additional equity or convertible debt securities or by borrowing money, in order to meet our capital needs;*  
*security and privacy breaches in our systems may damage client relations and inhibit our ability to grow;*  
*interruptions or delays in the services we provide from our data center hosting facilities could harm our business; and*  
*those additional factors which are listed under the section 1A. Risk Factors beginning on page 10 of this report.*

*The forward-looking statements contained in this report are made on the basis of the views and assumptions of management regarding future events and business performance as of the date this report is filed with the Securities and Exchange Commission (the SEC). We do not undertake any obligation to update these statements to reflect events or circumstances occurring after the date this report is filed.*

## PART I

### Item 1. BUSINESS

#### General

Smith Micro Software, Inc. provides software and services that simplify, secure and enhance the mobile experience. The Company's portfolio of wireless solutions includes a wide range of client and server applications that manage devices, communications and network connectivity for end-users as well as Machine-to-Machine ( M2M ) endpoints. Our primary customers are the world's leading wireless service providers, mobile device and chipset manufacturers, and enterprise businesses. In addition to our wireless and mobility software, Smith Micro offers personal productivity, graphics and animation products distributed through a variety of consumer channels worldwide.

With a 30-year history of technology innovation, leadership in industry standards, and extensive commercial deployment experience, Smith Micro continues to evolve its portfolio and business models to capitalize on new market opportunities. Over the past three decades, the Company has developed deep expertise in embedded software for networked devices, policy-based management platforms, and highly-scalable mobile applications and hosted services. For network operators and organizations struggling to reduce costs and complexity in the fragmented, rapidly evolving mobile market, Smith Micro offers proven solutions that increase reliability, security, and efficiency while accelerating time to market for mobile products and services.

The proliferation of mobile broadband technology continues to provide new opportunities for Smith Micro on a global scale. Today, Smith Micro's mission is to help our customers thrive in a connected world with software solutions that:

1. Simplify wireless connectivity to reduce support costs and increase accessibility;
2. Optimize network and device resources for maximum performance and efficiency;
3. Enable a safe, productive mobile environment that meets enterprise and governmental standards for security, control and regulatory compliance; and
4. Engage and grow high-value relationships with end customers using mobile devices.

The Company was incorporated in California in November 1983, and reincorporated in Delaware in June 1995. Our principal executive offices are located at 51 Columbia, Aliso Viejo, California 92656. Our telephone number is (949) 362-5800. Our website address is [www.smithmicro.com](http://www.smithmicro.com). Our NASDAQ symbol is SMSI, and we make our SEC filings available on the Investor Relations page of our website. Information contained on our website is not part of this Annual Report on Form 10-K.

#### Business Segments

Our operations are organized into two business segments: Wireless and Productivity & Graphics. We do not separately allocate operating expenses, nor do we allocate specific assets to these groups. Therefore, segment information reported includes only revenues and cost of revenues. See Note 6 of Notes to Consolidated Financial Statements for financial information related to our business segments and geographical information.

## Wireless

Rapid advancements in wireless technology, including higher speed networks, intelligent connected devices and an abundance of digital content and mobile applications, are fueling the mobile broadband market. The demand for pervasive connectivity is largely driven by the insatiable consumer desire to access information and digital entertainment - anytime, anywhere - from smartphones, tablets, laptop computers, e-readers, gaming devices and more. Further, the ability to instrument devices with meters, diagnostics and operational controls has led to an exploding M2M wireless market across a broad range of vertical industries. While the benefits and opportunities associated with increased mobility are plenty, so are the challenges of this highly dynamic environment:

Wireless data services are being adopted at such a fast pace that global wireless networks cannot support them without significant investments to increase capacity and performance.

Operators are being marginalized by over-the-top applications and social networks as they struggle to supplement declining voice and messaging revenues with new data services.

Device and module makers face increasing pressure to differentiate their platforms and accelerate time to market while burdened by network certification requirements that differ for each wireless carrier.

Commercial and public sector organizations are challenged to mobilize their operations and provide their work forces with wireless access to critical information without sufficient tools to manage security, performance and costs.

End users must adapt to a variety of mobile platforms, a deluge of mobile apps, and unreliable connection methods while learning to understand and manage costs of consuming data.

To address these challenges, Smith Micro has developed a robust software portfolio comprised of three product families that help our customers *connect*, *control* and *capitalize* on the mobile internet:

**QuickLink®** connection management applications and software components that help users and devices access 3G, 4G and Wi-Fi networks, easily and securely.

**NetWise®** policy-based *control* solutions for intelligently managing data traffic, network authentication, user entitlement to wireless services, and device behavior.

**CommSuite®** a premium services platform that allows operators and enterprises to deliver and monetize advanced voice, video and messaging applications.

Our flagship QuickLink connectivity solutions have been shipped on more than 100 million devices worldwide. This patented technology allows mobile users to easily connect a tablet, laptop or other wireless device to cellular or Wi-Fi networks. Many of the world's largest mobile network operators, including AT&T, Bell Canada, Bouygues, Orange, Sprint, T-Mobile, Verizon Wireless, and Vodafone, have offered QuickLink as a white-label connection management application to their subscribers. QuickLink components are embedded by leading chipset manufacturers and module makers to ensure that connectivity is consistent across device types. QuickLink is also used by enterprises and public sector organizations with mobile workforces to provide enhanced security and configurability over public and private wireless networks.

NetWise is a policy-driven platform for managing data and devices over heterogeneous networks. Using an intelligent device client NetWise provides visibility and control over 3G, 4G and Wi-Fi network connections to ensure the best possible quality of experience for end users. NetWise helps operators reduce congested networks and helps enterprises reduce escalating telecom budgets through discovery, authentication and seamless offload of data to Wi-Fi networks. NetWise also provides remote device and user access management to ensure secure, compliant access to networked systems and information.

With the CommSuite premium services platform, operators can drive new revenues and better compete with over-the-top ( OTT ) applications by offering innovative new messaging features, such as Voice-to-Text, Avatar messaging, Videomail, live Videocasting, and more. CommSuite services are offered stand-alone or can be bundled with existing voicemail and messaging systems, including Rich Communication Services ( RCS ). The CommSuite gateway provides application management and supports flexible business models, such as monthly subscription, content-driven purchases, and freemium ad-sponsored plans, by integrating with operator billing/provisioning systems and advertising mediation engines. For enterprises, CommSuite offers increased productivity through a single client application for accessing mobile and office voice messages, as well as secure, adaptive streaming of mobile video, including rights-managed content (like on-demand movies), closed-circuit video, and more.

Beyond the advanced features within each product family, the expertise to integrate technologies across the entire portfolio is an advantage that Smith Micro uniquely brings to its customers. For example, CommSuite Videomail can be managed by NetWise data policies to ensure that video traffic is restricted to Wi-Fi or 4G networks. Using technology and experience acquired over 30 years, Smith Micro continues to deliver new solutions to meet new market challenges.

## Productivity & Graphics

The Productivity & Graphics group focuses on developing a variety of software for the consumer, prosumer, and professional markets. Our solutions span compression, graphics and utilities. This group also republishes and markets third party software titles that complement our existing line of products. All of these products are available through direct sales on the Smith Micro websites (smithmicro.com, mysmithmicro.com and contentparadise.com), on affiliate websites, direct through customer service order desks, on-line resellers and through traditional retail outlets.

The group's primary product offering is its line of graphic titles, in particular Poser®, Anime Studio®, Manga Studio® and MotionArtist . These products are aimed at digital artists of all skill levels helping them to produce professional level animations, comics, and other 2D and 3D art. Poser is the industry leading tool for 3D human figure design and animation. Anime Studio is used by both hobbyists and professional artists working for high-end animation studios like Disney, and Manga Studio is at the top of the market for comic illustration software, used by famous graphic novelists such as Dave Gibbons, the author of the Watchmen. The group is focused on pursuing adjacent markets to these graphic arts, as well as new platforms for the existing titles, such as iOS.

The secondary product line is StuffIt®, driven by its patented and patent-pending image compression, with a focus on our innovative lossless JPEG compression technology. StuffIt provides superior lossless compression, encryption and archiving. We have enhanced this industry-leading product's feature set with new, online file transfer capabilities.

## Products and Services

Our primary products consist of the following:

| Product Groups | Products                           | Description   |
|----------------|------------------------------------|---|
|                | QuickLink® Mobile                  | Connection management application to control, customize and automate wireless connections from PCs and Macs to WWAN and WLAN/Wi-Fi networks   |
|                | QuickLink® Mobility                | Mobile VPN and connection manager targeted to enterprises with mobile workforces and the public sector  |
|                | QuickLink® Hotspot QuickLink® Zero | An application that optimizes the user-experience with billing integration, automated diagnostics, and usage metering for mobile hotspot features on smartphones and mobile broadband devices |
|                | QuickLink® MiTile                  | Connection manager for Microsoft Windows 8 devices  |
|                | QuickLink® MBIM Drivers            | Customizable drivers that support the Mobile Broadband Interface Model (MBIM) standard for connecting USB devices to a variety of operating systems   |
|                | NetWise® Director                  | Intelligent traffic management for data offload and seamless, secure network transitions between 3G/4G/Wi-Fi; provides application controls, user entitlement, and automated authentication   |
|                | NetWise® I/O                       | A toolkit for testing client/server interoperability using the ANDSF networking standard.   |
|                | NetWise® SmartSpot                 | Wi-Fi discoverability, promotion and automated authentication   |
|                | NetWise® DM Suite                  | Device Management platform for mobile device provisioning and configuration   |
|                | NetWise® FOTA                      | Lightweight device agent and deployment server for updating Firmware Over The Air (FOTA)  |
|                | CommSuite® PTT                     | A push-to-talk (PTT) data service that uses a mobile Internet connection to send and receive walkie-talkie style calls  |
|                | CommSuite® VVM                     | Visual Voicemail (VVM) delivered directly to a mobile phone app and managed like email  |
|                | CommSuite® VTT                     | Voice-to-Text (VTT) transcription of voicemail and voice SMS messages   |
|                | CommSuite® Avatarmail              | Talking Avatars that use voice, wallpapers, stickers and photos to communicate  |
|                | CommSuite® VIDIO                   | Adaptive streaming of video content to support mobile viewing across laptops, tablets, phones, TVs, and more  |
|                | CommSuite® Videocast and Videomail | Delivery of live or pre-recorded video messages captured on mobile devices and available via web link with no client application required   |
| Productivity & | Poser®                             | A solution for creating 3D character art and animations   |
| Graphics       | Anime Studio®                      | An animation tool for professionals and digital artists   |
|                | Manga Studio®                      | A solution for creating manga and comic art   |
|                | MotionArtist                       | A solution for creating interactive presentations   |
|                | ScatterShow                        | Creates interactive slide shows from photo albums on mobile devices   |
|                | StuffIt Deluxe®                    | Patented, lossless compression solution for documents and media   |



## Marketing and Sales Strategy

Because of our broad product portfolio and deep device integration experience, we are able to leverage technologies across a wide range of platforms and operating systems to quickly bring to market innovative solutions that meet the evolving needs of our customers. We continue to offer flexible, performance-based business models that align with our customers' needs to create new revenue opportunities and differentiate their products and services among their competitors.

Our sales strategy is as follows:

*Leverage Carrier and OEM Relationships.* We continue to capitalize on our strong relationships with the world's leading wireless carriers and mobile device manufacturers. Our carrier customers serve as our primary distribution channel, providing access to hundreds of millions of end-users around the world, and also providing market feedback for future product offerings.

*Focus on High-Growth Markets.* We continue to focus on wireless connectivity and communications solutions taking advantage of enhanced 4G networks developed by wireless carriers and an increasing availability of rich media and multi-media enabled smartphones, tablets, eReaders and other emerging cellular and Wi-Fi devices.

*Expand our Customer Base.* In addition to introducing new products to current customers, we are growing our domestic and international business through sales to new carriers and device manufacturers, as well as increased penetration of the enterprise market, with particular focus on public safety, education, and vertical markets utilizing M2M technologies.

*Selectively Pursue Partnerships and Acquisitions of Complementary Products and Services.* We continue to pursue partnerships and acquisition opportunities that will enhance our portfolio, help us enter complementary markets, and extend our geographic reach. We will leverage partnerships with technology providers and systems integrators to further our penetration into new markets and deliver more comprehensive solutions to our customers.

Revenues to two customers (Sprint and Verizon Wireless) and their respective affiliates in the Wireless business segment accounted for 53.1% and 13.0%, respectively, of the Company's total revenues for the fiscal year 2013. Revenues to FastSpring in the Productivity & Graphics business segment accounted for 11.4% of the Company's total revenues for the fiscal year 2013. In 2012, our two largest customers (Sprint and Verizon Wireless) accounted for 40.7% and 20.5%, respectively, of our total revenues. In 2011, our three largest customers (Sprint, Verizon Wireless and AT&T) accounted for 24.8%, 18.4% and 11.7%, respectively, of our total revenues. Our major customers could reduce their orders of our products in favor of a competitor's product or for any other reason. The loss of any of our major customers or decisions by a significant customer to substantially reduce purchases could have a material adverse effect on our business.

## Customer Service and Technical Support

We provide technical support and customer service through our online knowledge base, via email, live chat and by telephone. OEM customers generally provide their own primary customer support functions and rely on us for support to their own technical support personnel.

## Product Development

The software industry, particularly the wireless market, is characterized by rapid and frequent changes in technology and user needs. We work closely with industry groups and customers, both current and potential, to help us anticipate changes in technology and determine future customer needs. Software functionality depends upon the capabilities of the hardware. Accordingly, we maintain engineering relationships with various hardware manufacturers and we develop our software in tandem with their product development. Our engineering relationships with manufacturers, as well as with our major customers, are central to our product development efforts. We remain focused on the development and expansion of our technology, particularly in the wireless space. Research and development expenditures amounted to \$21.3 million, \$24.8 million, and \$41.7 million for the years ended December 31, 2013, 2012 and 2011, respectively.

## Manufacturing

Although we primarily deliver our software via electronic downloads, we do deliver our software in several other forms. We offer a package or kit that may include CD-ROMs and certain other documentation or marketing material. We also permit selected OEM customers to duplicate our products on their own CD-ROMs, USB devices, or embedded devices, and pay a royalty based on usage. Some OEM business requires that we provide a CD, which includes a soft copy of a user guide. Finally, we grant licenses to certain OEM customers that enable those customers to preload a copy of our software onto a personal computer. With the enterprise sales program, we offer site licenses under which a corporate user is allowed to distribute copies of the software to users within their corporate sites.

Our product development group produces a product master for each product that is then duplicated and packaged into products by the manufacturing organization. All product components are purchased by our personnel in our Aliso Viejo, California facility. Our manufacturing is subcontracted to outside vendors and includes the replication of CD-ROMs and the printing of documentation materials. Assembly of the final package is completed by our Aliso Viejo, California facility.

## Competition

The markets in which we operate are highly competitive and subject to rapid changes in technology. These conditions create new opportunities for Smith Micro, as well as for our historical connection management competitors, and we expect new competitors to enter the market. We also believe that competition from established and emerging software companies will continue to intensify as the emerging mobile, wireless and Internet markets evolve. We compete with other software vendors for new customer contracts, as well as in our efforts to acquire technology and qualified personnel.

We believe that the principal competitive factors affecting the mobile software market include domain expertise, product features, usability, quality, price, customer service and effective sales and marketing efforts. Although we believe that our products currently compete favorably with respect to these factors, there can be no assurance that we can maintain our competitive position against current and potential competitors. We also believe that the market for our software products has been and will continue to be characterized by significant price competition. A material reduction in the price of our products could negatively affect our profitability.

Many existing and potential carrier and OEM customers have the resources to develop products that compete directly with our products. These customers may discontinue the purchase of our products. Our future performance is substantially dependent upon the extent to which existing carrier and OEM customers elect to purchase software from us rather than design and develop their own software.

## Proprietary Rights and Licenses

Our success and ability to compete is dependent upon our software code base, our programming methodologies and other intellectual properties. To protect our proprietary technology and intellectual property, we rely on a combination of trade secrets, nondisclosure agreements, patents, copyright and trademark law that may afford only limited protection. As of December 31, 2013, we owned 79 issued U.S. patents and have 29 U.S. patent applications that are currently pending. These patents are intended to provide generalized protection of our intellectual property technology base and we will continue to apply for various patents and trademarks in the future as we deem necessary to protect our intellectual property technology base.

We seek to avoid unauthorized use and disclosure of our proprietary intellectual property by requiring employees and consultants with access to our proprietary information to execute confidentiality agreements with us and by restricting access to our source code. The deterrent steps that we have taken to protect our proprietary technology may not be adequate to deter misappropriation of our proprietary information or prevent the successful assertion of any adverse claim against us relating to software or intellectual property utilized by us. In addition, we may not be able to detect unauthorized use of our intellectual property rights or take effective steps to enforce those rights.

In selling our products, we primarily rely on shrink wrap licenses that are not signed by licensees and may be unenforceable under the laws of certain jurisdictions. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as do the laws of the United States. Accordingly, the means we currently use to protect and enforce all of our proprietary rights and intellectual property rights may not be adequate. Moreover, our competitors may independently develop competitive technology similar to ours. We also license technology on a non-exclusive basis from several companies for inclusion in our products and anticipate that we will continue to do so in the future. If we are unable to continue to license these technologies or to license other necessary technologies for inclusion in our products, or such third party technologies become subject to claims directed to or against the third party technologies used by us, or if we experience substantial increases in royalty payments under these third party licenses, our business could be materially and adversely affected.

## Employees

As of December 31, 2013, we had a total of 241 employees within the following departments: 143 in engineering, 52 in sales and marketing, 22 in operations and customer support and 24 in management and administration. We are not subject to any collective bargaining agreement and we believe that our relationships with our employees are good.

## Item 1A. RISK FACTORS

Our future operating results are highly uncertain. Before deciding to invest in our common stock or to maintain or increase your investment, you should carefully consider the risks described below, in addition to the other information contained in this report and in our other filings with the SEC, including our reports on Forms 10-K, 10-Q and 8-K. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. If any of these risks actually occur, that could seriously harm our business, financial condition or results of operations. In that event, the market price for our common stock could decline and you may lose all or part of your investment.

*We derive a significant portion of our revenues from sales of a small number of products to Sprint and Verizon Wireless, so our revenues and operating results are highly vulnerable to shifts in demand and may continue to decline.*

In our Wireless business segment, we sell primarily to large carriers and original equipment manufacturers ( OEMs ), so there are a limited number of actual and potential customers for our products, resulting in customer concentration for sales of our products and services. For the year ended December 31, 2013, sales to Sprint and Verizon Wireless comprised 53.1% and 13.0% of our total revenues, respectively. Because of our customer concentration, these carriers and other large customers may have significant pricing power over us, and any material decrease in sales to any of them would materially affect our revenues and profitability. Additionally, carriers and OEMs are not the end-users of our products. If any of their efforts to market products and services incorporating our software are unsuccessful in the marketplace, our revenues and profitability could be adversely affected.

On July 10, 2013, Softbank and Sprint Nextel completed a merger which could further intensify the competitive pressures that we face. Furthermore, the uncertainties created by this merger could cause it to delay or cancel planned purchases of our products and services, particularly if there are proposed changes or uncertainties in the future management, product offerings and technical specifications of Sprint and its product portfolio.

We also derive a significant portion of our revenues from a few vertical markets, such as wireless carriers and handset manufacturers. In order to sustain and grow our business, we must continue to sell our software products into these vertical markets. Shifts in the dynamics of these vertical markets, such as new product introductions by our competitors, could materially harm our results of operations, financial condition and prospects. To increase our sales outside our core vertical markets, for example to large enterprises, requires us to devote time and resources to hire and train sales employees familiar with those industries. Even if we are successful in hiring and training sales teams, customers in other vertical markets may not need or sufficiently value our current products or new product introductions.

*We announced a restructuring plan in July 2013 and we may take additional restructuring actions in the future that would result in additional charges, which would have a negative impact on our results of operations in the period the action is taken.*

On July 25, 2013, the Board of Directors approved a new restructuring plan which was implemented primarily during the fiscal quarter ending September 30, 2013. This restructuring plan involved changes in management structure in order to streamline the organization, facility consolidations/closures, and headcount reductions that amounted to approximately 26% of the Company's worldwide workforce. This resulted in one-time restructuring charges of approximately \$5.6 million that was recorded in the three month period ended September 30, 2013. If the demand for our legacy and new products does not increase, we may need to take additional restructuring actions in future quarters, although we currently do not have any intention to do so. If future restructuring actions are taken, this could have a material adverse effect on our financial condition and results of operations in the period that the action is taken.

*Our restructuring plan includes organizational changes and facility closures and consolidations, which could have a negative impact on our operations and customers.*

Our recently announced restructuring plan involves a transfer of significant duties and responsibilities from employees who are being terminated and facilities which are being closed or consolidated. Such duties and responsibilities will be transferred to employees and facilities which we are retaining. If the transfer of duties and responsibilities, including underlying product knowledge and expertise of our existing product lines, is not executed successfully and seamlessly, this could adversely affect our levels of customer service and satisfaction, which could adversely affect our business and future revenues. In addition, the restructuring may cause us future difficulties in hiring and retaining highly skilled employees, particularly in competitive specialties.

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*If we fail to meet the requirements for continued listing on the NASDAQ Global Market, our common stock would likely be delisted from trading on the NASDAQ Global Market, which could adversely affect the liquidity of our common stock and cause our trading price to decline.*

Our common stock is currently listed for quotation on the NASDAQ Global Market. We are required to meet specified financial requirements in order to maintain our listing on the NASDAQ Global Market. One such requirement is that we maintain a minimum closing bid price of at least \$1.00 per share for our common stock. NASDAQ notified the Company on November 7, 2013 that the bid price of the Company's common stock had closed below the minimum \$1.00 per share requirement over the previous 30 consecutive business days and, as a result, the Company was not in compliance with Listing Rule 5450(a)(1). On November 25, 2013, NASDAQ notified the Company that the closing bid price of its common stock had been at \$1.00 per share or greater for at least 10 consecutive business days. Accordingly, NASDAQ confirmed to the Company that it had regained compliance with the minimum bid price rule and the matter was now closed.

Our common stock price could again fall below the \$1.00 per share threshold for 30 consecutive business days, in which case we would receive another deficiency letter. If we fail to satisfy the NASDAQ Global Market's continued listing requirements, our common stock would likely be delisted from the NASDAQ Global Market, in which case our stock may trade on the NASDAQ Capital Market for a period of time, or our stock may trade on the OTC Bulletin Board. Any potential delisting of our common stock from the NASDAQ Global Market would likely result in decreased liquidity and increased volatility of our common stock, and could cause our trading price to decline.

*Our quarterly revenues and operating results are difficult to predict and could fall below analyst or investor expectations, which could cause the price of our common stock to fall.*

Our quarterly revenues and operating results have fluctuated significantly in the past and may continue to vary from quarter to quarter due to a number of factors, many of which are not within our control. If our operating results do not meet the expectations of securities analysts or investors, our stock price may decline. Fluctuations in our operating results may be due to a number of factors, including the following:

- the gain or loss of a key customer;
- the size and timing of orders from and shipments to our major customers;
- the size and timing of any product return requests;
- our ability to maintain or increase gross margins;
- variations in our sales channels or the mix of our product sales;
- our ability to anticipate market needs and to identify, develop, complete, introduce, market and produce new products and technologies in a timely manner to address those needs;
- the availability and pricing of competing products and technologies and the resulting effect on sales and pricing of our products;
- acquisitions;
- the effect of new and emerging technologies;
- the timing of acceptance of new mobile services by users of our customers' services;
- deferrals of orders by our customers in anticipation of new products, applications, product enhancements or operating systems; and
- general economic and market conditions.

We have difficulty predicting the volume and timing of orders. In any given quarter, our sales have involved, and we expect will continue to involve, large financial commitments from a relatively small number of customers. As a result, the cancellation or deferral of even a small number of orders would

reduce our revenues, which would adversely affect our quarterly financial performance. Also, we have often booked a large amount of our sales in the last month of the quarter and often in the last week of that month. Accordingly, delays in the closing of sales near the end of a quarter could cause quarterly revenues to fall substantially short of anticipated levels. Significant sales may also occur earlier than expected, which could cause operating results for later quarters to compare unfavorably with operating results from earlier quarters.

Future orders may come from new customers, or from existing customers for new products. The sales cycles may be greater than what we have experienced in the past, increasing the difficulty to predict quarterly revenues.

Because we sell primarily to large carriers and OEM customers, we have no direct relationship with most end-users of our products. This indirect relationship delays feedback and blurs signals of change in the quick-to-evolve wireless ecosystem, and is one of the reasons we have difficulty predicting demand.

A large portion of our operating expenses, including rent, depreciation and amortization, is fixed and difficult to reduce or change. Accordingly, if our total revenue does not meet our expectations, we may not be able to adjust our expenses quickly enough to compensate for the shortfall in revenue. In that event, our business, financial condition and results of operations would be materially and adversely affected.

Due to all of the foregoing factors, and the other risks discussed in this report, you should not rely on quarter-to-quarter comparisons of our operating results as an indication of future performance.

*We may have further impairments of long-lived assets if our business does not improve and our stock price declines which could cause a material adverse effect on our financial condition and results of operations.*

The Company assesses potential impairment to its long-lived assets as required by FASB ASC Topic No. 360, Property, Plant, and Equipment, when there is evidence that events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss is recognized when the carrying amount of the long-lived assets exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. Any required impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value and is recorded as a reduction in the carrying value of the related asset and a charge to operating results.

For the year ended December 31, 2013, we recorded a charge for impairment of long-lived assets of \$1.0 million as a result of our 2013 restructuring. For the year ended December 31, 2011, we recorded a charge for impairment of long-lived assets of \$18.7 million (\$13.4 million on intangible assets and \$5.3 million on fixed assets) due, in part, to continued declines in our revenues and profitability and our continued depressed stock price. In future years, we may be required to take further charges for impairment of equipment and improvements, which could have a material adverse effect on our financial condition and results of operations.

*Technology and customer needs change rapidly in our market, which could render our products obsolete and negatively affect our business, financial condition and results of operations.*

Our success depends on our ability to anticipate and adapt to changes in technology and industry standards. We will also need to continue to develop and introduce new and enhanced products to meet our target markets' changing demands, keep up with evolving industry standards, including changes in the Microsoft, Google and Apple operating systems with which our products are designed to be compatible, and to promote those products successfully. The communications and utilities software markets in which we operate are characterized by rapid technological change, changing customer needs, frequent new product introductions, evolving industry standards and short product life cycles. In addition, the technology we market, which has been sold as software in the past, can be integrated at the chipset level by the leading mobile chipset manufacturers. Any of these factors could render our existing products obsolete and unmarketable. In addition, new products and product enhancements can require long development and

testing periods as a result of the complexities inherent in today's computing environments and the performance demanded by customers and called for by evolving wireless networking technologies. If our target markets do not develop as we anticipate, our products do not gain widespread acceptance in these markets, or we are unable to develop new versions of our software products that can operate on future wireless networks and PC and mobile device operating systems and interoperate with other popular applications, our business, financial condition and results of operations could be materially and adversely affected.

*Competition within our target markets is intense and includes numerous established competitors and new entrants, which could negatively affect our revenues and results of operations.*

We operate in markets that are extremely competitive and subject to rapid changes in technology. Because there are low barriers to entry into the software markets in which we participate and may participate in the future, we expect significant competition to continue from both established and emerging software companies in the future, both domestic and international. In fact, our growth opportunities in new product markets could be limited to the extent established and emerging software companies enter or have entered those markets. Furthermore, our existing and potential OEM customers may acquire or develop products that compete directly with our products.

Many of our other current and prospective competitors have significantly greater financial, marketing, service, support, technical and other resources than we do. As a result, they may be able to adapt more quickly than we can to new or emerging technologies and changes in customer requirements or to devote greater resources to the promotion and sale of their products. Announcements of competing products by competitors could result in the cancellation of orders by customers in anticipation of the introduction of such new products. In addition, some of our competitors are currently making complementary products that are sold separately. Such competitors could decide to enhance their competitive position by bundling their products to attract customers seeking integrated, cost-effective software applications. Some competitors have a retail emphasis and offer OEM products with a reduced set of features. The opportunity for retail upgrade sales may induce these and other competitors to make OEM products available at their own cost or even at a loss. We also expect competition to increase as a result of software industry consolidations, which may lead to the creation of additional large and well-financed competitors. Increased competition is likely to result in price reductions, fewer customer orders, reduced margins and loss of market share.

*We are entering new, emerging markets in which we have limited experience; if these markets do not develop or we are unable to otherwise succeed in them, our revenues will suffer and the price of our common stock will likely decline.*

Our recent and planned product introductions to support new higher speed networking and 4G technologies have allowed us to enter new markets. A viable market for these products may not develop or be sustainable, and we may face intense competition in these markets. In addition, our success in these markets depends on our carrier customers' ability to successfully introduce new mobile services enabled by our products and our ability to broaden our carrier customer base, which we believe will be difficult and time-consuming. If the expected benefits from entering new markets do not materialize, our revenues will suffer and the price of our common stock would likely decline. In addition, to the extent we enter new markets through acquisitions of companies or technologies, our financial condition could be harmed or our stockholders could suffer dilution without a corresponding benefit to our company if we do not realize expected benefits of entering such new markets.



*If the adoption of and investments in new technologies and services grows more slowly than anticipated in our product planning and development, our operating results, financial condition and prospects may be negatively affected.*

If the adoption of and investments in new networking and 4G technologies and services does not grow or grows more slowly than anticipated, we will not obtain the anticipated returns from our planning and development investments. For example, our Enterprise products allow our customers to update mobile devices from a home office and incorporate technology that provides a mechanism to allow for efficient firmware updates for mobile devices. In addition, we have introduced new high-speed networking and 4G products, but the pace of the market introduction of such technologies is uncertain. Future sales and any future profits from these and related products are substantially dependent upon the acceptance and use of these new technologies, and on the continued adoption and use of mobile data services by end-users.

Many of our customers and other communications service providers have made and continue to make major investments in next generation networks that are intended to support more complex applications. If communications service providers delay their deployment of networks or fail to deploy such networks successfully, demand for our products could decline, which would adversely affect our revenues. Also, to the extent we devote substantial resources and incur significant expenses to enable our products to be interoperable with new networks that have failed or have been delayed or not deployed, our operating results, financial condition and prospects may be negatively affected.

*If we are unable to retain key personnel, the loss of their services could materially and adversely affect our business, financial condition and results of operations.*

Our future performance depends in significant part upon the continued service of our senior management and other key technical and consulting personnel. We do not have employment agreements with our key employees that govern the length of their service. The loss of the services of our key employees would materially and adversely affect our business, financial condition and results of operations. Our future success also depends on our ability to continue to attract, retain and motivate qualified personnel, particularly highly skilled engineers involved in the ongoing research and development required to develop and enhance our products. Competition for these employees remains high and employee retention is a common problem in our industry. Our inability to attract and retain the highly trained technical personnel that are essential to our product development, marketing, service and support teams may limit the rate at which we can generate revenue, develop new products or product enhancements and generally would have an adverse effect on our business, financial condition and results of operations.

*We rely directly and indirectly on third-party intellectual property and licenses, which may not be available on commercially reasonable terms or at all.*

Many of the Company's products and services include third-party intellectual property, which requires licenses from those third parties directly to us or to unrelated companies which provide us with sublicenses and/or execution of services for the operation of our business. These products and services include our wireless suite of products as well as our productivity and graphics products. The Company has historically been able to obtain such licenses on reasonable terms. There is however no assurance that in the future the necessary licenses could be obtained on acceptable terms or at all. If the Company or our third party service providers are unable to obtain or renew critical licenses on reasonable terms, we may be forced to terminate or curtail our products and services which rely on such intellectual property and our financial condition and operating results may be materially adversely affected.

*If we fail to continue to establish and maintain strategic relationships with mobile device manufacturers, wireless carriers and network infrastructure manufacturers, market acceptance of our products and our profitability may suffer.*

Most of our strategic relationships with mobile device manufacturers are not subject to written contract, but rather are in the form of informal working relationships. We believe these relationships are valuable to our success. In particular, these relationships provide us with insights into product development and emerging technologies, which allows us to keep abreast of, or anticipate, market trends and helps us serve our current and prospective customers. Because these relationships are not typically governed by written agreements, there is no obligation for many of our partners to continue working with us. If we are unable to maintain our existing strategic relationships with mobile device manufacturers or if we fail to enter into additional strategic relationships or the parties with whom we have strategic relationships favor one of our



competitors, our ability to provide products that meet our current and prospective customers' needs could be compromised and our reputation and future revenue prospects could suffer. For example, if our software does not function well with a popular mobile device because we have not maintained a relationship with its manufacturer, carriers seeking to provide that device to their respective customers could choose a competitor's software over ours or develop their own. Even if we succeed in establishing these relationships, they may not result in additional customers or revenues.

*Our growth depends in part on our customers' ability and willingness to promote services and attract and retain new customers or achieve other goals outside of our control.*

We sell our products for use on handheld devices primarily through our carrier customers. Losing the support of these customers may limit our ability to compete in existing and potential markets and could negatively affect our revenues. In addition, the success of these customers and their ability and willingness to market services supported by our products is critical to our future success. Our ability to generate revenues from sales of our software is also constrained by our carrier customers' ability to attract and retain customers. We have no input into or influence upon their marketing efforts and sales and customer retention activities. If our large carrier customers fail to maintain or grow demand for their services, revenues or revenue growth from our products designed for use on mobile devices will decline and our results of operations will suffer.

*The ongoing uncertainty and volatility in U.S. and worldwide economic conditions may adversely affect our operating results.*

Our operations and performance depend significantly on economic conditions in the United States and worldwide. The U.S. and global economic outlook remains uncertain. A general weakening of, and related decline of confidence in, the U.S. and global economies or the curtailment in government or corporate spending could make it difficult for current or potential wireless carrier and OEM customers and their end users to accurately forecast and plan future business activities and capital expenditures, which could cause them to slow spending on our products and services. These and other economic factors could adversely affect demand for our products and services and our financial condition and operating results, and may require us to record additional charges related to restructuring costs and/or the impairment of long-lived assets.

*Acquisitions of companies or technologies may disrupt our business and divert management attention and cause our current operations to suffer.*

We have historically made targeted acquisitions of smaller companies with important technology and expect to continue to do so in the future. As part of any acquisition, we will be required to assimilate the operations, products and personnel of the acquired businesses and train, retain and motivate key personnel from the acquired businesses. We may not be able to maintain uniform standards, controls, procedures and policies if we fail in these efforts. Similarly, acquisitions may cause disruptions in our operations and divert management's attention from our company's day-to-day operations, which could impair our relationships with our current employees, customers and strategic partners. Acquisitions may also subject us to liabilities and risks that are not known or identifiable at the time of the acquisition.

We may also have to incur debt or issue equity securities in order to finance future acquisitions. Our financial condition could be harmed to the extent we incur substantial debt or use significant amounts of our cash resources in acquisitions. The issuance of equity securities for any acquisition could be substantially dilutive to our existing stockholders. In addition, we expect our profitability could be adversely affected because of acquisition-related accounting costs, write offs, amortization expenses, and charges related to acquired intangible assets. In consummating acquisitions, we are also subject to risks of entering geographic and business markets in which we have had limited or no prior experience. If we are unable to fully integrate acquired businesses, products or technologies within existing operations, we may not receive the intended benefits of acquisitions.

***Our operating income or loss may continue to change due to shifts in our sales mix and increased spending on our research and development.***

Our operating income or loss can change quarter to quarter and year to year due to a change in our sales mix and the timing of our continued investments in research and development and infrastructure. We continue to invest in research and development which is the lifeline of our technology portfolio. The timing of these additional expenses can vary significantly quarter to quarter and even from year to year.

***Our products may contain undetected software defects, which could negatively affect our revenues.***

Our software products are complex and may contain undetected defects. In the past, we have discovered software defects in certain of our products and have experienced delayed or lost revenues during the period it took to correct these problems. Although we and our OEM customers test our products, it is possible that errors may be found or occur in our new or existing products after we have commenced commercial shipment of those products. Defects, whether actual or perceived, could result in adverse publicity, loss of revenues, product returns, a delay in market acceptance of our products, loss of competitive position or claims against us by customers. Any such problems could be costly to remedy and could cause interruptions, delays, or cessation of our product sales, which could cause us to lose existing or prospective customers and could negatively affect our results of operations. In addition, some of our software contains open source components that are licensed under the GNU General Public License and similar open source licenses. These components may contain undetected defects or incompatibilities, may cause us to lose control over the development of portions of our software code, and may expose us to claims of infringement if these components are, or incorporate, infringing materials, the licenses are not enforceable or are modified to become incompatible with other open source licenses, or exposure to misappropriation claims if these components include unauthorized materials from a third party.

***Regulations affecting our customers and us and future regulations, to which they or we may become subject to, may harm our business.***

Certain of our customers in the communications industry are subject to regulation by the Federal Communications Commission, which could have an indirect effect on our business. In addition, the United States telecommunications industry has been subject to continuing deregulation since 1984. We cannot predict when, or upon what terms and conditions, further regulation or deregulation might occur or the effect regulation or deregulation may have on demand for our products from customers in the communications industry. Demand for our products may be indirectly affected by regulations imposed upon potential users of those products, which may increase our costs and expenses.

***We may be unable to adequately protect our intellectual property and other proprietary rights, which could negatively impact our revenues.***

Our success is dependent upon our software code base, our programming methodologies and other intellectual properties and proprietary rights. In order to protect our proprietary technology, we rely on a combination of trade secrets, nondisclosure agreements, patents, and copyright and trademark law. We currently own U.S. trademark registrations for certain of our trademarks and U.S. patents for certain of our technologies. However, these measures afford us only limited protection. Furthermore, we rely primarily on shrink wrap licenses that are not signed by the end user and, therefore, may be unenforceable under the laws of certain jurisdictions. Accordingly, it is possible that third parties may copy or otherwise obtain our rights without our authorization. It is also possible that third parties may independently develop technologies similar to ours. It may be difficult for us to detect unauthorized use of our intellectual property and proprietary rights.

We may be subject to claims of intellectual property infringement as the number of trademarks, patents, copyrights and other intellectual property rights asserted by companies in our industry grows and the coverage of these patents and other rights and the functionality of software products increasingly overlap. From time to time, we have received communications from third parties asserting that our trade name or features, content, or trademarks of certain of our products infringe upon intellectual property rights held by

such third parties. We have also received correspondence from third parties separately asserting that our products may infringe on certain patents held by each of the parties. Although we are not aware that any of our products infringe on the proprietary rights of others, third parties may claim infringement by us with respect to our current or future products. Additionally, our customer agreements require that we indemnify our customers for infringement claims made by third parties involving our intellectual property embedded in their products. Infringement claims, whether with or without merit, could result in time-consuming and costly litigation, divert the attention of our management, cause product shipment delays or require us to enter into royalty or licensing agreements with third parties. If we are required to enter into royalty or licensing agreements, they may not be on terms that are acceptable to us. Unfavorable royalty or licensing agreements could seriously impair our ability to market our products.

*We may raise additional capital through the issuance of additional equity or convertible debt securities or by borrowing money, in order to meet our capital needs. Additional funds may not be available on terms acceptable to us to allow us to meet our capital needs.*

We believe that the cash and cash equivalents and short-term investments on hand and the cash we expect to generate from operations will be sufficient to meet our capital needs for at least the next twelve months. However, it is possible that we may need or choose to obtain additional financing to fund our activities in the future. We could raise these funds by selling more stock to the public or to selected investors, or by borrowing money. We may not be able to obtain additional funds on favorable terms, or at all. If adequate funds are not available, we may be required to curtail our operations or other business activities significantly or to obtain funds through arrangements with strategic partners or others that may require us to relinquish rights to certain technologies or potential markets.

In addition, we may file with the SEC a shelf registration statement to sell from time to time additional shares of our common stock in one or more offerings in amounts, at prices and on the terms that we will determine at the time of offering. If we raise additional funds by issuing additional equity or convertible debt securities (whether in a public offering or private placement), the ownership percentages of existing stockholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock. We currently have no established line of credit or other business borrowing facility in place.

It is possible that our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors, including:

the market acceptance of our products;

the levels of promotion and advertising that will be required to launch our products and achieve and maintain a competitive position in the marketplace;

our business, product, capital expenditure and research and development plans and product and technology roadmaps;

the levels of inventory and accounts receivable that we maintain;

capital improvements to new and existing facilities;

our ability to meet our headcount hiring commitment to the state of Pennsylvania;

technological advances;

our competitors' response to our products; and

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our relationships with suppliers and customers.

In addition, we may raise additional capital to accommodate planned growth, hiring, infrastructure and facility needs or to consummate acquisitions of other businesses, products or technologies.

*Our business, financial condition and operating results could be adversely affected as a result of legal, business and economic risks specific to international operations.*

In recent years, our revenues derived from sales to customers outside the U.S. have not been material. Our revenues derived from such sales can vary from quarter to quarter and from year to year. We also frequently ship products to our domestic customers' international manufacturing divisions and subcontractors. In the future, we may expand these international business activities. International operations are subject to many inherent risks, including:

general political, social and economic instability;

trade restrictions;

the imposition of governmental controls;

exposure to different legal standards, particularly with respect to intellectual property;

burdens of complying with a variety of foreign laws;

import and export license requirements and restrictions of the United States and any other country in which we operate;

unexpected changes in regulatory requirements;

foreign technical standards;

changes in tariffs;

difficulties in staffing and managing international operations;

difficulties in securing and servicing international customers;

difficulties in collecting receivables from foreign entities;

fluctuations in currency exchange rates and any imposition of currency exchange controls; and

potentially adverse tax consequences.

These conditions may increase our cost of doing business. Moreover, as our customers are adversely affected by these conditions, our business with them may be disrupted and our results of operations could be adversely affected.

*Security and privacy breaches may harm our business.*

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The uninterrupted operation of our hosted solutions and the confidentiality and security of third-party information is critical to our business. Any failures in our security and privacy measures could have a material adverse effect on our financial position and results of operations. If we are unable to protect, or our customers perceive that we are unable to protect, the security and privacy of our electronic information, our growth could be materially adversely affected. A security or privacy breach may:

cause our customer to lose confidence in our solutions;

harm our reputation;

expose us to liability; and

increase our expense from potential remediation costs.

While we believe we use proven applications designed for data security and integrity to process electronic transactions, there can be no assurance that our use of these applications will be sufficient to address changing market conditions or the security and privacy concerns of existing and potential customers. In addition, our customers and end users may use our products and services in a manner which violates security or data privacy laws in one or more jurisdictions. Any significant or high profile data privacy breaches or violations of data privacy laws, whether directly through our hosted solutions or by third parties using our products and services, could result in the loss of business and reputation, litigation against us and regulatory investigations and penalties that could adversely affect our operating results and financial condition.

*Interruptions or delays in service from data center hosting facilities could impair the delivery of our service and harm our business.*

We currently serve our customers from data center hosting facilities. Any damage to, or failure of, our systems generally could result in interruptions in our service. Interruptions in our service may reduce our revenue, cause us to issue credits or pay penalties, cause customers to terminate their on-demand services and adversely affect our renewal rates and our ability to attract new customers.

*We may have exposure to additional tax liabilities.*

As a multinational corporation, we are subject to income taxes as well as sales, use and other non-income based taxes, in both the United States and various foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes, sales and use taxes, and other tax liabilities. Changes in tax laws or tax rulings may have a significantly adverse impact on our effective tax rate.

We are also subject to non-income based taxes, such as payroll, sales, use, value-added, net worth, property and goods and services taxes, in both the United States and various foreign jurisdictions. We are regularly under audit by tax authorities with respect to these non-income based taxes and may have exposure to additional non-income based tax liabilities. An increasing number of states have considered or adopted laws that attempt to impose obligations on out-of-state retailers to collect sales and use taxes on their behalf. A successful assertion by one or more states or foreign countries requiring us to collect sales and use taxes where we do not do so could result in substantial tax liabilities, including for past sales, as well as penalties and interest.

Although we believe that our income and non-income based tax estimates are reasonable, there is no assurance that our provisions for taxes are correct, or that the final determination of tax audits or tax disputes will not be different from what is reflected in our historical income tax provisions and accruals. If we are required to pay substantially more taxes in the future or for prior periods, our operating results and financial condition could be adversely affected.

## **Item 1B. UNRESOLVED STAFF COMMENTS**

None.

## **Item 2. PROPERTIES**

Our corporate headquarters, including our principal administrative, sales and marketing, customer support and research and development facility, is located in Aliso Viejo, California, where we currently lease and occupy approximately 52,700 square feet of space pursuant to leases that expire on May 31, 2016 and January 31, 2022. We lease approximately 55,600 square feet in Pittsburgh, Pennsylvania under a lease that expires December 31, 2021. We lease approximately 16,000 square feet in Sunnyvale, California under a lease that expires February 28, 2015. We lease approximately 15,300 square feet in Watsonville, California under a lease that expires September 30, 2018. Internationally, we lease space in Belgrade, Serbia that expires December 30, 2016.

### **Item 3. LEGAL PROCEEDINGS**

The Company is and may become involved in various legal proceedings arising from its business activities. While management does not believe the ultimate disposition of these matters will have a material adverse impact on the Company's consolidated results of operations, cash flows or financial position, litigation is inherently unpredictable, and depending on the nature and timing of these proceedings, an unfavorable resolution could materially affect the Company's future consolidated results of operations, cash flows or financial position in a particular period.

### **Item 4. MINE SAFETY DISCLOSURES**

Not Applicable.



## PART II

### Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

#### Market Information

Our common stock is traded on the NASDAQ Global Market under the symbol SMSI. The high and low sale prices for our common stock as reported by NASDAQ are set forth below for the periods indicated.

|                                      | High    | Low     |
|--------------------------------------|---------|---------|
| <b>YEAR ENDED DECEMBER 31, 2013:</b> |         |         |
| First Quarter                        | \$ 1.78 | \$ 1.26 |
| Second Quarter                       | 1.49    | 1.06    |
| Third Quarter                        | 1.31    | 0.88    |
| Fourth Quarter                       | 1.57    | 0.79    |
| <b>YEAR ENDED DECEMBER 31, 2012:</b> |         |         |
| First Quarter                        | \$ 2.87 | \$ 1.14 |
| Second Quarter                       | 2.37    | 1.46    |
| Third Quarter                        | 2.16    | 1.49    |
| Fourth Quarter                       | 1.89    | 1.10    |

On February 18, 2014, the closing sale price for our common stock as reported by NASDAQ was \$1.79.

For information regarding Securities Authorized for Issuance under Equity Compensation Plans, please refer to Item 12.

#### Stock Performance Graph

The following graph and information compares the cumulative total stockholder return on our common stock against the cumulative total return of the S&P Midcap 400 Index and the S&P Midcap Applications Software Index (Peer Group) for the same period.

The graph covers the period from December 31, 2008 through December 31, 2013. The graph assumes that \$100 was invested in our common stock on December 31, 2008, and in each index, and that all dividends were reinvested. No cash dividends have been declared on our common stock. Stockholder returns over the indicated period should not be considered indicative of future stockholder returns.

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**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***

Among Smith Micro Software, Inc., the S&P Midcap 400 Index, and S&P MidCap Application

Software

\*\$100 invested on 12/31/08 in stock or index, including reinvestment of dividends. Fiscal year ending December 31.

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|                                 | 12/08  | 12/09  | 12/10  | 12/11  | 12/12  | 12/13  |
|---------------------------------|--------|--------|--------|--------|--------|--------|
| Smith Micro Software, Inc.      | 100.00 | 164.57 | 283.09 | 20.32  | 26.98  | 26.62  |
| S&P Midcap 400                  | 100.00 | 137.38 | 173.98 | 170.96 | 201.53 | 269.04 |
| S&P MidCap Application Software | 100.00 | 144.42 | 199.15 | 200.22 | 234.09 | 297.54 |

**Holders**

As of February 18, 2014, there were approximately 161 holders of record of our common stock based on information provided by our transfer agent.

## Dividends

We have never paid any cash dividends on our common stock and we have no current plans to do so.

## Recent Sales of Unregistered Securities

None.

## Purchases of Equity Securities by the Company

The table set forth below shows all purchases of securities by us during the fiscal year 2013:

### ISSUER PURCHASES OF EQUITY SECURITIES

| Period          | Total<br>Number of<br>Shares<br>(or<br>Units)<br>Purchased | Average<br>Price<br>Paid per<br>Share (or<br>Unit) | Total   |   |
|-----------------|--|--|---|---|
|                 |  |  | Number of<br>Shares<br>(or<br>Units)<br>Purchased<br>as Part<br>of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number (or<br>Approximate<br>Dollar Value)<br>of Shares (or<br>Units) that<br>May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
| Jan. 1-31, 2013 | -  | -  | -   | 4,625,000   |
| Feb. 1-28, 2013 | -  | -  | -   | 4,625,000   |
| Mar. 1-31, 2013 | 5,122  | \$ 1.45  | -   | 4,625,000   |
| Apr. 1-30, 2013 | -  | -  | -   | 4,625,000   |
| May 1-31, 2013  | -  | -  | -   | 4,625,000   |
| Jun. 1-30, 2013 | 29,681   | \$ 1.38  | -   | 4,625,000   |
| July 1-31, 2013 | -  | -  | -   | 4,625,000   |
| Aug. 1-31, 2013 | -  | -  | -   | 4,625,000   |
| Sep. 1-30, 2013 | 29,296   | \$ 1.13  | -   | 4,625,000   |
| Oct. 1-31, 2013 | -  | -  | -   | 4,625,000(b)  |
| Nov. 1-30, 2013 | -  | -  | -   | -   |
| Dec. 1-31, 2013 | 32,131   | \$ 1.04  | -   | -   |
| Total           | 96,230(a)  |  | -   | -   |

The above table includes:

(a) Acquisition of stock by the Company as payment of withholding taxes in connection with the vesting of restricted stock awards, in an aggregate amount of 96,230 shares during the periods set forth in the table. All of the shares were cancelled when they were acquired.

(b) There were no repurchases of stock during the fiscal year 2013 under a program announced on November 2, 2011 authorizing the repurchase by the Company of up to 5,000,000 shares over a period of up to two years. The Company repurchased 375,000 shares in fiscal year 2012 but none in fiscal year 2011. The program ended on November 1, 2013.

## Item 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the related notes thereto appearing elsewhere in this Annual Report. The following selected consolidated statement of comprehensive income data for the years ended December 31, 2013, 2012 and 2011, and the consolidated balance sheet data at December 31, 2013 and 2012, have been derived from audited consolidated financial statements included elsewhere in this Annual Report. The consolidated statement of comprehensive income data presented below for the years ended December 31, 2010 and 2009, and the consolidated balance sheet data at December 31, 2011, 2010 and 2009 are derived from audited consolidated financial statements that are not included in this Annual Report.

|   | Year Ended December 31, |             |              |            |            |
|---|-------------------------|-------------|--------------|------------|------------|
|   | 2013                    | 2012        | 2011         | 2010       | 2009       |
| <b>Consolidated Statement of Comprehensive Income Data (in thousands, except per share data):</b> |                         |             |              |            |            |
| Revenues  | \$ 42,675               | \$ 43,329   | \$ 57,767    | \$ 130,501 | \$ 107,279 |
| Cost of revenues  | 9,707                   | 8,448       | 13,761       | 15,507     | 15,486     |
| Gross profit  | 32,968                  | 34,881      | 44,006       | 114,994    | 91,793     |
| Operating expenses:   |                         |             |              |            |            |
| Selling and marketing   | 15,675                  | 16,666      | 26,594       | 29,708     | 24,999     |
| Research and development  | 21,305                  | 24,767      | 41,711       | 42,759     | 36,530     |
| General and administrative  | 18,216                  | 20,211      | 25,279       | 24,146     | 19,155     |
| Restructuring expenses  | 5,602                   | 238         | 3,184        | -          | -          |
| Goodwill and long-lived asset impairment  | -                       | -           | 112,904      | -          | -          |
| Total operating expenses  | 60,798                  | 61,882      | 209,672      | 96,613     | 80,684     |
| Operating income (loss)   | (27,830)                | (27,001)    | (165,666)    | 18,381     | 11,109     |
| Non-operating income:   |                         |             |              |            |            |
| Change in fair value of contingent liability  | -                       | 1,210       | -            | -          | -          |
| Interest and other income, net  | 30                      | 94          | 131          | 130        | 381        |
| Income (loss) before provision for income taxes   | (27,800)                | (25,697)    | (165,535)    | 18,511     | 11,490     |
| Provision for income tax expense (benefit)  | 153                     | (234)       | (5,929)      | 6,165      | 6,738      |
| Net income (loss)   | (27,953)                | (25,463)    | (159,606)    | 12,346     | 4,752      |
| Other comprehensive income (loss), before tax:  |                         |             |              |            |            |
| Unrealized holding gains (losses) on available-for-sale securities                                | 7                       | 33          | (24)         | (14)       | (118)      |
| Income tax expense (benefit) related to items of other comprehensive income (expense)             | -                       | 6           | 1            | (6)        | (47)       |
| Other comprehensive income (expense), net of tax  | 7                       | 27          | (25)         | (8)        | (71)       |
| Comprehensive income (loss)   | \$ (27,946)             | \$ (25,436) | \$ (159,631) | \$ 12,338  | \$ 4,681   |
| Net income (loss) per share:  |                         |             |              |            |            |
| Basic   | \$ (0.76)               | \$ (0.71)   | \$ (4.48)    | \$ 0.36    | \$ 0.15    |
| Diluted   | \$ (0.76)               | \$ (0.71)   | \$ (4.48)    | \$ 0.36    | \$ 0.14    |
| Weighted average shares:  |                         |             |              |            |            |
| Basic   | 36,982                  | 35,849      | 35,617       | 34,204     | 32,438     |

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|         |        |        |        |        |        |
|---------|--------|--------|--------|--------|--------|
| Diluted | 36,982 | 35,849 | 35,617 | 34,615 | 32,897 |
|---------|--------|--------|--------|--------|--------|

|  | As of December 31, |           |           |            |            |
|--|--------------------|-----------|-----------|------------|------------|
|  | 2013               | 2012      | 2011      | 2010       | 2009       |
| <b>Consolidated Balance Sheet Data (in thousands):</b> |                    |           |           |            |            |
| Total assets   | \$ 31,538          | \$ 54,395 | \$ 79,941 | \$ 234,892 | \$ 205,934 |
| Total liabilities                                      | 13,367             | 11,733    | 15,081    | 16,627     | 17,955     |
| Accumulated comprehensive (deficit) earnings           | (196,485)          | (168,539) | (143,103) | 16,528     | 4,190      |
| Total stockholders' equity                             | \$ 18,171          | \$ 42,662 | \$ 64,860 | \$ 218,265 | \$ 187,979 |

## Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Annual Report. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made in Item 1A of Part I of this Annual Report under the caption Risk Factors.

Risk factors that could cause actual results to differ from those contained in the forward-looking statements include but are not limited to: our dependence upon the large carrier customers for a significant portion of our revenues; deriving revenues from a small number of customers and products; potential further impairments of long-lived assets or additional restructuring charges; our failure to successfully execute our business and restructuring plans; being delisted from NASDAQ; potential fluctuations in quarterly results; changes in technology; our failure to successfully compete; our entry into new markets; failure of our customers to adopt new technologies; loss of key personnel; the availability of third party intellectual property and licenses; exposure to intellectual property claims; failure to maintain strategic relationships with device manufacturers; failure of our products to achieve broad acceptance; uncertainty and volatility of current global economic conditions; undetected software defects; our failure to protect intellectual property; our inability to raise more funds to meet our capital needs; security and privacy breaches in our systems or interruptions or delays in the services we provide which could damage client relations; and doing business internationally.

### Introduction and Overview

Smith Micro Software, Inc. provides software and services that simplify, secure and enhance the mobile experience. The Company's portfolio of wireless solutions includes a wide range of client and server applications that manage devices, communications and network connectivity for end-users as well as Machine-to-Machine ( M2M ) endpoints. Our primary customers are the world's leading wireless service providers, mobile device and chipset manufacturers, and enterprise businesses. In addition to our wireless and mobility software, Smith Micro offers personal productivity, graphics and animation products distributed through a variety of consumer channels worldwide.

With a 30-year history of technology innovation, leadership in industry standards, and extensive commercial deployment experience, Smith Micro continues to evolve its portfolio and business models to capitalize on new market opportunities. Over the past three decades, the Company has developed deep expertise in embedded software for networked devices, policy-based management platforms, and highly-scalable mobile applications and hosted services. For network operators and organizations struggling to reduce costs and complexity in the fragmented, rapidly evolving mobile market, Smith Micro offers proven solutions that increase reliability, security, and efficiency while accelerating time to market for mobile products and services.

During fiscal year 2011, we experienced a significant decrease in our revenues. This was primarily due to the introduction and market acceptance of mobile hotspot devices, tablets and smartphones capable of functioning as a WWAN hotspot, resulting in lower demand in our North American marketplace for our legacy connection management products. While we launched new wireless products that addressed this technology shift, they are new to the market and their rate of adoption and deployment is unknown at this time causing material uncertainty regarding the timing of our future wireless revenues.

As a result of our decreased revenues, slow adoption of our new products, operating losses and depressed stock prices, we recorded a goodwill and other long-lived asset impairment charge of \$112.9 million in fiscal year 2011. All goodwill and intangible assets have been written off as of December 31, 2011.

For the year ended December 31, 2013, revenues to two customers and their respective affiliates in the Wireless business segment accounted for 53.1% and 13.0% of the Company's total revenues, and one customer in the Productivity & Graphics business segment accounted for 11.4% of the Company's total revenues. These three customers accounted for 83% of accounts receivable for the year ended December 31, 2013. For the year ended December 31, 2012, revenues to two customers and their respective affiliates in the Wireless business segment accounted for 40.7% and 20.5% of the Company's total revenues and 78% of accounts receivable. For the year ended December 31, 2011, revenues to three customers and their respective affiliates in the Wireless business segment accounted for 24.8%, 18.4% and 11.7% of the Company's total revenues and 63% of accounts receivable.

## Results of Operations

The following table sets forth certain consolidated statement of comprehensive income data as a percentage of total revenues for the periods indicated:

|  | Year Ended December 31, |         |          |
|--|-------------------------|---------|----------|
|  | 2013                    | 2012    | 2011     |
| Revenues                                     | 100.0%                  | 100.0%  | 100.0%   |
| Cost of revenues                             | 22.7                    | 19.5    | 23.8     |
| Gross profit                                 | 77.3                    | 80.5    | 76.2     |
| Operating expenses:                          |                         |         |          |
| Selling and marketing                        | 36.7                    | 38.5    | 46.0     |
| Research and development                     | 49.9                    | 57.2    | 72.2     |
| General and administrative                   | 42.7                    | 46.6    | 43.8     |
| Restructuring expenses                       | 13.2                    | 0.5     | 5.5      |
| Goodwill and long-lived asset impairment     | -                       | -       | 195.5    |
| Total operating expenses                     | 142.5                   | 142.8   | 363.0    |
| Operating loss                               | (65.2)                  | (62.3)  | (286.8)  |
| Non-operating income:                        |                         |         |          |
| Change in fair value of contingent liability | -                       | 2.8     | -        |
| Interest and other income, net               | 0.1                     | 0.2     | 0.2      |
| Loss before provision for income taxes       | (65.1)                  | (59.3)  | (286.6)  |
| Provision for income tax expense (benefit)   | 0.4                     | (0.5)   | (10.3)   |
| Net loss                                     | (65.5)%                 | (58.8)% | (276.3)% |

## Revenues and Expense Components

The following is a description of the primary components of our revenues and expenses:

**Revenues.** Revenues are net of sales returns and allowances. Our operations are organized into two business segments:

Wireless, which includes our QuickLink, NetWise and CommSuite family of products; and



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Productivity & Graphics, which includes our consumer-based products: Poser, Anime Studio, Manga Studio, MotionArtist and StuffIt.

The following table shows the revenues generated by each business segment (in thousands):

|                         | Year Ended December 31, |                  |                  |
|-------------------------|-------------------------|------------------|------------------|
|                         | 2013                    | 2012             | 2011             |
| Wireless                | \$ 35,853               | \$ 37,154        | \$ 48,951        |
| Productivity & Graphics | 6,822                   | 6,175            | 8,816            |
| <b>Total revenues</b>   | <b>42,675</b>           | <b>43,329</b>    | <b>57,767</b>    |
| Cost of revenues        | 9,707                   | 8,448            | 13,761           |
| <b>Gross profit</b>     | <b>\$ 32,968</b>        | <b>\$ 34,881</b> | <b>\$ 44,006</b> |

*Cost of revenues.* Cost of revenues consists of direct product costs, royalties, and the amortization of purchased intangibles and capitalized software.

*Selling and marketing.* Selling and marketing expenses consist primarily of personnel costs, advertising costs, sales commissions, trade show expenses, and the amortization of certain purchased intangibles. These expenses vary significantly from quarter to quarter based on the timing of trade shows and product introductions.

*Research and development.* Research and development expenses consist primarily of personnel and equipment costs required to conduct our software development efforts and the amortization of certain acquired intangibles.

*General and administrative.* General and administrative expenses consist primarily of personnel costs, professional services and fees paid for external service providers, space and occupancy costs, and legal and other public company costs.

*Restructuring expenses.* Restructuring expenses consist primarily of one-time employee termination benefits, lease and other contract terminations and costs to consolidate facilities and relocate employees.

*Goodwill and long-lived asset impairment.* Goodwill and long-lived asset impairment charges are a result of determining that the recoverability of the carrying value of goodwill, intangible assets, and fixed assets will not be realized.

*Change in fair value of contingent liability.* This is the return-to-profit of a milestone payment accrual that we did not have to pay.

*Interest and other income, net.* Interest and other income, net is primarily related to our average cash and short term investment balances during the period and vary among periods. Our other excess cash is invested in short term marketable equity and debt securities classified as cash equivalents.

*Provision for income tax expense (benefit).* The Company accounts for income taxes as required by Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) Topic No. 740, Income Taxes. This Topic clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Topic also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Topic requires an entity to recognize the financial statement impact of a tax position when it is more likely than not that the position will be sustained upon examination. The amount recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. We must make significant judgments to determine the provision for income taxes, deferred tax assets and liabilities, unrecognized tax benefits and any valuation allowance to be recorded against deferred tax assets. After consideration of the Company's continuing cumulative loss position as of December 31, 2013, the Company retained a valuation allowance related to its U.S.-based deferred tax amounts which was first established during the year ended December 31, 2011 for \$53.2 million.

*Year Ended December 31, 2013 Compared to the Year Ended December 31, 2012*

*Revenues.* Revenues of \$42.7 million for fiscal year 2013 decreased \$0.6 million, or 1.5%, from \$43.3 million for fiscal year 2012. Wireless revenues of \$35.9 million decreased \$1.3 million, or 3.5%, primarily due to lower sales of our legacy connection manager products of \$5.2 million partially offset by higher sales of our CommSuite products of \$3.2 million and NetWise products of \$0.7 million. Productivity & Graphics sales increased \$0.7 million, or 10.5%, primarily due to increases in our core product lines of Poser and Manga Studio. Due to the introduction and market acceptance of mobile hotspot devices, tablets and smartphones capable of functioning as a WWAN hotspot, our legacy connection management products continue to experience lower demand in our North American marketplace. While we have launched new wireless products that address this technology shift, they are new to the market and their rate of adoption and deployment is unknown at this time causing material uncertainty regarding the timing of our future wireless revenues.

*Cost of revenues.* Cost of revenues of \$9.7 million for fiscal year 2013 increased \$1.3 million, or 14.9%, from \$8.4 million for fiscal year 2012. The increase was primarily due to the product mix in Wireless of \$1.1 million and product mix in Productivity & Graphics of \$0.2 million.

*Gross profit.* Gross profit of \$33.0 million or 77.3% of revenues for fiscal year 2013 decreased \$1.9 million, or 5.5%, from \$34.9 million, or 80.5% of revenues for fiscal year 2012. The 3.2 percentage point decrease was primarily due to the lower revenues and product mix.

*Selling and marketing.* Selling and marketing expenses of \$15.7 million for fiscal year 2013 decreased \$1.0 million, or 5.9%, from \$16.7 million for fiscal year 2012. This decrease was primarily due to lower personnel related expenses and severance of \$0.4 million and lower travel and trade shows of \$0.5 million. Stock-based compensation decreased from \$0.9 million to \$0.8 million, or \$0.1 million due to the acceleration of expense related to the termination of an employee.

*Research and development.* Research and development expenses of \$21.3 million for fiscal year 2013 decreased \$3.5 million, or 14.0%, from \$24.8 million for fiscal year 2012. This decrease was primarily due to lower headcount. Stock-based compensation increased from \$0.8 million to \$0.9 million, or \$0.1 million due to stock options being issued to many of the engineers late in fiscal year 2012.

*General and administrative.* General and administrative expenses of \$18.2 million for fiscal year 2013 decreased \$2.0 million, or 9.9%, from \$20.2 million for fiscal year 2012. This decrease was primarily due to lower space and occupancy costs as a result of our restructuring of \$1.3 million and lower legal and accounting fees of \$0.6 million partially offset by increased travel and other expenses of \$0.2 million. Stock-based compensation expense decreased from \$2.4 million to \$2.1 million, or \$0.3 million.

*Restructuring expenses.* Restructuring expenses of \$5.6 million for fiscal year 2013 were related to lease/rental terminations of \$3.3 million, severance costs for affected employees of \$1.1 million, equipment and improvements write-offs as a result of our lease/rental terminations of \$1.0 million and other related costs of \$0.2 million. Restructuring expenses of \$0.2 million for fiscal year 2012 were related to one-time employee termination and other costs as a result of headcount reductions.

*Change in fair value of contingent liability.* When we acquired Core Mobility in October 2009, we established a pre-acquisition contingency made up of two milestone payments that were part of the purchase price of the business. The first milestone was met and \$0.6 million was paid in March 2010. The second milestone was not met and therefore not paid. The Core Mobility shareholders disputed the second milestone in a lawsuit which was found in our favor in August 2012. The plaintiffs chose not to appeal the decision. As a result, we reduced the contingent liability of \$1.2 million to its fair value of \$0 at December 31, 2012.

*Interest and other income, net.* Interest and other income, net was de minimis for fiscal year 2013 and \$0.1 million for fiscal year 2012.

*Provision for income tax expense (benefit).* We recorded income tax expense of \$0.2 million for fiscal year 2013 primarily related to foreign income taxes. We recorded an income tax benefit of \$0.2 million for fiscal year 2012 related to state R&D tax credits of \$0.7 million, partially offset by state and foreign income taxes of \$0.5 million.

### *Year Ended December 31, 2012 Compared to the Year Ended December 31, 2011*

*Revenues.* Revenues of \$43.3 million for fiscal year 2012 decreased \$14.4 million, or 25.0%, from \$57.7 million for fiscal year 2011. Wireless revenues of \$37.2 million decreased \$11.8 million, or 24.1%, primarily due to lower sales of our base business connection manager products to our carrier customers of \$15.5 million and PC OEM customers of \$3.2 million, partially offset by higher sales of our CommSuite products of \$3.9 million and NetWise products of \$3.0 million. Productivity & Graphics sales decreased \$2.6 million, or 30.0%, primarily due to lower sell through at large retailers and lower overall demand. Due to the introduction and market acceptance of mobile hotspot devices, tablets and smartphones capable of functioning as a WWAN hotspot, our core connection management products continue to experience lower demand in our North American marketplace. We have launched new wireless products and services, but they are new to the market and their rate of adoption and deployment is unknown at this time causing material uncertainty regarding the timing of our future wireless revenues.

*Cost of revenues.* Cost of revenues of \$8.4 million for fiscal year 2012 decreased \$5.4 million, or 38.6%, from \$13.8 million for fiscal year 2011. Amortization of intangibles decreased \$3.8 million due to the impairment charge we recorded for these assets in fiscal year 2011. There was no amortization of intangibles in fiscal year 2012. Direct product costs decreased \$1.6 million primarily due to cost reductions.

*Gross profit.* Gross profit of \$34.9 million or 80.5% of revenues for fiscal year 2012 decreased \$9.1 million, or 20.7%, from \$44.0 million, or 76.2% of revenues for fiscal year 2011. The 4.3 percentage point increase in gross profit was primarily due to no amortization of intangibles in fiscal year 2012 of 6.5 points, partially offset by lower product margins of 2.2 points as a result of the lower revenues not absorbing our fixed overhead costs.

*Selling and marketing.* Selling and marketing expenses of \$16.7 million for fiscal year 2012 decreased \$9.9 million, or 37.3%, from \$26.6 million for fiscal year 2011. This decrease was primarily due to lower personnel related expenses of \$5.8 million and lower third party commissions and advertising costs of \$0.8 million. Amortization of intangibles decreased \$2.1 million due to the impairment charge we recorded for these assets in fiscal year 2011. There was no amortization of intangibles in fiscal year 2012. Stock-based compensation decreased from \$2.1 million to \$0.9 million.

*Research and development.* Research and development expenses of \$24.8 million for fiscal year 2012 decreased \$16.9 million, or 40.6%, from \$41.7 million for fiscal year 2011. Personnel related, travel and supplies and equipment expenses decreased \$16.1 million. Stock-based compensation decreased from \$1.4 million to \$0.8 million, or \$0.6 million. Amortization of purchased technologies decreased \$0.2 million due to the impairment charge we recorded for these assets in fiscal year 2011. There was no amortization of purchased technologies in fiscal year 2012.

*General and administrative.* General and administrative expenses of \$20.2 million for fiscal year 2012 decreased \$5.0 million, or 20.0%, from \$25.2 million for fiscal year 2011. This decrease was primarily due to personnel related expenses of \$1.8 million, lower outside legal and accounting fees of \$0.7 million, and other cost reductions of \$0.6 million. Stock-based compensation expense decreased from \$4.3 million to \$2.4 million, or \$1.9 million.

*Restructuring expenses.* Restructuring expenses of \$0.2 million for fiscal year 2012 were related to one-time employee termination and other costs as a result of headcount reductions. Restructuring expenses of \$3.2 million for fiscal year 2011 were related to the Chicago facility shutdown of \$0.8 million, the Sweden facility shutdown of \$0.8 million and other one-time employee termination and other costs in the U.S. of \$1.6 million

*Goodwill and long-lived asset impairment.* There were no impairment charges in fiscal year 2012. Goodwill and long-lived asset impairment charges of \$112.9 million for fiscal year 2011 were related to goodwill of \$94.2 million, intangible assets of \$13.4 million, and fixed assets of \$5.3 million.

*Change in fair value of contingent liability.* When we acquired Core Mobility in October 2009, we established a pre-acquisition contingency made up of two milestone payments that were part of the purchase price of the business. The first milestone was met and \$0.6 million was paid in March 2010. The second milestone was not met and therefore not paid. The Core Mobility shareholders disputed the second milestone in a lawsuit which was found in our favor in August 2012. The plaintiffs chose not to appeal the decision. As a result, we have reduced the contingent liability of \$1.2 million to its fair value of \$0 at December 31, 2012.

*Interest and other income, net.* Interest and other income, net was \$0.1 million for both fiscal year 2012 and 2011.

*Provision for income tax expense (benefit).* We recorded an income tax benefit of \$0.2 million for fiscal year 2012 related to state R&D tax credits of \$0.7 million, partially offset by state and foreign income taxes of \$0.5 million. We recorded an income tax benefit of \$5.9 million for fiscal year 2011. The effective tax rate for fiscal year 2011 was impacted by the valuation allowance and carryback of losses to offset taxable income in prior years.

## Liquidity and Capital Resources

At December 31, 2013, we had \$14.8 million in cash and cash equivalents and short-term investments and \$14.5 million of working capital.

Capital expenditures were \$0.8 million for the fiscal year 2013 versus \$0.3 million for the fiscal year 2012. The 2013 expenditures were put into place late in the year to increase capacity in our datacenters for the CommSuite product line.

In November 2011, the Company announced that its Board of Directors had approved a program authorizing the repurchase of up to five million shares of the Company's common stock over a period of up to two years. During the fiscal year 2012 we repurchased 375,000 shares at a cost of \$0.8 million. The Company did not repurchase any shares during the fiscal years 2011 and 2013. The program ended on November 1, 2013.

We believe that our existing cash, cash equivalents and short-term investment balances will be sufficient to finance our working capital and capital expenditure requirements through at least the next twelve months. We are hopeful that our new products will gain market acceptance in order to increase our revenues in upcoming quarters. If our new products do not gain market acceptance, or market acceptance is slower than anticipated, then we anticipate that it will be necessary to undertake additional restructuring to lower costs to bring them more in line with actual revenues, thus slowing the usage of cash. We may require additional funds to support our working capital requirements or for other purposes and may seek to raise additional funds through public or private equity or debt financing or from other sources. If additional financing is needed, we cannot assure that such financing will be available to us at commercially reasonable terms or at all.

### Operating Activities

In 2013, net cash used in operations was \$16.6 million primarily due to our net loss adjusted for depreciation, amortization, write-off of fixed assets related to our restructuring, non-cash stock-based compensation, inventory and accounts receivable reserves, and other assets of \$18.7 million. This usage was partially offset by an increase in accounts payable and accrued liabilities of \$1.4 million and a decrease in accounts receivable of \$0.7 million.

In 2012, net cash used in operations was \$12.8 million primarily due to our net loss adjusted for depreciation, amortization, non-cash stock-based compensation, and inventory and accounts receivable reserves of \$17.0 million, a decrease of accounts payable and accrued liabilities of \$2.2 million, and an increase in accounts receivable of \$1.5 million. This usage was partially offset by a decrease of income taxes receivable of \$7.6 million and a decrease in prepaid and other assets of \$0.3 million.

In 2011, net cash used in operations was \$13.5 million primarily due to our net loss adjusted for goodwill and long-lived asset impairments, depreciation, amortization, non-cash stock-based compensation, deferred income taxes and inventory and accounts receivable reserves of \$28.0 million, an increase of income taxes receivable of \$5.4 million and a decrease in accounts payable and accrued liabilities of \$2.3 million. This usage was partially offset by a decrease in accounts receivable of \$20.0 million and lease incentives of \$2.2 million.

### Investing Activities

In 2013, cash provided by investing activities of \$9.4 million was due to the sale of short-term investments of \$10.2 million, partially offset by capital expenditures of \$0.8 million.

In 2012, cash provided by investing activities of \$24.9 million was due to the sale of short-term investments of \$25.2 million, partially offset by capital expenditures of \$0.3 million.

In 2011, cash provided by investing activities of \$2.7 million was due to the sale of short-term investments of \$16.1 million, partially offset by capital expenditures of \$13.4 million which were primarily for leasehold improvements and to expand our datacenters.

### Financing Activities

In 2013, cash provided by financing activities was \$36,000 as a result of cash received from the sale of stock for our employee stock purchase plan.

In 2012, cash used in financing activities of \$0.7 million was due to the repurchase of our common stock of \$0.8 million which was partially offset by cash received from the sale of stock for our employee stock purchase plan of \$0.1 million.

In 2011, cash provided by financing activities of \$0.4 million was from the sale of stock for our employee stock purchase plan.

### Contractual Obligations and Commercial Commitments

As of December 31, 2013, we had no debt. The following table summarizes our contractual obligations as of December 31, 2013 (in thousands):

| Contractual obligations:    | Payments due by period |                     |                 |                 |                      |
|-----------------------------|------------------------|---------------------|-----------------|-----------------|----------------------|
|                             | Total                  | Less than<br>1 year | 1-3 years       | 3-5 years       | More than<br>5 years |
| Operating lease obligations | \$ 15,267              | \$ 2,597            | \$ 4,566        | \$ 3,516        | \$ 4,588             |
| Purchase obligations        | 1,800                  | 1,800               | -               | -               | -                    |
| <b>Total</b>                | <b>\$ 17,067</b>       | <b>\$ 4,397</b>     | <b>\$ 4,566</b> | <b>\$ 3,516</b> | <b>\$ 4,588</b>      |

During our normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include: intellectual property indemnities to our customers and licensees in connection with the use, sale and/or license of our products; indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease; indemnities to vendors and service



providers pertaining to claims based on the negligence or willful misconduct; indemnities involving the accuracy of representations and warranties in certain contracts; and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware. We may also issue a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain customer contracts. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees may not provide for any limitation of the maximum potential for future payments we could be obligated to make. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying consolidated balance sheets.

### *Real Property Leases*

Our corporate headquarters, including our principal administrative, sales and marketing, customer support and research and development facility, is located in Aliso Viejo, California, where we currently lease and occupy approximately 52,700 square feet of space pursuant to leases that expire on May 31, 2016 and January 31, 2022. We lease approximately 55,600 square feet in Pittsburgh, Pennsylvania under a lease that expires December 31, 2021. We lease approximately 16,000 square feet in Sunnyvale, California under a lease that expires February 28, 2015. We lease approximately 15,300 square feet in Watsonville, California under a lease that expires September 30, 2018. Internationally, we lease space in Belgrade, Serbia that expires December 30, 2016.

### *Off-Balance Sheet Arrangements*

As of December 31, 2013, we did not have any off-balance sheet arrangements.

### *Critical Accounting Policies and Estimates*

Our discussion and analysis of results of operations, financial condition and liquidity are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments 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 base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may materially differ from these estimates under different assumptions or conditions. On an on-going basis, we review our estimates to ensure that they appropriately reflect changes in our business or new information as it becomes available.

We believe the following critical accounting policies affect our more significant estimates and assumptions used in the preparation of our consolidated financial statements:

#### *Revenue Recognition*

We currently report our net revenues under two operating groups: Wireless and Productivity & Graphics. Within each of these groups software revenue is recognized based on the customer and contract type. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectability is probable as required by FASB ASC Topic No. 985-605, Software-Revenue Recognition. We recognize revenues from sales of our software to our customers or end users as completed products are shipped and title passes; or from royalties generated as authorized customers duplicate our software, if the other requirements are met. If the requirements are not met at the date of shipment, revenue is not recognized until these elements are known or resolved. For Wireless sales, returns from customers are limited to defective goods or goods shipped in error. Historically, customer returns have not exceeded the very nominal estimates and reserves. We also provide some technical support to our customers. Such costs have historically been insignificant.



We have a few multiple element agreements for which we have contracted to provide a perpetual license for use of proprietary software, to provide non-recurring engineering, and in some cases to provide software maintenance (post contract support). For these software and software-related multiple element arrangements, we must: (1) determine whether and when each element has been delivered; (2) determine whether undelivered products or services are essential to the functionality of the delivered products and services; (3) determine the fair value of each undelivered element using vendor-specific objective evidence ( VSOE ), and (4) allocate the total price among the various elements. VSOE of fair value is used to allocate a portion of the price to the undelivered elements and the residual method is used to allocate the remaining portion to the delivered elements. Absent VSOE, revenue is deferred until the earlier of the point at which VSOE of fair value exists for any undelivered element or until all elements of the arrangement have been delivered. However, if the only undelivered element is post contract support, the entire arrangement fee is recognized ratably over the performance period. We determine VSOE for each element based on historical stand-alone sales to third parties or from the stated renewal rate for the elements contained in the initial arrangement. In determining VSOE, we require that a substantial majority of the selling prices for a product or service fall within a reasonably narrow pricing range. We have established VSOE for our post contract support services and non-recurring engineering.

For Productivity & Graphics sales, management reviews available retail channel information and makes a determination of a return provision for sales made to distributors and retailers based on current channel inventory levels and historical return patterns. Certain sales to distributors or retailers are made on a consignment basis. Revenue for consignment sales are not recognized until sell through to the final customer is established. Certain revenues are booked net of revenue sharing payments. Sales directly to end-users are recognized upon shipment. End users have a thirty day right of return, but such returns are reasonably estimable and have historically been immaterial. We also provide technical support to our customers. Such costs have historically been insignificant.

### *Sales Incentives*

For our Productivity & Graphics sales, the cost of sales incentives the Company offers without charge to customers that can be used in, or that are exercisable by a customer as a result of, a single exchange transaction is accounted for as a reduction of revenue as required by FASB ASC Topic No. 985-605, Software-Revenue Recognition. We use historical redemption rates to estimate the cost of customer incentives. Total sales incentives were \$1.2 million, \$0.9 million, and \$1.2 million for the years ended December 31, 2013, 2012 and 2011, respectively.

### *Accounts Receivable and Allowance for Doubtful Accounts*

We sell our products worldwide. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history, the customer's current credit worthiness and various other factors, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers. We estimate credit losses and maintain an allowance for doubtful accounts reserve based upon these estimates. While such credit losses have historically been within our estimated reserves, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. If not, this could have an adverse effect on our consolidated financial statements.

### *Internal Software Development Costs*

Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. The Company considers technological feasibility to be established when all planning, designing, coding and testing has been completed according to design specifications. After technological feasibility is established, any additional costs are capitalized. Through December 31, 2013, software has been substantially completed concurrently with the establishment of technological feasibility; accordingly, no costs have been capitalized to date.

### *Impairment of Goodwill and Long-Lived Assets*

During the period ended September 30, 2011, the Company concluded that a decline in its stock price and market capitalization was representative of the fair value of the reporting unit as a whole.

The triggering events that led us to this conclusion were:

Revenues declined for the third consecutive quarter.

New product launches although we were in trials for several of our new products, as of September 30, 2011 we had not realized any revenues from these new products.

Profitability declined for the third consecutive quarter.

Stock price remained at depressed prices.

As such, the Company performed Step 1 of the goodwill impairment test which failed, triggering Step 2. As a result of this analysis, the excess of the carrying value of goodwill was compared to the implied fair value of goodwill and resulted in an impairment loss of \$94.2 million in the fiscal quarter ended September 30, 2011.

As a result of the triggering events described above in our goodwill impairment analysis, the Company reviewed its long-lived assets for recoverability. As a result of this analysis, the Company recognized a long-lived asset impairment charge of \$18.7 million in the fiscal quarter ended September 30, 2011 which was allocated pro-rata to the intangible assets of \$13.4 million and \$5.3 million to equipment and improvements, primarily related to our leasehold improvements.

As a result of the \$112.9 million goodwill and long-lived asset impairment charge recorded in the fiscal quarter ended September 30, 2011, there were no more goodwill or intangible assets on the balance sheet as of that date.

### *Income Taxes*

We account for income taxes as required by FASB ASC Topic No. 740, Income Taxes. This Topic clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Topic also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Topic requires an entity to recognize the financial statement impact of a tax position when it is more likely than not that the position will be sustained upon examination. The amount recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. In addition, the Topic permits an entity to recognize interest and penalties related to tax uncertainties either as income tax expense or operating expenses. The Company has chosen to recognize interest and penalties related to tax uncertainties as operating expense.

The Company assesses whether a valuation allowance should be recorded against its deferred tax assets based on the consideration of all available evidence, using a more likely than not realization standard. The four sources of taxable income that must be considered in determining whether deferred tax assets will be realized are: (1) future reversals of existing taxable temporary differences (i.e., offset of gross deferred tax assets against gross deferred tax liabilities); (2) taxable income in prior carryback years, if carryback is permitted under the applicable tax law; (3) tax planning strategies and (4) future taxable income exclusive of reversing temporary differences and carryforwards.

In assessing whether a valuation allowance is required, significant weight is to be given to evidence that can be objectively verified. A significant factor in the Company's assessment is that the Company has been in a three-year historical cumulative loss as of the end of fiscal 2012. In addition, the Company is also in a loss for the year ending December 31, 2013. These facts, combined with uncertain near-term market and economic conditions, reduced the Company's ability to rely on projections of future taxable income in assessing the realizability of its deferred tax assets.

After a review of the four sources of taxable income as of December 31, 2013 (as described above), and after consideration of the Company's continuing cumulative loss position as of December 31, 2013, the Company recorded a valuation allowance related to its U.S.-based deferred tax amounts, with a corresponding charge to income tax expense, of \$53.2 million during the year ended December 31, 2011.

### *Stock-Based Compensation*

The Company accounts for all stock-based payment awards made to employees and directors based on their fair values and recognized as compensation expense over the vesting period using the straight-line method over the requisite service period for each award as required by FASB ASC Topic No. 718, Compensation-Stock Compensation.

### *Recent Accounting Pronouncements*

In July 2013, the FASB issued Accounting Standards Update (ASU) No. 2013-11, *Income Taxes (Topic 740)*. The amendments in this Update provide guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The Company has no uncertain tax positions being presented in the previous gross presentation, thus the Company is in compliance with the amendments as of December 31, 2013.

In February 2013, the FASB issued Accounting Standards Update (ASU) No. 2013-02, *Other Comprehensive Income (Topic 220)*. The amendments in this Update supersede and replace the presentation requirements for reclassifications out of accumulated other comprehensive income in ASUs 2011-05 (issued in June 2011) and 2011-12 (issued in December 2011) for all public and private organizations. The amendments require an entity to provide additional information about reclassifications out of accumulated other comprehensive income. The amendments in this Update are effective for the reporting periods beginning after December 15, 2012. Early adoption is permitted. The Company is in compliance with the amendments as of December 31, 2013.

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## **Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

### **Interest Rate Risk**

Our financial instruments include cash and cash equivalents and short-term investments. At December 31, 2013, the carrying values of our financial instruments approximated fair values based on current market prices and rates.

### **Foreign Currency Risk**

While a majority of our business is denominated in U.S. dollars, we do occasionally invoice in foreign currencies. For the three years ended December 31, 2013, 2012 and 2011, our revenues denominated in foreign currencies were \$0.1 million, \$0.6 million, and \$1.1 million, respectively. Fluctuations in the rate of exchange between the U.S. dollar and certain other currencies may affect our results of operations and period-to-period comparisons of our operating results. We do not currently engage in hedging or similar transactions to reduce these risks. The operational expenses of our foreign entities reduce the currency exposure we have because our foreign currency revenues are offset in part by expenses payable in foreign currencies. As such, we do not believe we have a material exposure to foreign currency rate fluctuations at this time.

## **Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our consolidated financial statements and schedule appear in a separate section of this Annual Report on Form 10-K beginning on page F-1 and S-1, respectively.

## **Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **Item 9A. CONTROLS AND PROCEDURES**

### **Evaluation of Disclosure Controls and Procedures**

We conducted an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 ( Exchange Act )) as of December 31, 2013. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have determined that as of December 31, 2013, our disclosure controls and procedures were effective to ensure that the information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

## Management's Responsibility for Financial Statements

Our management is responsible for the integrity and objectivity of all information presented in this report. The consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States of America and include amounts based on management's best estimates and judgments. Management believes the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements fairly represent the Company's financial position and results of operations for the periods and as of the dates stated therein.

The Audit Committee of the Board of Directors, which is composed solely of independent directors, meets regularly with our independent registered public accounting firm, SingerLewak LLP, and representatives of management to review accounting, financial reporting, internal control and audit matters, as well as the nature and extent of the audit effort. The Audit Committee is responsible for the engagement of the independent auditors. The independent auditors have free access to the Audit Committee.

## Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting during the quarter ended December 31, 2013 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## Report of Management on Internal Control Over Financial Reporting

Our management, including the Chief Executive Officer and Chief Financial Officer, is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934).

Our management, including the Chief Executive Officer and Chief Financial Officer, assessed the effectiveness of our internal control over financial reporting as of December 31, 2013. Management based this assessment on criteria for effective internal control over financial reporting described in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on this assessment, management determined that, as of December 31, 2013, we maintained effective internal control over financial reporting.

## Item 9B. OTHER INFORMATION

None.

## PART III

### Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The following table sets forth certain information regarding our executive officers and certain key officers as of February 14, 2014:

| Name                  | Age | Position   |
|-----------------------|-----|--|
| William W. Smith, Jr. | 66  | Chairman of the Board, President and Chief Executive Officer |
| Andrew C. Schmidt     | 52  | Vice President and Chief Financial Officer                   |
| Rick Carpenter        | 50  | Senior Vice President Engineering                            |
| Chris G. Lippincott   | 42  | Senior Vice President Global Operations                      |
| Daniel Rawlings       | 51  | Chief Revenue Officer  |
| David P. Sperling     | 45  | Vice President and Chief Technology Officer                  |
| Steven M. Yasbek      | 60  | Chief Accounting Officer                                     |

*Mr. Smith* co-founded Smith Micro and has served as the Chairman of the Board, President and Chief Executive Officer since inception in 1982. Mr. Smith was employed by Rockwell International Corporation in a variety of technical and management positions from 1975 to 1984. Mr. Smith served with Xerox Data Systems from 1972 to 1975 and RCA Computer Systems Division from 1969 to 1972 in mainframe sales and pre-sale technical roles. Mr. Smith received a B.A. in Business Administration from Grove City College.

*Mr. Schmidt* joined the Company in June of 2005 and serves as the Company's Chief Financial Officer. Prior to joining Smith Micro, Mr. Schmidt was the Chief Financial Officer of Genius Products, Inc., a publicly traded entertainment company from August 2004 to June 2005. From April 2003 to June 2004, he was Vice President (Finance) and acting Chief Accounting Officer of Peregrine Systems, Inc., a publicly held provider of enterprise level software then in Chapter 11 reorganization. From July 2000 to January 2003, he was Executive Vice President and Chief Financial Officer of Mad Catz Interactive, Inc., a publicly traded provider of console video game accessories. He holds a B.B.A. in Finance from the University of Texas and an M.S. in Accountancy from San Diego State University.

*Mr. Carpenter* joined the Company in May of 2009 as the Vice President of Engineering for the Company's Connectivity & Security Business Unit and then served as the Vice President and General Manager of the Wireless Business Unit. Mr. Carpenter currently serves as the Senior Vice President of Engineering. Prior to joining Smith Micro, Mr. Carpenter served as a Vice President of Engineering at NextWave Wireless where he was responsible for WiMAX chipset development. From 2000 to 2005, he was Director of Software Engineering for CDMA products at AirPrime, which was ultimately acquired by Sierra Wireless. Mr. Carpenter has also held engineering management positions at Motorola and DENSO Wireless and started his professional career in May of 1986. He holds a BS in Computer Science from the University of Texas, Permian Basin and studied Masters-level Computer Science & Engineering at the University of Texas Arlington.

*Mr. Lippincott* joined the Company in February of 1993. From 1993 to 2000, Mr. Lippincott held various sales positions within the Company including Director of OEM Sales, Director of Retail Sales and Vice President of Enterprise Sales. In 2000, Mr. Lippincott began serving as General Manager of the company's Internet Solutions Division, until 2004 when he accepted the role of Vice President, Worldwide Operations. Mr. Lippincott currently serves as the Senior Vice President of Global Operations. Mr. Lippincott attended the University of California, Berkeley studying Business Administration.

*Mr. Rawlings* joined the Company as Chief Strategy Officer in late 2012, overseeing Corporate Development, Business Development, Channels & Alliances. In June 2013, Mr. Rawlings assumed the position of Chief Revenue Officer, with responsibility for all revenue streams & customer management functions. Mr. Rawlings brings a successful 25-year track record of sales and executive management experience with leading software companies such as Oracle, PeopleSoft, Lawson Software and Ariba. Mr. Rawlings holds a Bachelor of Arts degree from Azusa Pacific University.

*Mr. Sperling* joined the Company in April of 1989 and has been the Director of Software Engineering since April 1992. He assumed the Chief Technology Officer position in September 1999. Mr. Sperling began his professional career as a software engineer with us and he currently has two patents and three patents pending for various telephony and Internet technologies. Mr. Sperling holds a B.S. degree in Computer Science and an MBA from the University of California, Irvine.

*Mr. Yasbek* joined the Company in May of 2008 as the Chief Accounting Officer. Mr. Yasbek has held executive finance and information technology positions with REMEC, Paradigm Wireless Systems, Intellisys Group, Pacific Scientific Company, Symbol Technologies, TRW, and most recently as Chief Financial Officer of Alphatec Spine. He holds a B.S. in Accounting and M.B.A from Loyola Marymount University, and is a Certified Public Accountant.

Officers are elected by, and serve at the discretion of, the Board of Directors.

For information about our Directors, please see the section titled **Directors and Executive Officers** appearing in our Proxy Statement for our 2014 Annual Meeting of Stockholders, which is hereby incorporated by reference.

The section titled **Corporate Governance** appearing in our Proxy Statement for our 2014 Annual Meeting of Stockholders is hereby incorporated by reference.

## Audit Committee; Audit Committee Financial Expert

Our Board of Directors has a standing Audit Committee. The members of the Audit Committee are Messrs. Arno, Gulko and Szabo. Our Board has determined that Mr. Gulko, Chairman of the Audit Committee, is an audit committee financial expert as defined by Item 401(h) of Regulation S-K and that each member of the Audit Committee is independent within the meaning of Nasdaq Marketplace Rule 4200(a)(15).

## Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires certain of the company's executive officers, as well as its directors and persons who own more than ten percent (10%) of a registered class of the Company's equity securities to file reports of ownership and changes in ownership with the Securities and Exchange Commission.

Based solely on its review of the copies of such forms received by the Company, or written representations from certain reporting persons, the Company believes that all filing requirements applicable to our executive officers, directors and more than 10% stockholders were met in a timely manner in 2013.

## Code of Ethics

We have adopted a Code of Ethics that applies to all of our employees, including our principal executive officer, our principal financial officer, and all members of our finance department performing similar functions. Our Code of Ethics was filed as Exhibit 14 to the Annual Report on Form 10-K for the year ended December 31, 2003 which was filed on March 25, 2004. In the event of an amendment to, or a waiver from, certain provisions of our Code of Ethics, we intend, to the extent possible, to satisfy Form 8-K disclosure requirements by disclosing this information on our website at [www.smithmicro.com](http://www.smithmicro.com).

## Item 11. EXECUTIVE COMPENSATION

The section titled "Executive Compensation and Related Information" appearing in our Proxy Statement for our 2014 Annual Meeting of Stockholders is hereby incorporated by reference.

## Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The section titled "Ownership of Securities and Related Stockholder Matters" appearing in our Proxy Statement for our 2014 Annual Meeting of Stockholders is hereby incorporated by reference.

### Securities Authorized for Issuance Under An Equity Compensation Plan

The following table provides information as of December 31, 2013 with respect to the shares of common stock that may be issued under our existing equity compensation plans:

| (in thousands, except per share amounts)              | Number of shares to be issued upon exercise of outstanding options | Weighted average exercise price of outstanding options | Number of shares remaining available for future issuance |
|---|--|--|--|
| Equity compensation plan approved by shareholders (1) | 2,170  | \$6.76   | 2,020  |
| Equity compensation plan not approved by shareholders | -  | -  | -  |
| <b>Total</b>  | <b>2,170</b>   | <b>\$6.76</b>  | <b>2,020</b>   |

(1) The number of shares to be issued upon exercise includes options granted under both the 1995 Stock Option/Stock Issuance Plan and the 2005 Stock Option/Stock Issuance Plan. The number of shares remaining available for future issuance consists only of the 2005 Plan.

## Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The section titled "Related Party Transactions" and "Director Independence" appearing in our Proxy Statement for our 2014 Annual Meeting of Stockholders is incorporated herein by reference.

## Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The section titled "Ratification of Appointment of Independent Registered Public Accounting Firm" "Principal Accountant Fees and Services" appearing in our Proxy Statement for our 2014 Annual Meeting of Stockholders is incorporated herein by reference.



## PART IV

### Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

#### (a) (1) Financial Statements

Smith Micro's financial statements appear in a separate section of this Annual Report on Form 10-K beginning on the pages referenced below:

|  | <b>Page</b> |
|--|-------------|
| <u>REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM</u> | F-1         |
| <u>CONSOLIDATED BALANCE SHEETS</u>                             | F-2         |
| <u>CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS</u>           | F-3         |
| <u>CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY</u>         | F-4         |
| <u>CONSOLIDATED STATEMENTS OF CASH FLOWS</u>                   | F-5         |
| <u>NOTES TO CONSOLIDATED FINANCIAL STATEMENTS</u>              | F-6         |

#### (2) Financial Statement Schedule

Smith Micro's financial statement schedule appears in a separate section of this Annual Report on Form 10-K on the pages referenced below. All other schedules have been omitted as they are not applicable, not required or the information is included in the consolidated financial statements or the notes thereto.

|  | <b>Page</b> |
|--|-------------|
| <u>SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS</u> | S-1         |

#### (3) Exhibits

| <b>Exhibit No.</b> | <b>Title</b>  | <b>Method of Filing</b>   |
|--------------------|---|---|
| 3.1                | Amended and Restated Certificate of Incorporation of the Registrant.  | Incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement No. 33-95096.                                 |
| 3.1.1              | Amendment to Amended and Restated Certificate of Incorporation of the Registrant.   | Incorporated by reference to Exhibit 3.1.1 to the Registrant's Quarterly Report on Form 10-Q for the period ended June 30, 2000.  |
| 3.1.2              | Amendment to Amended and Restated Certificate of Incorporation of Registrant as filed August 18, 2005 with Delaware Secretary of State. | Incorporated by reference to Exhibit 3.1.2 to the Registrant's Annual Report on Form 10-K for the period ended December 31, 2005. |
| 3.1.3              | Certificate of Designations of Series A Junior Participating Preferred Stock of the Registrant dated April 25, 2012.                    | Incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed on April 25, 2012.                  |

| <b>Exhibit No.</b> | <b>Title</b>   | <b>Method of Filing</b>   |
|--------------------|--|---|
| 3.2                | Amended and Restated Bylaws of the Registrant.   | Incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement No. 33-95096.   |
| 3.3                | Amendment to Amended and Restated Bylaws of the Registrant.  | Incorporated by reference to Exhibit 3.3 to the Registrant's Current Report on Form 8-K filed on October 31, 2007.  |
| 4.1                | Specimen certificate representing shares of Common Stock of the Registrant.  | Incorporated by reference to Exhibit 4.1 to the Registrant's Registration Statement No. 33-95096.   |
| 4.2                | Stockholder Rights Agreement, dated as of April 24, 2012, between the Registrant and Computershare Trust Company, N.A., as Rights Agent.   | Incorporated by reference to Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed on April 25, 2012.  |
| 10.1               | Form of Indemnification Agreement.   | Incorporated by reference to Exhibit 10.1 to the Registrant's Registration Statement No. 33-95096.  |
| 10.2               | 1995 Stock Option/Stock Issuance Plan as Amended and Restated through February 7, 2001.  | Incorporated by reference to the Appendix attached to the Definitive Proxy Statement for the 2001 Annual Meeting of Stockholders filed on April 27, 2001. |
| 10.3               | Amended and Restated 2005 Stock Option / Stock Issuance Plan.  | Incorporated by reference to Exhibit 10.7 to the Registrant's Registration Statement on Form S-8 (Reg. No. 333-149222).                                   |
| 10.4               | Master Software License and Distribution Agreement (Contract No. 220-00-0134) effective as of December 1, 2000, between Cellico Partnership (d/b/a Verizon Wireless) and the Registrant. | Incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.                          |
| 10.4.1             | Amendment of Master Software License and Distribution Agreement (Contract No. 220-00-0134).  | Incorporated by reference to Exhibit 10.1.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.                        |
| 10.4.2             | Amendment No. 2 to the Master Software License and Distribution Agreement (Contract No. 220-00-0134).  | Incorporated by reference to Exhibit 10.1.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.                        |
| 10.4.3             | Amendment No. 6 to the Master Software License and Distribution Agreement (Contract No. 220-00-0134).  | Incorporated by reference to Exhibit 10.4.3 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009.                          |
| 10.4.4             | Amendment No. 7 to the Master Software License and Distribution Agreement (Contract No. 220-00-0134).  | Incorporated by reference to Exhibit 10.4.4 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009.                          |
| 10.4.5             | Amendment No. 9 to the Master Software License and Distribution Agreement (Contract No. 220-00-0134).  | Incorporated by reference to Exhibit 10.4.5 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009.                          |
| 10.5               | Letter Agreement, dated June 13, 2005, by and between the Registrant and Andrew Schmidt.   | Incorporated by reference to Exhibit 10.5 to the Registrant's Current Report on Form 8-K filed on November 30, 2006.                                      |

| <b>Exhibit No.</b> | <b>Title</b>   | <b>Method of Filing</b>   |
|--------------------|--|---|
| 10.6               | Summary of oral agreement dated June 2005 by and between William W. Smith, Jr. and the Registrant.                                       | Incorporated by reference to Exhibit 10.10 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2009.               |
| 10.7               | Amended & Restated Employee Stock Purchase Plan.   | Incorporated by reference to Exhibit 10.11 to the Registrant's Registration Statement on Form S-8 (No. 333-169671) filed on September 30, 2010. |
| 10.8               | Agreement and General Release dated July 9, 2013, by and between the Registrant and Von Cameron.   | Incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K/A filed on July 12, 2013.                              |
| 14.1               | Code of Ethics.  | Incorporated by reference to Exhibit 14.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003.                  |
| 14.1.1             | Attachment 1 to Code of Ethics.  | Incorporated by reference to Exhibit 14.1.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003.                |
| 21.1               | Subsidiaries.  | Filed herewith.   |
| 23.1               | Consent of Independent Registered Public Accounting Firm.  | Filed herewith.   |
| 31.1               | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                  | Filed herewith.   |
| 31.2               | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                  | Filed herewith.   |
| 32.1               | Certifications of the Chief Executive Officer and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | Furnished herewith.   |
| 101.INS            | XBRL Instance Document.  | Filed herewith.   |
| 101.SCH            | XBRL Taxonomy Extension Schema Document.   | Filed herewith.   |
| 101.CAL            | XBRL Taxonomy Extension Calculation Linkbase Document.   | Filed herewith.   |
| 101.DEF            | XBRL Taxonomy Extension Definition Linkbase Document.  | Filed herewith.   |
| 101.LAB            | XBRL Taxonomy Extension Label Linkbase Document.   | Filed herewith.   |
| 101.PRE            | XBRL Taxonomy Extension Presentation Linkbase Document.  | Filed herewith.   |

Confidential treatment has been granted with respect to certain confidential portions of this exhibit pursuant to Rule 24b-2 under the Securities Exchange Act of 1934, which confidential portions have been omitted from the exhibit and filed separately with the Securities and Exchange Commission.

## **(b) Exhibits**

The exhibits filed as part of this report are listed above in Item 15(a) (3) of this Form 10-K.

## **(c) Financial Statement Schedule**

The Financial Statement Schedule required by Regulation S-X and Item 8 of this Form are listed above in Item 15(a)(2) of this Form 10-K.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**SMITH MICRO SOFTWARE, INC.**

Date: March 7, 2014

By: /s/ William W. Smith, Jr.  
 William W. Smith, Jr.  
 Chairman of the Board,  
 President and Chief Executive Officer  
 (Principal Executive Officer)

Date: March 7, 2014

By: /s/ Andrew C. Schmidt  
 Andrew C. Schmidt,  
 Vice President and Chief Financial Officer  
 (Principal Financial and Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| <b>Signature</b>          | <b>Title</b>   | <b>Date</b>   |
|---------------------------|--|---------------|
| /s/ William W. Smith, Jr. | Chairman of the Board,   | March 7, 2014 |
| William W. Smith, Jr.     | President and Chief Executive Officer<br><br>(Principal Executive Officer) |               |
| /s/ Andrew C. Schmidt     | Vice President and Chief Financial Officer                                 | March 7, 2014 |
| Andrew C. Schmidt         | (Principal Financial and Accounting Officer)                               |               |
| /s/ Andrew Arno           | Director   | March 7, 2014 |
| Andrew Arno               |  |               |
| /s/ Thomas G. Campbell    | Director   | March 7, 2014 |
| Thomas G. Campbell        |  |               |
| /s/ Samuel Gulko          | Director   | March 7, 2014 |
| Samuel Gulko              |  |               |
| /s/ Gregory J. Szabo      | Director   | March 7, 2014 |
| Gregory J. Szabo          |  |               |

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders

Smith Micro Software, Inc.

We have audited the accompanying consolidated balance sheets of Smith Micro Software, Inc. and subsidiaries (collectively, the Company) as of December 31, 2013 and 2012, and the related consolidated statements of comprehensive loss, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2013. Our audits also included the financial statement schedule of the Company listed in Item 15(a). These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ SingerLewak LLP

Los Angeles, California

March 7, 2014

## SMITH MICRO SOFTWARE, INC.

## CONSOLIDATED BALANCE SHEETS

(in thousands, except share and par value data)

|  | December 31,     |                  |
|--|------------------|------------------|
|  | 2013             | 2012             |
| <b>Assets</b>  |                  |                  |
| Current assets:  |                  |                  |
| Cash and cash equivalents  | \$ 11,763        | \$ 18,873        |
| Short-term investments   | 3,078            | 13,328           |
| Accounts receivable, net of allowances for doubtful accounts and other adjustments of \$617 (2013) and \$482 (2012)  | 7,563            | 8,953            |
| Income tax receivable  | 699              | 681              |
| Inventories, net of reserves for excess and obsolete inventory of \$301 (2013) and \$352 (2012)  | 167              | 176              |
| Prepaid expenses and other current assets  | 871              | 903              |
| Deferred tax asset   | 152              | 89               |
| <b>Total current assets</b>  | <b>24,293</b>    | <b>43,003</b>    |
| Equipment and improvements, net  | 7,023            | 11,211           |
| Other assets   | 222              | 181              |
| <b>Total assets</b>  | <b>\$ 31,538</b> | <b>\$ 54,395</b> |
| <b>Liabilities and Stockholders Equity</b>   |                  |                  |
| Current liabilities:   |                  |                  |
| Accounts payable   | \$ 1,632         | \$ 1,978         |
| Accrued liabilities  | 7,734            | 4,829            |
| Deferred revenue   | 464              | 1,436            |
| <b>Total current liabilities</b>   | <b>9,830</b>     | <b>8,243</b>     |
| Non-current liabilities:   |                  |                  |
| Deferred rent and other long term liabilities  | 3,383            | 3,399            |
| Deferred tax liability   | 154              | 91               |
| <b>Total non-current liabilities</b>   | <b>3,537</b>     | <b>3,490</b>     |
| Commitments and contingencies (Note 5)   |                  |                  |
| Stockholders equity:   |                  |                  |
| Preferred stock, par value \$0.001 per share; 5,000,000 shares authorized; none issued or outstanding  | -                | -                |
| Common stock, par value \$0.001 per share; 100,000,000 shares authorized; 36,994,318 and 35,873,418 shares issued and outstanding at December 31, 2013 and December 31, 2012, respectively | 37               | 36               |
| Additional paid-in capital   | 214,619          | 211,165          |
| Accumulated comprehensive deficit  | (196,485)        | (168,539)        |
| <b>Total stockholders equity</b>   | <b>18,171</b>    | <b>42,662</b>    |
| <b>Total liabilities and stockholders equity</b>   | <b>\$ 31,538</b> | <b>\$ 54,395</b> |

See accompanying notes to the consolidated financial statements.

## SMITH MICRO SOFTWARE, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(in thousands, except per share amount)

|   | Year ended December 31, |             |              |
|---|-------------------------|-------------|--------------|
|   | 2013                    | 2012        | 2011         |
| Revenues  | \$ 42,675               | \$ 43,329   | \$ 57,767    |
| Cost of revenues  | 9,707                   | 8,448       | 13,761       |
| Gross profit  | 32,968                  | 34,881      | 44,006       |
| Operating expenses:   |                         |             |              |
| Selling and marketing   | 15,675                  | 16,666      | 26,594       |
| Research and development  | 21,305                  | 24,767      | 41,711       |
| General and administrative  | 18,216                  | 20,211      | 25,279       |
| Restructuring expenses  | 5,602                   | 238         | 3,184        |
| Goodwill and long-lived asset impairment                                    | -                       | -           | 112,904      |
| Total operating expenses  | 60,798                  | 61,882      | 209,672      |
| Operating loss  | (27,830)                | (27,001)    | (165,666)    |
| Non-operating income:   |                         |             |              |
| Change in fair value of contingent liability                                | -                       | 1,210       | -            |
| Interest and other income, net  | 30                      | 94          | 131          |
| Loss before provision for income taxes                                      | (27,800)                | (25,697)    | (165,535)    |
| Provision for income tax expense (benefit)                                  | 153                     | (234)       | (5,929)      |
| Net loss  | (27,953)                | (25,463)    | (159,606)    |
| Other comprehensive income (loss), before tax:                              |                         |             |              |
| Unrealized holding gains (losses) on available-for-sale securities          | 7                       | 33          | (24)         |
| Income tax expense related to items of other comprehensive income (expense) | -                       | 6           | 1            |
| Other comprehensive income (expense), net of tax                            | 7                       | 27          | (25)         |
| Comprehensive loss  | \$ (27,946)             | \$ (25,436) | \$ (159,631) |
| Net loss per share:   |                         |             |              |
| Basic and diluted   | \$ (0.76)               | \$ (0.71)   | \$ (4.48)    |
| Weighted average shares outstanding:  |                         |             |              |
| Basic and diluted   | 36,982                  | 35,849      | 35,617       |

See accompanying notes to the consolidated financial statements.

## SMITH MICRO SOFTWARE, INC.

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands)

|  | Common stock  |              | Additional<br>paid-in<br>capital | Accumulated<br>comprehensive<br>income (deficit) | Total             |
|--|---------------|--------------|----------------------------------|--|-------------------|
|  | Shares        | Amount       |                                  |  |                   |
| <b>BALANCE, December 31, 2010</b>                            | <b>34,971</b> | <b>\$ 35</b> | <b>\$ 201,702</b>                | <b>\$ 16,528</b>                                 | <b>\$ 218,265</b> |
| Exercise of common stock options                             | 7             | -            | 12                               | -  | 12                |
| Non cash compensation recognized on stock options and ESPP   | -             | -            | 973                              | -  | 973               |
| Restricted stock grants, net of cancellations                | 575           | 1            | 5,556                            | -  | 5,557             |
| Cancellation of shares for payment of withholding tax        | (37)          | -            | (303)                            | -  | (303)             |
| Employee stock purchase plan                                 | 96            | -            | 413                              | -  | 413               |
| Tax benefit deficiencies related to restricted stock expense | -             | -            | (426)                            | -  | (426)             |
| Comprehensive loss   | -             | -            | -                                | (159,631)  | (159,631)         |
| <b>BALANCE, December 31, 2011</b>                            | <b>35,612</b> | <b>\$ 36</b> | <b>\$ 207,927</b>                | <b>\$ (143,103)</b>                              | <b>\$ 64,860</b>  |
| Exercise of common stock options                             | 32            | -            | 16                               | -  | 16                |
| Non cash compensation recognized on stock options and ESPP   | -             | -            | 66                               | -  | 66                |
| Restricted stock grants, net of cancellations                | 574           | -            | 3,883                            | -  | 3,883             |
| Cancellation of shares for payment of withholding tax        | (23)          | -            | (40)                             | -  | (40)              |
| Employee stock purchase plan                                 | 53            | -            | 66                               | -  | 66                |
| Shares repurchased and cancelled                             | (375)         | -            | (753)                            | -  | (753)             |
| Comprehensive loss   | -             | -            | -                                | (25,436)   | (25,436)          |
| <b>BALANCE, December 31, 2012</b>                            | <b>35,873</b> | <b>\$ 36</b> | <b>\$ 211,165</b>                | <b>\$ (168,539)</b>                              | <b>\$ 42,662</b>  |
| Non cash compensation recognized on stock options and ESPP   | -             | -            | 168                              | -  | 168               |
| Restricted stock grants, net of cancellations                | 1,179         | 1            | 3,364                            | -  | 3,365             |
| Cancellation of shares for payment of withholding tax        | (96)          | -            | (114)                            | -  | (114)             |
| Employee stock purchase plan                                 | 38            | -            | 36                               | -  | 36                |
| Comprehensive loss   | -             | -            | -                                | (27,946)   | (27,946)          |
| <b>BALANCE, December 31, 2013</b>                            | <b>36,994</b> | <b>\$ 37</b> | <b>\$ 214,619</b>                | <b>\$ (196,485)</b>                              | <b>\$ 18,171</b>  |

See accompanying notes to the consolidated financial statements.



## SMITH MICRO SOFTWARE, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

|   | Year ended December 31, |             |              |
|---|-------------------------|-------------|--------------|
|   | 2013                    | 2012        | 2011         |
| <b>Operating activities:</b>  |                         |             |              |
| Net loss  | \$ (27,953)             | \$ (25,463) | \$ (159,606) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                         |             |              |
| Depreciation and amortization   | 4,006                   | 4,430       | 10,177       |
| Long-lived assets write-off due to restructuring                            | 1,011                   | -           | -            |
| Goodwill and long-lived asset impairment                                    | -                       | -           | 112,904      |
| Change in fair value of contingent liability                                | -                       | (1,210)     | -            |
| Loss on disposal of fixed assets  | -                       | 163         | 181          |
| Lease incentives  | -                       | -           | 2,223        |
| Provision for adjustments to accounts receivable and doubtful accounts      | 730                     | 1,045       | 1,244        |
| Provision for excess and obsolete inventory                                 | 76                      | 73          | 158          |
| Non cash compensation related to stock options and restricted stock         | 3,533                   | 3,949       | 6,530        |
| Deferred income taxes   | -                       | -           | 414          |
| Change in operating accounts:   |                         |             |              |
| Accounts receivable   | 660                     | (1,473)     | 20,043       |
| Income tax receivable   | (18)                    | 7,612       | (5,421)      |
| Inventories   | (67)                    | 60          | (97)         |
| Prepaid expenses and other assets   | (9)                     | 268         | 58           |
| Accounts payable and accrued liabilities                                    | 1,457                   | (2,259)     | (2,355)      |
| Net cash used in operating activities                                       | (16,574)                | (12,805)    | (13,547)     |
| <b>Investing activities:</b>  |                         |             |              |
| Capital expenditures  | (829)                   | (322)       | (13,431)     |
| Sales of short-term investments   | 10,257                  | 25,196      | 16,172       |
| Net cash provided by investing activities                                   | 9,428                   | 24,874      | 2,741        |
| <b>Financing activities:</b>  |                         |             |              |
| Cash received from stock sale for employee stock purchase plan              | 36                      | 66          | 413          |
| Cash received from exercise of stock options                                | -                       | 16          | 12           |
| Repurchase of common stock  | -                       | (753)       | -            |
| Net cash provided by (used in) financing activities                         | 36                      | (671)       | 425          |
| Net increase (decrease) in cash and cash equivalents                        | (7,110)                 | 11,398      | (10,381)     |
| Cash and cash equivalents, beginning of period                              | 18,873                  | 7,475       | 17,856       |
| Cash and cash equivalents, end of period                                    | \$ 11,763               | \$ 18,873   | \$ 7,475     |
| Supplemental disclosures of cash flow information:                          |                         |             |              |
| Cash paid for income taxes  | \$ 165                  | \$ 257      | \$ 700       |

See accompanying notes to the consolidated financial statements.

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SMITH MICRO SOFTWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. Organization, Basis of Presentation and Summary of Significant Accounting Policies

### *The Company*

Smith Micro Software, Inc. provides software and services that simplify, secure and enhance the mobile experience. The Company's portfolio of wireless solutions includes a wide range of client and server applications that manage devices, communications and network connectivity for end-users as well as Machine-to-Machine ( M2M ) endpoints. Our primary customers are the world's leading wireless service providers, mobile device and chipset manufacturers, and enterprise businesses. In addition to our wireless and mobility software, Smith Micro offers personal productivity, graphics and animation products distributed through a variety of consumer channels worldwide.

With a 30-year history of technology innovation, leadership in industry standards, and extensive commercial deployment experience, Smith Micro continues to evolve its portfolio and business models to capitalize on new market opportunities. Over the past three decades, the Company has developed deep expertise in embedded software for networked devices, policy-based management platforms, and highly-scalable mobile applications and hosted services. For network operators and organizations struggling to reduce costs and complexity in the fragmented, rapidly evolving mobile market, Smith Micro offers proven solutions that increase reliability, security, and efficiency while accelerating time to market for mobile products and services.

The proliferation of mobile broadband technology continues to provide new opportunities for Smith Micro on a global scale. Today, Smith Micro's mission is to help our customers thrive in a connected world with software solutions that:

1. Simplify wireless connectivity to reduce support costs and increase accessibility;
2. Optimize network and device resources for maximum performance and efficiency;
3. Enable a safe, productive mobile environment that meets enterprise and governmental standards for security, control and regulatory compliance; and
4. Engage and grow high-value relationships with end customers using mobile devices.

### *Basis of Presentation*

The accompanying consolidated financial statements reflect the operating results and financial position of Smith Micro Software, Inc. and its wholly owned subsidiaries in accordance with accounting principles generally accepted in the United States of America. All intercompany amounts have been eliminated in consolidation.

### *Foreign Currency Transactions*

The Company has international operations resulting from acquisitions in prior years. The countries in which the Company has a subsidiary or branch office in are Hong Kong, Serbia, the United Kingdom and Canada. The functional currency for all of these foreign entities is the U.S. dollar in accordance with the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) Topic No. 830-30, Foreign Currency Matters-Translation of Financial Statements. Foreign currency transactions that increase or decrease expected functional currency

cash flows is a foreign currency transaction gain or loss that are included in determining net income for the period in which the exchange rate changes. Likewise, a transaction gain or loss (measured from the transaction date or the most recent intervening balance sheet date, whichever is later) realized upon settlement of a foreign currency transaction is included in determining net income for the period in which the transaction is settled.

### *Use of Estimates*

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

### *Fair Value of Financial Instruments*

The Company measures and discloses fair value measurements as required by FASB ASC Topic No. 820, Fair Value Measurements and Disclosures.

The carrying value of accounts receivable, foreign cash accounts, prepaid expenses, other current assets, accounts payable, and accrued liabilities are considered to be representative of their respective fair values because of the short-term nature of those instruments.

Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that is determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, the FASB establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Include other inputs that are directly or indirectly observable in the marketplace.

Level 3 - Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

As required by FASB ASC Topic No. 820, we measure our cash equivalents and short-term investments at fair value. Our cash equivalents and short-term investments are classified within Level 1 by using quoted market prices utilizing market observable inputs.

As required by FASB ASC Topic No. 825, Financial Instruments, an entity can choose to measure at fair value many financial instruments and certain other items that are not currently required to be measured at fair value. Subsequent changes in fair value for designated items are required to be reported in earnings in the current period. This Topic also establishes presentation and disclosure requirements for similar types of assets and liabilities measured at fair value. As permitted, the Company has elected not to use the fair value option to measure our available-for-sale securities under this Topic and will continue to report as required by FASB ASC Topic No. 320, Investments-Debt and Equity Securities. We have made this election because the nature of our financial assets and liabilities are not of such complexity that they would benefit from a change in valuation to fair value.

### *Significant Concentrations*

For the year ended December 31, 2013, three customers, each accounting for over 10% of revenues, made up 77.5% of revenues and 83% of accounts receivable, and one service provider with more than 10% of purchases totaled 28% of accounts payable. For the year ended December 31, 2012, two customers, each accounting for over 10% of revenues, made up 61.2% of revenues and 78% of accounts receivable, and no service provider accounted for more than 10% of purchases. For the year ended December 31, 2011, three customers, each accounting for over 10% of revenues, made up 54.9% of revenues and 63% of accounts receivable, and no service provider accounted for more than 10% of purchases.

The Company currently outsources a key information technology service, an important component of one of its products, from one supplier. Although there are a limited number of third party providers for this type of service, management believes that other suppliers could provide similar services on comparable terms. A change in suppliers, however, could cause a disruption or delay in services which could result in a possible loss of revenues and customer confidence, all of which would adversely affect our operating results.

### *Cash and Cash Equivalents*

Cash and cash equivalents generally consist of cash, government securities, mutual funds, and money market funds. These securities are primarily held in two financial institutions and are uninsured except for the minimum Federal Deposit Insurance Corporation ( FDIC ) coverage, and have original maturity dates of three months or less. As of December 31, 2013 and 2012, bank balances totaling approximately \$11.6 million and \$9.1 million, respectively, were uninsured. As of January 1, 2013, the Dodd-Frank Deposit Insurance Provision which provided insurance on substantially all deposits held in non-interest bearing transaction accounts, expired. Had this provision expired at year-end, our uninsured bank balance would have been approximately \$18.6 million at December 31, 2012.

### *Short-Term Investments*

Short-term investments consist of corporate notes, bonds, and commercial paper and U.S. government agency and government sponsored enterprise obligations. The Company accounts for these short-term investments as required by FASB ASC Topic No. 320, Investments-Debt and Equity Securities. These debt and equity securities are not classified as either held-to-maturity securities or trading securities. As such, they are classified as available-for-sale securities. Available-for-sale securities are recorded at fair value, with unrealized gains or losses recorded as a separate component of accumulated other comprehensive income in stockholders' equity until realized.

### *Accounts Receivable and Allowance for Doubtful Accounts*

We sell our products worldwide. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history, the customer's current credit worthiness and various other factors, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers. We estimate credit losses and maintain an allowance for doubtful accounts reserve based upon these estimates. While such credit losses have historically been within our estimated reserves, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. If not, this could have an adverse effect on our consolidated financial statements. Allowances for product returns are included in other adjustments to accounts receivable on the accompanying consolidated balance sheets. Product returns are estimated based on historical experience and have also been within management's estimates.

### *Inventories*

Inventories consist principally of compact disks ( CDs ), boxes and manuals and are stated at the lower of cost (determined by the first-in, first-out method) or market. The Company regularly reviews its inventory quantities on hand and records a provision for excess and obsolete inventory based primarily on management's forecast of product demand and production requirements. At December 31, 2013 and 2012, our net inventory balances of \$0.2 million consisted of \$0.1 million of assembled products and \$0.1 million of components.

### *Equipment and Improvements*

Equipment and improvements are stated at cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets, generally ranging from three to seven years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the lease term.

### *Internal Software Development Costs*

Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. The Company considers technological feasibility to be established when all planning, designing, coding and testing has been completed according to design specifications. After technological feasibility is established, any additional costs are capitalized. Through December 31, 2013, software has been substantially completed concurrently with the establishment of technological feasibility; accordingly, no costs have been capitalized to date.

### *Impairment of Goodwill and Long-Lived Assets*

During the period ended September 30, 2011, the Company concluded that a decline in its stock price and market capitalization was representative of the fair value of the reporting unit as a whole.

The triggering events that led us to this conclusion were:

- Revenues - declined for the third consecutive quarter.

- New product launches - although we were in trials for several of our new products, as of September 30, 2011 we had not realized any revenues from these new products.

- Profitability - declined for the third consecutive quarter.

- Stock price - remained at depressed prices.

As such, the Company performed Step 1 of the goodwill impairment test which failed, triggering Step 2. As a result of this analysis, the excess of the carrying value of goodwill was compared to the implied fair value of goodwill and resulted in an impairment loss of \$94.2 million in the fiscal quarter ended September 30, 2011.

As a result of the triggering events described above in our goodwill impairment analysis, the Company reviewed its long-lived assets for recoverability. As a result of this analysis, the Company recognized a long-lived asset impairment charge of \$18.7 million in the fiscal quarter ended September 30, 2011 which was allocated pro-rata to the intangible assets of \$13.4 million and \$5.3 million to equipment and improvements, primarily related to our leasehold improvements.

As a result of the \$112.9 million goodwill and long-lived asset impairment charge recorded in the fiscal quarter ended September 30, 2011, there were no more goodwill or intangible assets on the balance sheet as of that date.

### *Deferred Rent and Other Long-Term Liabilities*

The long-term liabilities are for deferred rent to account for the difference between straight-line and bargain rents, lease incentives included in deferred rent, restructuring expenses and deferred revenue beyond one year. The Pennsylvania Opportunity Grant liability was reclassified to accrued liabilities in 2013.

### *Revenue Recognition*

We currently report our net revenues under two operating groups: Wireless and Productivity & Graphics. Within each of these groups software revenue is recognized based on the customer and contract type. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectability is probable as required by FASB ASC Topic No. 985-605, Software-Revenue Recognition. We recognize revenues from sales of our software to our customers or end users as completed products are shipped and title passes; or from royalties generated as authorized customers duplicate our software, if the other requirements are met. If the requirements are not met at the date of shipment, revenue is not recognized until these elements are known or resolved. For Wireless sales, returns from customers are limited to defective goods or goods shipped in error. Historically, customer returns have not exceeded the very nominal estimates and reserves. We also provide some technical support to our customers. Such costs have historically been insignificant.

We have a few multiple element agreements for which we have contracted to provide a perpetual license for use of proprietary software, to provide non-recurring engineering, and in some cases to provide software maintenance (post contract support). For these software and software-related multiple element arrangements, we must: (1) determine whether and when each element has been delivered; (2) determine whether undelivered products or services are essential to the functionality of the delivered products and services; (3) determine the fair value of each undelivered element using vendor-specific objective evidence ( VSOE ), and (4) allocate the total price among the various elements. VSOE of fair value is used to allocate a portion of the price to the undelivered elements and the residual method is used to allocate the remaining portion to the delivered elements. Absent VSOE, revenue is deferred until the earlier of the point at which VSOE of fair value exists for any undelivered element or until all elements of the arrangement have been delivered. However, if the only undelivered element is post contract support, the entire arrangement fee is recognized ratably over the performance period. We determine VSOE for each element based on historical stand-alone sales to third parties or from the stated renewal rate for the elements contained in the initial arrangement. In determining VSOE, we require that a substantial majority of the selling prices for a product or service fall within a reasonably narrow pricing range. We have established VSOE for our post contract support services and non-recurring engineering.

For Productivity & Graphics sales, management reviews available retail channel information and makes a determination of a return provision for sales made to distributors and retailers based on current channel inventory levels and historical return patterns. Certain sales to distributors or retailers are made on a consignment basis. Revenue for consignment sales are not recognized until sell through to the final customer is established. Certain revenues are booked net of revenue sharing payments. Sales directly to end-users are recognized upon shipment. End users have a thirty day right of return, but such returns are reasonably estimable and have historically been immaterial. We also provide technical support to our customers. Such costs have historically been insignificant.

### *Sales Incentives*

For our Productivity & Graphics sales, the cost of sales incentives the Company offers without charge to customers that can be used in, or that are exercisable by a customer as a result of, a single exchange transaction is accounted for as a reduction of revenue as required by FASB ASC Topic No. 985-605, Software-Revenue Recognition. We use historical redemption rates to estimate the cost of customer incentives. Total sales incentives were \$1.2 million, \$0.9 million and \$1.2 million for the years ended December 31, 2013, 2012 and 2011, respectively.

*Advertising Expense*

Advertising costs are expensed as incurred. Advertising expenses were \$0.4 million, \$0.6 million, and \$0.7 million for the years ended December 31, 2013, 2012 and 2011, respectively.

*Stock-Based Compensation*

The Company accounts for all stock-based payment awards made to employees and directors based on their fair values and recognized as compensation expense over the vesting period using the straight-line method over the requisite service period for each award as required by FASB ASC Topic No. 718, Compensation-Stock Compensation.

*Net Income (Loss) Per Share*

The Company calculates earnings per share ( EPS ) as required by FASB ASC Topic No. 260, Earning Per Share. Basic EPS is calculated by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period, excluding common stock equivalents. Diluted EPS is computed by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period plus the weighted average number of dilutive common stock equivalents outstanding for the period determined using the treasury-stock method. For purposes of this calculation, common stock subject to repurchase by the Company and options are considered to be common stock equivalents and are only included in the calculation of diluted earnings per share when their effect is dilutive.

|   | Year Ended December 31,                  |            |             |
|---|--|------------|-------------|
|   | 2013                                     | 2012       | 2011        |
|   | (in thousands, except per share amounts) |            |             |
| <b>Numerator:</b>   |  |            |             |
| Net loss available to common stockholders   | (\$27,953)                               | (\$25,463) | (\$159,606) |
| <b>Denominator:</b>   |  |            |             |
| Weighted average shares outstanding basic   | 36,982                                   | 35,849     | 35,617      |
| Potential common shares options (treasury stock method)   | -  | -          | -           |
| Weighted average shares outstanding diluted   | 36,982                                   | 35,849     | 35,617      |
| Shares excluded (anti-dilutive)   | 2  | 174        | 126         |
| Shares excluded due to an exercise price greater than weighted average stock price for the period | 2,150                                    | 1,453      | 1,561       |
| <b>Net loss per common share:</b>   |  |            |             |
| Basic   | (\$0.76)                                 | (\$0.71)   | (\$4.48)    |
| Diluted   | (\$ 0.76)                                | (\$ 0.71)  | (\$ 4.48)   |



## Recent Accounting Pronouncements

In July 2013, the FASB issued Accounting Standards Update ( ASU ) No. 2013-11, *Income Taxes (Topic 740)*. The amendments in this Update provide guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The Company has no uncertain tax positions being presented in the previous gross presentation, thus the Company is in compliance with the amendments as of December 31, 2013.

In February 2013, the FASB issued Accounting Standards Update ( ASU ) No. 2013-02, *Other Comprehensive Income (Topic 220)*. The amendments in this Update supersede and replace the presentation requirements for reclassifications out of accumulated other comprehensive income in ASUs 2011-05 (issued in June 2011) and 2011-12 (issued in December 2011) for all public and private organizations. The amendments require an entity to provide additional information about reclassifications out of accumulated other comprehensive income. The amendments in this Update are effective for the reporting periods beginning after December 15, 2012. Early adoption is permitted. The Company is in compliance with the amendments as of December 31, 2013.

## 2. Restructuring

### 2013 Restructuring

On July 25, 2013, the Board of Directors approved a plan of restructuring intended to bring the Company's operating expenses better in line with revenues. The restructuring plan involved a realignment of organizational structures, facility consolidations/closures and headcount reductions of approximately 26% of the Company's worldwide workforce. The restructuring plan was implemented primarily during the three month period ended September 30, 2013 and should result in annualized savings of approximately \$16.0 million.

The restructuring plan resulted in special charges totaling \$5.6 million recorded in the year ended December 31, 2013. These charges were for lease/rental terminations of \$3.3 million, severance costs for affected employees of \$1.1 million, equipment and improvements write-offs as a result of our lease/rental terminations of \$1.0 million and other related costs of \$0.2 million. All are cash expenditures except for the equipment and improvements write-offs. Approximately \$1.4 million of cash expenditures were paid out in 2013, and the remaining cash expenditures will be paid in future years.

The following is the activity in our restructuring liability accounts of which \$2.0 million is included in accrued liabilities and \$1.4 million is included in deferred rent and other long term liabilities on the balance sheet for the year ended December 31, 2013 (in thousands):

|  | December 31, 2012 |                 |                   | December 31, 2013 |                 |
|--|-------------------|-----------------|-------------------|-------------------|-----------------|
|  | Balance           | Provision-net   | Usage             | Reclass           | Balance         |
| One-time employee termination benefits           | \$ -              | \$ 1,152        | \$ (924)          | \$ (13)           | \$ 215          |
| Lease/rental terminations                        | -                 | 3,260           | (145)             | -                 | 3,115           |
| Fixed asset write-offs, transition travel, other | -                 | 1,190           | (1,165)           | 13                | 38              |
| <b>Total</b>                                     | <b>\$ -</b>       | <b>\$ 5,602</b> | <b>\$ (2,234)</b> | <b>\$ -</b>       | <b>\$ 3,368</b> |

### 2012 Restructuring

In February 2012, we undertook a restructuring that included a 7% reduction of headcount and other cost reductions that resulted in annualized savings of approximately \$7.0 million. One-time employee termination and other costs resulted in restructuring expenses of \$0.2 million recorded in the year ended December 31, 2012.

The following is the activity in our restructuring liability account which is included in accrued liabilities on the balance sheet for the year ended December 31, 2013 (in thousands):

|  | December 31, 2012 |               |               |             | December 31, 2013 |  |
|--|-------------------|---------------|---------------|-------------|-------------------|--|
|  | Balance           | Provision-net | Usage         | Reclass     | Balance           |  |
| One-time employee termination benefits | \$ 8              | \$ -          | \$ -          | \$ (4)      | \$ 4              |  |
| Lease/rental terminations              | -                 | -             | -             | -           | -                 |  |
| Relocation, move, other expenses       | -                 | -             | (4)           | 4           | -                 |  |
| <b>Total</b>                           | <b>\$ 8</b>       | <b>\$ -</b>   | <b>\$ (4)</b> | <b>\$ -</b> | <b>\$ 4</b>       |  |

The remaining balance in the restructuring reserve is estimated to be used by the end of the fiscal year ending December 31, 2014.

## 3. Balance Sheet Details

### Short-Term Investments

Short-term investments consist of U.S. government agency and government sponsored enterprise obligations. The Company accounts for these short-term investments as required by FASB ASC Topic No. 320, Investments-Debt and Equity Securities. These debt and equity securities are not classified as either held-to-maturity securities or trading securities. As such, they are classified as available-for-sale securities. Available-for-sale securities are recorded at fair value, with unrealized gains or losses recorded as a separate component of accumulated other comprehensive income in stockholders' equity until realized. Available-for-sale securities with contractual maturities of less than 12 months were as follows (in thousands):

|                                    | December 31, 2013    |                       |                 | December 31, 2012    |                       |                  |
|------------------------------------|----------------------|-----------------------|-----------------|----------------------|-----------------------|------------------|
|                                    | Amortized cost basis | Gross unrealized loss | Fair value      | Amortized cost basis | Gross unrealized loss | Fair value       |
| Corporate notes, bonds and paper   | \$ 919               | \$ (1)                | \$ 918          | \$ 9,091             | \$ (7)                | \$ 9,084         |
| Government securities/money market | 2,160                | -                     | 2,160           | 4,245                | (1)                   | 4,244            |
| <b>Total</b>                       | <b>\$ 3,079</b>      | <b>\$ (1)</b>         | <b>\$ 3,078</b> | <b>\$ 13,336</b>     | <b>\$ (8)</b>         | <b>\$ 13,328</b> |

There was a de minimis amount of realized gains recognized for the year ended December 31, 2012. There were no realized gains (losses) recognized in interest and other income for the years ended December 31, 2013 and 2011.

*Equipment and Improvements*

Equipment and improvements consist of the following (in thousands):

|  | December 31, |           |
|--|--------------|-----------|
|  | 2013         | 2012      |
| Computer hardware, software, and equipment     | \$ 16,529    | \$ 16,122 |
| Leasehold improvements                         | 5,317        | 6,368     |
| Office furniture and fixtures                  | 1,213        | 1,611     |
|  | 23,059       | 24,101    |
| Less accumulated depreciation and amortization | (16,036)     | (12,890)  |
| Equipment and improvements, net                | \$ 7,023     | \$ 11,211 |

Depreciation and amortization expense on equipment and improvements was \$4.0 million, \$4.4 million and \$4.1 million for the years ended December 31, 2013, 2012 and 2011 respectively.

The Company recorded an impairment charge related to our restructuring against certain equipment and improvements in the amount of \$1.0 million for the year ended December 31, 2013. See Note 2 above, Restructuring.

*Other Assets*

These are office rent deposits.

*Accrued Liabilities*

Accrued liabilities consist of the following (in thousands):

|                                       | December 31, |          |
|---------------------------------------|--------------|----------|
|                                       | 2013         | 2012     |
| Salaries and benefits                 | \$ 3,651     | \$ 4,061 |
| Restructuring                         | 1,978        | 8        |
| Pennsylvania grant liability          | 1,000        | -        |
| Royalties and revenue sharing         | 803          | 544      |
| Income taxes                          | 176          | 167      |
| Marketing expenses, rebates and other | 126          | 49       |
| Total accrued liabilities             | \$ 7,734     | \$ 4,829 |

*Deferred Rent and Other Long Term Liabilities*

Deferred rent and other long term liabilities consist of the following (in thousands):

|                                 | December 31, |          |
|---------------------------------|--------------|----------|
|                                 | 2013         | 2012     |
| Deferred rent                   | \$ 1,986     | \$ 2,378 |
| Restructuring - beyond one year | 1,394        | -        |
| Pennsylvania grant liability    | -            | 1,000    |

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|   |  |    |       |          |
|---|--|----|-------|----------|
| Deferred revenue - long term                        |  | 3  |       | 21       |
| Total deferred rent and other long term liabilities |  | \$ | 3,383 | \$ 3,399 |

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## 4. Income Taxes

Income (loss) before provision for income taxes was generated from the following sources (in thousands):

|  | Year Ended December 31, |                    |                     |
|--|-------------------------|--------------------|---------------------|
|  | 2013                    | 2012               | 2011                |
| Domestic   | \$ (27,968)             | \$ (25,269)        | \$ (165,555)        |
| Foreign  | 168                     | (428)              | 20                  |
| <b>Total income (loss) before provision for income taxes</b> | <b>\$ (27,800)</b>      | <b>\$ (25,697)</b> | <b>\$ (165,535)</b> |

A summary of the income tax expense is as follows (in thousands):

|  | Year Ended December 31, |                 |                   |
|--|-------------------------|-----------------|-------------------|
|  | 2013                    | 2012            | 2011              |
| <b>Current:</b>                                      |                         |                 |                   |
| Federal  | \$ -                    | \$ 50           | \$ (6,844)        |
| State  | (19)                    | (440)           | 190               |
| Foreign  | 172                     | 156             | 311               |
| <b>Total current</b>                                 | <b>153</b>              | <b>(234)</b>    | <b>(6,343)</b>    |
| <b>Deferred:</b>                                     |                         |                 |                   |
| Federal  | -                       | -               | (873)             |
| State  | -                       | -               | 1,713             |
| Tax deficiencies related to restricted stock expense | -                       | -               | (426)             |
| <b>Total deferred</b>                                | <b>-</b>                | <b>-</b>        | <b>414</b>        |
| <b>Total provision</b>                               | <b>\$ 153</b>           | <b>\$ (234)</b> | <b>\$ (5,929)</b> |

A reconciliation of the provision for income taxes to the amount of income tax expense that would result from applying the federal statutory rate to the profit before income taxes is as follows:

|                                   | Year Ended December 31, |      |      |
|-----------------------------------|-------------------------|------|------|
|                                   | 2013                    | 2012 | 2011 |
| Federal statutory rate            | 35%                     | 35%  | 35%  |
| State tax, net of federal benefit | 4                       | 3    | 4    |
| Equity compensation               | (3)                     | (2)  | -    |
| R&D tax credit                    | -                       | -    | -    |
| Goodwill impairment               | -                       | -    | (5)  |
| Other                             | 2                       | (4)  | -    |
| Change in valuation allowance     | (39)                    | (31) | (30) |
|                                   | (1)%                    | 1%   | 4%   |

The major components of the Company's deferred tax assets and liabilities are as follows (in thousands):

|                                   | <b>Year Ended December 31,</b> |                |
|-----------------------------------|--------------------------------|----------------|
|                                   | <b>2013</b>                    | <b>2012</b>    |
| <b><u>Current</u></b>             |                                |                |
| Various reserves                  | \$ 162                         | \$ 199         |
| Nondeductible accruals            | 1,879                          | 1,352          |
| Prepaid expenses                  | (101)                          | (95)           |
| Other                             | 22                             | 43             |
| Valuation allowance               | (1,810)                        | (1,410)        |
| <b>Total Current</b>              | <b>\$ 152</b>                  | <b>\$ 89</b>   |
| <b><u>Non-current</u></b>         |                                |                |
| Credit carryforwards              | 3,708                          | 3,708          |
| Net operating loss carryforwards  | 38,204                         | 23,808         |
| Nondeductible accruals            | 606                            | -              |
| Fixed assets                      | 1,498                          | 1,299          |
| Amortization                      | 28,537                         | 31,483         |
| Identifiable intangibles acquired | (2,250)                        | (2,239)        |
| Equity based compensation         | 301                            | 934            |
| Other                             | 14                             | 24             |
| Valuation allowance               | (70,772)                       | (59,108)       |
| <b>Total Non-current</b>          | <b>\$ (154)</b>                | <b>\$ (91)</b> |

The Company has federal and state net operating loss carryforwards of approximately \$84.4 million and \$150.0 million, respectively, at December 31, 2013, to reduce future cash payments for income taxes. Of the \$84.4 million of NOL carryforwards at December 31, 2013, \$0.5 million relates to the excess tax benefits from employee restricted stock. Equity will be increased by \$0.5 million if and when such excess tax benefits are ultimately realized. These federal net operating loss carryforwards will expire from 2024 through 2033 and state net operating loss carryforwards will expire 2014 through 2033. The Company also had \$0.5 million of AMT credit carryforwards with an indefinite life, available to offset regular federal income tax requirements.

The Company has federal and state tax credit carryforwards of approximately \$3.4 million and \$0.7 million, respectively, at December 31, 2013. These tax credits will begin to expire in 2027.

To the extent that an ownership change has occurred under Internal Revenue Code Sections 382 and 383, the Company's use of its loss carryforwards and credit carryforwards to offset future taxable income may be limited.

The Company's gross unrecognized tax benefits as of December 31, 2013 and 2012 and the changes in those balances are as follows (in thousands):

|   | Year Ended December 31, |        |
|---|-------------------------|--------|
|   | 2013                    | 2012   |
| Beginning Balance   | \$ 592                  | \$ 324 |
| Increases for tax positions for current year              | -                       | -      |
| Increases/(Decreases) in tax positions for the prior year | -                       | 268    |
| Lapse in statute of limitations                           | -                       | -      |
| Settlements   | -                       | -      |
| Other   | -                       | -      |
| Change in valuation allowance                             | -                       | -      |
| Gross Unrecognized tax benefits, ending balance           | \$ 592                  | \$ 592 |

We account for income taxes as required by FASB ASC Topic No. 740, Income Taxes. This Topic clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Topic also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Topic requires an entity to recognize the financial statement impact of a tax position when it is more likely than not that the position will be sustained upon examination. The amount recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. In addition, the Topic permits an entity to recognize interest and penalties related to tax uncertainties either as income tax expense or operating expenses. The Company has chosen to recognize interest and penalties related to tax uncertainties as operating expense.

The Company assesses whether a valuation allowance should be recorded against its deferred tax assets based on the consideration of all available evidence, using a more likely than not realization standard. The four sources of taxable income that must be considered in determining whether deferred tax assets will be realized are: (1) future reversals of existing taxable temporary differences (i.e., offset of gross deferred tax assets against gross deferred tax liabilities); (2) taxable income in prior carryback years, if carryback is permitted under the applicable tax law; (3) tax planning strategies and (4) future taxable income exclusive of reversing temporary differences and carryforwards.

In assessing whether a valuation allowance is required, significant weight is to be given to evidence that can be objectively verified. A significant factor in the Company's assessment is that the Company has been in a three-year historical cumulative loss as of the end of fiscal 2012. In addition, the Company is also in a loss for the year ending December 31, 2013. These facts, combined with uncertain near-term market and economic conditions, reduced the Company's ability to rely on projections of future taxable income in assessing the realizability of its deferred tax assets.

After a review of the four sources of taxable income as of December 31, 2013 (as described above), and after consideration of the Company's continuing cumulative loss position as of December 31, 2013, the Company recorded a valuation allowance related to its U.S.-based deferred tax amounts, with a corresponding charge to income tax expense, of \$53.2 million during the year ended December 31, 2011.

We recognized interest and penalties accrued related to unrecognized tax benefits in tax expense. During the fiscal years 2013 and 2012, we recognized approximately \$3,000 and \$38,000, respectively, in interest and penalties. The cumulative interest and penalties at December 31, 2013 and 2012 were \$41,000 and \$38,000, respectively.

Unrecognized tax benefits of \$0.2 million at September 30, 2013 would impact the effective tax rate, if recognized after the valuation allowance has been released.

The Company is subject to U.S. federal income tax as well as to income tax of multiple state jurisdictions. Federal income tax returns of the Company are subject to IRS examination for the 2012 tax year. State income tax returns are subject to examination for a period of three to four years after filing. At December 31, 2013, the Company was under audit by the IRS for the tax year 2011 related to the loss carryback claim from 2011 to 2009 and 2010. This audit has subsequently been completed and there were no adjustments required. The outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with management expectations, the Company could be required to adjust its provision for income tax in the period such resolution occurs. As of December 31, 2013, a current estimate of the range of changes that may occur within the next twelve months cannot be made due to the uncertainty regarding the timing of these events.

## 5. Commitments and Contingencies

### *Leases*

The Company leases its buildings under operating leases that expire on various dates through 2022. Future minimum annual lease payments under such leases as of December 31, 2013 are as follows (in thousands):

| <b>Year Ending December 31,</b> | <b>Operating</b> |
|---------------------------------|------------------|
| 2014                            | \$ 2,597         |
| 2015                            | 2,431            |
| 2016                            | 2,135            |
| 2017                            | 1,789            |
| 2018                            | 1,727            |
| Beyond                          | 4,588            |
| <b>Total</b>                    | <b>\$ 15,267</b> |

As of December 31, 2013, \$6.4 million of the remaining lease commitments expense has been accrued as part of the 2013 Restructuring Plan, partially offset by future estimated sublease income of \$4.8 million.

Total rent expense was \$2.4 million, \$2.7 million and \$2.8 million for the years ended December 31, 2013, 2012 and 2011, respectively.

As a condition of our new lease in Pittsburgh, the landlord agreed to incentives of \$40.00 per square foot, or a total of \$2.2 million, for improvements to the space. These costs have been included in deferred rent in our long-term liabilities and are being amortized over the remaining lease term.

### *Pennsylvania Opportunity Grant Program*

On September 26, 2011, we received \$1.0 million from the State of Pennsylvania to help fund our agreement to start-up a new facility. The grant carried with it an obligation, or commitment, to employ at least 232 people within a three-year time period that ended on December 31, 2013. This grant contained conditions that would require us to return a pro-rata amount of the monies received if we failed to meet these conditions. As such, the monies have been recorded as a liability on the balance sheet until we are irrevocably entitled to retain the monies, or until it is determined that we need to return a portion or all of the monies received.



### *Litigation*

The Company is and may become involved in various legal proceedings arising from its business activities. While management does not believe the ultimate disposition of these matters will have a material adverse impact on the Company's consolidated results of operations, cash flows or financial position, litigation is inherently unpredictable, and depending on the nature and timing of these proceedings, an unfavorable resolution could materially affect the Company's future consolidated results of operations, cash flows or financial position in a particular period.

### *Other Contingent Contractual Obligations*

During its normal course of business, the Company has made certain indemnities, commitments and guarantees under which it may be required to make payments in relation to certain transactions. These include: intellectual property indemnities to the Company's customers and licensees in connection with the use, sale and/or license of Company products; indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease; indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct of the Company; indemnities involving the accuracy of representations and warranties in certain contracts; and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware. In addition, the Company has made contractual commitments to employees providing for severance payments upon the occurrence of certain prescribed events. The Company may also issue a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain customer contracts. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees may not provide for any limitation of the maximum potential for future payments the Company could be obligated to make. The Company has not recorded any liability for these indemnities, commitments and guarantees in the accompanying consolidated balance sheets.

## **6. Segment, Customer Concentration and Geographical Information**

### *Segment Information*

Public companies are required to report financial and descriptive information about their reportable operating segments as required by FASB ASC Topic No. 280, Segment Reporting. The Company has two primary business units based on how management internally evaluates separate financial information, business activities and management responsibility. Wireless includes our QuickLink, NetWise and CommSuite family of products. Productivity & Graphics includes our consumer-based products: Poser, Anime Studio, Manga Studio, MotionArtist and StuffIt.

The following table shows the revenues generated by each business unit (in thousands):

|                         | Year Ended December 31, |           |           |
|-------------------------|-------------------------|-----------|-----------|
|                         | 2013                    | 2012      | 2011      |
| Wireless                | \$ 35,853               | \$ 37,154 | \$ 48,951 |
| Productivity & Graphics | 6,822                   | 6,175     | 8,816     |
| Total revenues          | 42,675                  | 43,329    | 57,767    |
| Cost of revenues        | 9,707                   | 8,448     | 13,761    |
| Gross profit            | \$ 32,968               | \$ 34,881 | \$ 44,006 |

### Customer Concentration Information

A summary of the Company's customers that represent 10% or more of the Company's net revenues is as follows:

|                                     | Year Ended December 31, |       |       |
|-------------------------------------|-------------------------|-------|-------|
|                                     | 2013                    | 2012  | 2011  |
| <b>Wireless:</b>                    |                         |       |       |
| Sprint (& affiliates)               | 53.1%                   | 40.7% | 24.8% |
| Verizon Wireless (& affiliates)     | 13.0%                   | 20.5% | 18.4% |
| AT&T                                | -                       | -     | 11.7% |
| <b>Productivity &amp; Graphics:</b> |                         |       |       |
| FastSpring                          | 11.4%                   | -     | -     |

The customers listed above comprised 83%, 78% and 63% of our accounts receivable as of December 31, 2013, 2012 and 2011, respectively. Our major customers could reduce their orders of our products in favor of a competitor's product or for any other reason. The loss of any of our major customers or decisions by a significant customer to substantially reduce purchases could have a material adverse effect on our business.

### Geographical Information

During the years ended December 31, 2013, 2012 and 2011, the Company operated in three geographic locations: the Americas, Asia Pacific and EMEA (Europe, the Middle East, and Africa). Revenues attributed to the geographic location of the customer's bill-to address, were as follows (in thousands):

|                | Year ended December 31, |           |           |
|----------------|-------------------------|-----------|-----------|
|                | 2013                    | 2012      | 2011      |
| Americas       | \$ 38,532               | \$ 37,724 | \$ 51,784 |
| Asia Pacific   | 928                     | 2,871     | 2,812     |
| EMEA           | 3,215                   | 2,734     | 3,171     |
| Total revenues | \$ 42,675               | \$ 43,329 | \$ 57,767 |

The Company does not separately allocate specific assets to these geographic locations.

## 7. Profit Sharing

The Company offers its employees a 401(k) plan, in which the Company matches the employee contribution at a rate of 20%, subject to a vesting schedule. Total employer contributions amounted to \$0.3 million, \$0.3 million and \$0.5 million for the years ended December 31, 2013, 2012 and 2011, respectively.

## 8. Stock-Based Compensation

### *Stock Plans*

On July 28, 2005, our Shareholders approved the 2005 Stock Option / Stock Issuance Plan ( 2005 Plan ). The 2005 Plan, which became effective the same date, replaced the 1995 Stock Option / Stock Issuance Plan ( 1995 Plan ), which expired on May 24, 2005. All outstanding options under the 1995 Plan remained outstanding, but no further grants will be made under that Plan.

The 2005 Plan provides for the issuance of non-qualified or incentive stock options and restricted stock to employees, non-employee members of the board and consultants. The exercise price per share for option grants is not to be less than the fair market value per share of the Company's common stock on the date of grant. The Board of Directors has the discretion to determine the vesting schedule. Options may be exercisable immediately or in installments, but generally vest over a four-year period from the date of grant. In the event the holder ceases to be employed by the Company, all unvested options terminate and all vested options may be exercised within a period following termination. In general, options expire ten years from the date of grant. Restricted stock is valued using the closing stock price on the date of the grant. The total value is expensed over the vesting period of 12 to 48 months. The maximum number of shares of the Company's common stock that were available for issuance over the term of the original 2005 Plan previously could not exceed 5,000,000 shares, plus additional shares equal to 2.5% of the number of shares of common stock outstanding on the last trading day of the calendar year commencing with calendar year 2006, but not in excess of 750,000 shares. On October 11, 2007, our shareholders voted to approve an amendment to the 2005 Plan to increase the maximum number of shares of common stock that may be issued under the 2005 Plan from 5,000,000 shares (plus an annual increase) to 7,000,000 shares (plus an annual increase).

### *Employee Stock Purchase Plan*

The Company has a shareholder approved employee stock purchase plan ( ESPP ), under which substantially all employees may purchase the Company's common stock through payroll deductions at a price equal to 85% of the lower of the fair market values of the stock as of the beginning and end of six-month offering periods. An employee's payroll deductions under the ESPP are limited to 10% of the employee's compensation and employees may not purchase more than the lesser of \$25,000 of stock, or 1,000 shares, for any purchase period. Additionally, no more than 1,000,000 shares may be purchased under the plan.

### *Stock Compensation Expense*

The Company accounts for all stock-based payment awards made to employees and directors based on their fair values and recognized as compensation expense over the vesting period using the straight-line method over the requisite service period for each award as required by FASB ASC Topic No. 718, Compensation-Stock Compensation.

*Valuation of Stock Option and Restricted Stock Awards*

The assumptions used to compute the share-based compensation costs for the stock options granted during the years ended December 31, 2013, 2012 and 2011, respectively, using the Black-Scholes option pricing model, were as follows:

|   | Year Ended December 31, |         |         |
|---|-------------------------|---------|---------|
|   | 2013                    | 2012    | 2011    |
| Weighted average grant-date fair value of stock options | \$ 0.63                 | \$ 0.80 | \$ 1.16 |
| <i>Assumptions</i>                                      |                         |         |         |
| Risk-free interest rate (weighted average)              | 0.6%                    | 0.5%    | 0.2%    |
| Expected dividend yield                                 | -                       | -       | -       |
| Weighted average expected life (years)                  | 4                       | 4       | 1       |
| Volatility (weighted average)                           | 68.1%                   | 80.0%   | 73.0%   |
| Forfeiture rate   | 11.4%                   | 13.7%   | -       |

The risk-free interest rate assumption was based on the United States Treasury rates for U.S. Treasury zero-coupon bonds with maturities similar to those of the expected term of the award being valued. The Company assumed no dividend yield because it does not expect to pay dividends for the foreseeable future. The weighted average expected life is the vesting period for those options granted during that period. The average volatility is based on the actual historical volatility of our common stock. The forfeiture rate was based on modified employee turnover.

Grants of restricted stock are valued using the closing stock price on the date of grant. In the year ended December 31, 2013, a total of 40,000 shares of restricted stock, with a total value of \$0.1 million, were granted to non-employee members of the Board of Directors. This cost will be amortized over a period of 12 months. In addition, 1.5 million shares of restricted stock, with a total value of \$2.5 million, were granted to key officers and employees of the Company. This cost will be amortized over a period of 48 months.

*Valuation of ESPP*

The fair values are estimated at the beginning of each offering period using a Black-Scholes valuation model that uses the assumptions noted in the following table. The risk-free rate is based on the U.S. treasury yield curve in effect at the time of grant. Expected volatility was based on the historical volatility on the day of grant. Following is a schedule of the shares purchased, the fair value per share, and the Black-Scholes model assumptions for each offering period:

| Offering Period Ended                  | (Ending)          |                       | March 31,<br>2013 | September 31,<br>2012 | March 31,<br>2012 |
|--|-------------------|-----------------------|-------------------|-----------------------|-------------------|
|  | March 31,<br>2014 | September 31,<br>2013 |                   |                       |                   |
| Shares purchased for offering period   |                   | 19,490                | 18,594            | 8,052                 | 44,666            |
| Fair value per share                   | \$ 0.30           | \$ 0.44               | \$ 0.65           | \$ 0.93               | \$ 0.69           |
| <i>Assumptions</i>                     |                   |                       |                   |                       |                   |
| Risk-free interest rate (average)      | 0.40%             | 0.11%                 | 0.14%             | 0.14%                 | 0.50%             |
| Expected dividend yield                | -                 | -                     | -                 | -                     | -                 |
| Weighted average expected life (years) | 0.5               | 0.5                   | 0.5               | 0.5                   | 0.5               |
| Volatility (average)                   | 44.0%             | 45.0%                 | 74.0%             | 78.0%                 | 105.0%            |

### Compensation Costs

Stock-based non-cash compensation expenses related to stock options, restricted stock grants and the ESPP were recorded in the financial statements as follows (in thousands):

|  | Year Ended December 31, |                 |                 |
|--|-------------------------|-----------------|-----------------|
|  | 2013                    | 2012            | 2011            |
| Cost of revenues                                 | \$ 20                   | \$ 13           | \$ 31           |
| Selling and marketing                            | 766                     | 865             | 1,922           |
| Research and development                         | 809                     | 765             | 1,198           |
| General and administrative                       | 1,938                   | 2,306           | 3,379           |
| <b>Total non-cash stock compensation expense</b> | <b>\$ 3,533</b>         | <b>\$ 3,949</b> | <b>\$ 6,530</b> |

Total share-based compensation for each year includes cash payment of income taxes related to grants of restricted stock in the amounts of \$0.4 million, \$0.4 million and \$1.5 million for the years ended December 31, 2013, 2012 and 2011, respectively.

### Stock Options

A summary of the Company's stock options outstanding under the 2005 Plan as of December 31, 2013 and the activity during the years ended herein are as follows (in thousands except per share amounts):

|   | Shares       | Weighted Ave.<br>Exercise Price | Aggregate<br>Intrinsic Value |
|---|--------------|---------------------------------|------------------------------|
| <b>Outstanding as of December 31, 2010</b>                                  | <b>2,706</b> | <b>\$ 11.69</b>                 | <b>\$ -</b>                  |
| (2,545 options exercisable at a weighted average exercise price of \$11.54) |              |                                 |                              |
| Granted (weighted average fair value of \$1.16)                             | 25           | \$ 4.07                         |                              |
| Exercised   | (7)          | \$ 1.77                         |                              |
| Cancelled   | (557)        | \$ 14.04                        |                              |
| <b>Outstanding as of December 31, 2011</b>                                  | <b>2,167</b> | <b>\$ 11.03</b>                 | <b>\$ -</b>                  |
| (2,167 options exercisable at a weighted average exercise price of \$11.03) |              |                                 |                              |
| Granted (weighted average fair value of \$0.80)                             | 826          | \$ 1.39                         |                              |
| Exercised   | (32)         | \$ 0.50                         |                              |
| Cancelled   | (686)        | \$ 12.37                        |                              |
| <b>Outstanding as of December 31, 2012</b>                                  | <b>2,275</b> | <b>\$ 7.02</b>                  | <b>\$ -</b>                  |
| (1,474 options exercisable at a weighted average exercise price of \$10.09) |              |                                 |                              |
| Granted (weighted average fair value of \$0.63)                             | 120          | \$ 1.31                         |                              |
| Exercised   | -            | \$ -                            |                              |
| Cancelled   | (225)        | \$ 6.52                         |                              |
| <b>Outstanding as of December 31, 2013</b>                                  | <b>2,170</b> | <b>\$ 6.76</b>                  | <b>\$ -</b>                  |

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|  |       |    |      |    |   |
|--|-------|----|------|----|---|
| Exercisable as of December 31, 2013              | 1,573 | \$ | 8.81 | \$ | - |
| Vested and expected to vest at December 31, 2013 | 2,092 | \$ | 6.96 | \$ | - |

No options were exercised during the year ended December 31, 2013. The weighted-average grant-date fair value of options granted during the year ended December 31, 2013 was \$0.63. As of December 31, 2013, there is \$4.3 million of unrecognized compensation costs related to non-vested stock options and restricted stock granted under the Plan. At December 31, 2013, there were 2.0 million shares available for future grants under the 2005 Stock Issuance / Stock Option Plan.

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**Restricted Stock Awards**

A summary of the Company's restricted stock awards outstanding under the 2005 Plan as of December 31, 2013, and the activity during years ended therein, are as follows (in thousands):

|                               | <b>Number<br/>of shares</b> | <b>Weighted average<br/>grant date fair value</b> |
|-------------------------------|-----------------------------|---|
| Unvested at December 31, 2010 | 1,604                       | \$ 7.23   |
| Granted                       | 1,000                       | \$ 8.86   |
| Vested                        | (823)                       | \$ 7.40   |
| Cancelled and forfeited       | (426)                       | \$ 7.81   |
| Unvested at December 31, 2011 | 1,355                       | \$ 3.21   |
| Granted                       | 995                         | \$ 2.64   |
| Vested                        | (611)                       | \$ 6.42   |
| Cancelled and forfeited       | (420)                       | \$ 8.73   |
| Unvested at December 31, 2012 | 1,319                       | \$ 4.60   |
| Granted                       | 1,495                       | \$ 1.70   |
| Vested                        | (752)                       | \$ 4.43   |
| Cancelled and forfeited       | (316)                       | \$ 3.00   |
| Unvested at December 31, 2013 | 1,746                       | \$ 2.48   |

**9. Stock Repurchase Program**

In November 2011, the Company announced that its Board of Directors had approved a program authorizing the repurchase of up to five million shares of the Company's common stock over a period of up to two years. The Company repurchased 375,000 shares at a cost of \$0.8 million during fiscal year 2012. The Company did not repurchase any shares in fiscal years 2013 or 2011. The program ended on November 1, 2013.

**10. Subsequent Events**

The Company evaluates and discloses subsequent events as required by ASC Topic No. 855, Subsequent Events. The Topic establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued.

Subsequent events have been evaluated as of the date of this filing and there are no further disclosures required.

## 11. Quarterly Financial Data (Unaudited)

The following financial information reflects all normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of the results of the interim periods. Summarized quarterly data for fiscal 2013 and 2012 are as follows (in thousands, except per share data):

|  | Year ended December 31, 2013 |             |             |             |
|--|------------------------------|-------------|-------------|-------------|
|  | 1st Quarter                  | 2nd Quarter | 3rd Quarter | 4th Quarter |
| <b>Selected quarterly financial data:</b>    |                              |             |             |             |
| Revenues                                     | \$ 11,602                    | \$ 10,484   | \$ 8,746    | \$ 11,843   |
| Gross profit                                 | \$ 9,158                     | \$ 8,083    | \$ 6,254    | \$ 9,473    |
| Operating (loss)                             | \$ (6,101)                   | \$ (7,248)  | \$ (12,980) | \$ (1,501)  |
| Net (loss)                                   | \$ (6,158)                   | \$ (7,244)  | \$ (13,049) | \$ (1,502)  |
| Net (loss) per share, basic (1)              | \$ (0.17)                    | \$ (0.19)   | \$ (0.35)   | \$ (0.04)   |
| Weighted average shares outstanding, basic   | 36,614                       | 37,247      | 37,036      | 37,027      |
| Net (loss) per share, diluted (1)            | \$ (0.17)                    | \$ (0.19)   | \$ (0.35)   | \$ (0.04)   |
| Weighted average shares outstanding, diluted | 36,614                       | 37,247      | 37,036      | 37,027      |
|  | Year ended December 31, 2012 |             |             |             |
|  | 1st Quarter                  | 2nd Quarter | 3rd Quarter | 4th Quarter |
| <b>Selected quarterly financial data:</b>    |                              |             |             |             |
| Revenues                                     | \$ 10,114                    | \$ 10,171   | \$ 11,012   | \$ 12,032   |
| Gross profit                                 | \$ 7,919                     | \$ 8,375    | \$ 8,892    | \$ 9,695    |
| Operating (loss)                             | \$ (9,615)                   | \$ (6,824)  | \$ (6,007)  | \$ (4,555)  |
| Net (loss)                                   | \$ (9,682)                   | \$ (6,825)  | \$ (4,813)  | \$ (4,143)  |
| Net (loss) per share, basic (1)              | \$ (0.27)                    | \$ (0.19)   | \$ (0.13)   | \$ (0.12)   |
| Weighted average shares outstanding, basic   | 35,590                       | 36,045      | 35,879      | 35,882      |
| Net (loss) per share, diluted (1)            | \$ (0.27)                    | \$ (0.19)   | \$ (0.13)   | \$ (0.12)   |
| Weighted average shares outstanding, diluted | 35,590                       | 36,045      | 35,879      | 35,882      |

(1) Basic and diluted net (loss) per share is computed independently for each of the quarters presented. Therefore, the sum of the quarterly per share amounts will not necessarily equal the total for the year.



**SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS**

**FOR EACH OF THE THREE YEARS**

**IN THE PERIOD ENDED DECEMBER 31, 2013**

(In thousands)

|   | <b>Balance at<br/>beginning<br/>of period</b> | <b>Additions<br/>charged to<br/>costs and<br/>expenses</b> | <b>Deductions</b> | <b>Balance at<br/>end of<br/>period</b> |
|---|---|--|-------------------|---|
| <b>Allowance for accounts receivable (1):</b>       |   |  |                   |   |
| 2013  | \$ 482  | \$ 730   | \$ (595)          | \$ 617                                  |
| 2012  | 1,382   | 1,045  | (1,945)           | 482                                     |
| 2011  | 855   | 1,244  | (717)             | 1,382                                   |
| <b>Allowance for excess and obsolete inventory:</b> |   |  |                   |   |
| 2013  | \$ 352  | \$ 76  | \$ (127)          | \$ 301                                  |
| 2012  | 417   | 73   | (138)             | 352                                     |
| 2011  | 558   | 158  | (299)             | 417                                     |

(1) Allowances are for retail return reserves, marketing development funds and doubtful accounts.

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