

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS AND
INDEPENDENT AUDITOR'S REPORT

December 31, 2019 and 2018

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

CONTENTS

Independent Auditor's Report	1 - 2
Consolidated Financial Statements	
Consolidated Balance Sheets	3
Consolidated Statements of Operations	4
Consolidated Statements of Changes in Stockholders' Equity	5
Consolidated Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7-30

Independent Auditor's Report

Board of Directors
Costar Technologies, Inc.
Coppell, Texas

We have audited the accompanying consolidated financial statements of Costar Technologies, Inc. and Subsidiaries, which comprise the balance sheets as of December 31, 2019, and 2018, and the related statements of operations, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Board of Directors
Costar Technologies, Inc.
Page 2

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Costar Technologies, Inc. and Subsidiaries as of December 31, 2019, and 2018, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in *Note 2* to the financial statements, in 2019, the Company adopted new accounting guidance for accounting for leases. Our opinion is not modified with respect to these matters.

BKD, LLP

Dallas, Texas
March 30, 2020

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (AMOUNTS SHOWN IN THOUSANDS)

	December 31, 2019	December 31, 2018
ASSETS		
Current assets		
Cash and cash equivalents	\$ 1	\$ 189
Accounts receivable, less allowance for doubtful accounts of \$471 and \$859 in 2019 and 2018, respectively	9,056	9,333
Inventories, net of reserve for obsolescence of \$1,264 and \$1,101 in 2019 and 2018, respectively	20,196	20,618
Prepaid expenses and other current assets	2,295	1,531
Total current assets	<u>31,548</u>	<u>31,671</u>
Non-current assets		
Property and equipment, net	910	915
Deferred financing costs, net	59	99
Deferred tax asset, net	4,514	3,766
Trade names, net	2,198	2,561
Distribution agreements, net	801	905
Customer relationships, net	4,187	4,884
Covenants not to compete, net	60	92
Patents, net	169	200
Technology, net	268	335
Goodwill	6,513	6,513
Right of use assets	3,131	
Other non-current assets	149	109
Total non-current assets	<u>22,959</u>	<u>20,379</u>
Total assets	<u>\$ 54,507</u>	<u>\$ 52,050</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 5,639	\$ 5,786
Accrued expenses and other	5,879	7,075
Line of credit	15,953	11,738
Current maturities of long-term debt, net of unamortized financing fees	781	773
Contingent purchase price	1,490	1,048
Current maturities of notes payable, unrelated party	583	
Current maturities of notes payable, related party		805
Current maturities of lease liabilities	990	
Total current liabilities	<u>31,315</u>	<u>27,225</u>
Long-Term liabilities		
Long-term debt, net of current maturities and unamortized financing fees	3,592	4,373
Contingent purchase price, net of current portion		992
Non-current maturities of lease liabilities	2,389	
Total long-term liabilities	<u>5,981</u>	<u>5,365</u>
Total liabilities	<u>37,296</u>	<u>32,590</u>
Stockholders' Equity		
Preferred stock		
Common stock	3	3
Additional paid-in capital	157,478	157,029
Accumulated deficit	(135,749)	(133,051)
Less common stock held in treasury, at cost	(4,521)	(4,521)
Total stockholders' equity	<u>17,211</u>	<u>19,460</u>
Total liabilities and stockholders' equity	<u>\$ 54,507</u>	<u>\$ 52,050</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS (AMOUNTS SHOWN IN THOUSANDS, EXCEPT NET INCOME PER SHARE)

	For the Years Ended December 31,	
	2019	2018
Net revenues	\$ 69,526	\$ 58,906
Cost of revenues	<u>42,960</u>	<u>37,156</u>
Gross profit	26,566	21,750
Selling, general and administrative expenses	22,395	18,512
Engineering and development expense	5,722	4,046
Transaction and related expense		729
Change in fair value of contingent purchase price	<u>498</u>	<u>932</u>
	<u>28,615</u>	<u>24,219</u>
Income (loss) from operations	<u>(2,049)</u>	<u>(2,469)</u>
Other expenses		
Interest expense	(1,320)	(804)
Other income (expense), net	<u>10</u>	<u>(413)</u>
Total other expenses, net	<u>(1,310)</u>	<u>(1,217)</u>
Income (loss) before taxes	(3,359)	(3,686)
Current income tax expense	123	117
Deferred income tax benefit	<u>(784)</u>	<u>(923)</u>
Net loss	<u>\$ (2,698)</u>	<u>\$ (2,880)</u>
<u>Net loss per share:</u>		
Basic	\$ (1.72)	\$ (1.87)
Diluted	\$ (1.72)	\$ (1.87)
<u>Weighted average shares outstanding:</u>		
Basic	1,568	1,542
Diluted	1,568	1,542

See notes to consolidated financial statements.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (AMOUNTS SHOWN IN THOUSANDS)

For the Years Ended December 31, 2019 and 2018

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Treasury Stock		Total Stockholders' Equity
	Shares	Amount			Shares	Amount	
Balances at December 31, 2017	1,758	\$ 3	\$ 156,767	\$ (130,171)	226	\$ (4,521)	\$ 22,078
Net loss				(2,880)			(2,880)
Exercise of stock options	6		35				35
Stock based compensation	13		227				227
Balances at December 31, 2018	1,777	\$ 3	\$ 157,029	\$ (133,051)	226	\$ (4,521)	\$ 19,460
Net loss				(2,698)			(2,698)
Exercise of stock options	19		37				37
Stock based compensation	14		412				412
Balances at December 31, 2019	1,810	\$ 3	\$ 157,478	\$ (135,749)	226	\$ (4,521)	\$ 17,211

See notes to consolidated financial statements.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (AMOUNTS SHOWN IN THOUSANDS)

For the Years Ended December 31,	2019	2018
Cash flows from operating activities		
Net loss	\$ (2,698)	\$ (2,880)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Loss on asset disposal	2	
Stock based compensation	412	227
Depreciation and amortization	1,746	1,667
Amortization of deferred financing costs	56	90
Amortization of right of use assets	857	
Provision for doubtful accounts	(388)	762
Provision for obsolete inventory	163	286
Change in fair value of contingent purchase price	498	932
Deferred tax asset	(748)	(850)
Changes in operating assets and liabilities, net effect of acquisition		
Accounts receivable, net	665	1,411
Inventories, net	259	(1,549)
Prepaid expenses and other current assets	(764)	437
Right of use assets	(39)	
Other non-current assets	(40)	377
Accounts payable	(147)	(48)
Lease liabilities	(717)	
Accrued expenses and other	(1,049)	655
Net cash provided by (used in) operating activities	(1,932)	1,517
Cash flows from investing activities		
Purchase of property and equipment	(449)	(328)
Proceeds from the sale of property and equipment		3
Acquisition of Arecont Vision Costar		(11,647)
Net cash used in investing activities	(449)	(11,972)
Cash flows from financing activities		
Payment of contingent purchase price	(1,048)	(339)
Deferred financing costs		(154)
Proceeds from (repayment of) line of credit	4,215	11,738
Proceeds from long-term debt		5,500
Payment of long-term debt	(789)	(5,579)
Proceeds from note payable, unrelated party, net	583	
Payment of notes payable, related party	(805)	(753)
Exercise of stock options	37	35
Net cash provided by financing activities	2,193	10,448
Net change in cash and cash equivalents	(188)	(7)
Cash and cash equivalents, beginning of year	189	196
Cash and cash equivalents, end of year	\$ 1	\$ 189
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	\$ 1,244	\$ 697
Cash paid during the period for taxes	\$ 143	\$ 112
Right of use assets obtained in exchange for operating lease liabilities	\$ 3,949	\$

See notes to consolidated financial statements.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

1. Nature of Operations

Costar Technologies, Inc. ("Costar Technologies") was incorporated in the State of Delaware in February 1997 under the name "Fairmarket, Inc.". Costar Technologies, and its wholly owned subsidiaries, Costar Video Systems, LLC ("Costar") and its wholly owned subsidiaries Innotech Security, Inc. ("Innotech") and Arecont Vision Costar, LLC ("Arecont Vision"), LQ Corporation ("LQ") and CohuHD Costar, LLC ("CohuHD Costar") (collectively the "Company"), develops, designs and distributes a range of security solution products such as surveillance cameras, lenses, digital video recorders, high speed domes and industrial vision products. CohuHD Costar is a leading provider of video cameras and related products, specializing in IP video solutions for traffic monitoring, security, surveillance and military applications; and accessories, such as cables, camera mounts, lenses and data storage devices.

On July 13, 2018, Costar acquired the assets of Arecont Vision, a manufacturer of network cameras and megapixel surveillance cameras, offering a large selection of megapixel IP cameras.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and include the accounts of Costar Technologies and its wholly owned subsidiaries. All material intercompany transactions have been eliminated in consolidation.

These consolidated financial statements were approved by management and available for issuance on March 30, 2020. Subsequent events have been evaluated through this date.

Commitments and Contingencies

The Company records and/or discloses commitments and contingencies in accordance with ASC 450, Contingencies. ASC 450 applies to an existing condition, situation, or set of circumstances involving uncertainty as to possible loss that will ultimately be resolved when one or more future events occur or fail to occur. At this time there are no matters that are expected to have an adverse, material effect on the consolidated financial statements.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid debt instruments with original maturities of three months or less to be cash equivalents. As of December 31, 2019 and December 31, 2018, the Company had \$1 and \$189 in cash and cash equivalents, respectively.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable are uncollateralized customer obligations recorded at net realizable values. The Company maintains an allowance for estimated losses resulting from the failure of customers to make required payments and for anticipated returns. The allowance is based on specific facts and circumstances surrounding individual customers as well as historical experience. Provisions for losses on receivables and returns are charged to income to maintain the allowance at a level considered adequate to cover losses and future returns. Receivables are charged off against the reserve when they are deemed uncollectible and returns are charged off against the reserve when the actual returns are incurred.

Inventories

Inventories are recorded on the first in first out basis and are stated at the lower of average cost or net realizable value. A provision is made to reduce excess or obsolete inventories to their net realizable value. The reserve for inventory obsolescence was \$1,264 and \$1,101 as of December 31, 2019 and December 31, 2018, respectively. Inventories at December 31, 2019 and December 31, 2018 were comprised of the following:

	<u>December 31, 2019</u>	<u>December 31, 2018</u>
Parts, components, and materials	\$ 4,411	\$ 9,165
Work-in-process	3	1,475
Finished products	<u>15,782</u>	<u>9,978</u>
Total Inventory	<u>\$ 20,196</u>	<u>\$ 20,618</u>

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization is computed using the straight-line method over estimated useful lives as follows:

Computer hardware and software	3 years
Furniture and fixtures and demo and network equipment	3 - 5 years
Leasehold improvements	Shorter of lease term or asset useful life

Long-Lived Assets

In accordance with GAAP, intangible assets with indefinite lives are not amortized, but instead tested for impairment. Intangible assets are reviewed for impairment at least annually or whenever events or changes in circumstances indicate the carrying value of the assets may not be recoverable. Impairment losses are recognized if the fair value of the intangible asset is less than its carrying value.

Property and equipment and intangible assets with finite lives are amortized over their estimated useful lives. These assets are reviewed for impairment, at the asset group level, whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be recoverable. A loss is recognized in the consolidated statements of operations if it is determined that an impairment exists based on expected future undiscounted cash flows. The amount of the impairment is the excess of the carrying amount of the impaired asset over its fair value.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

Goodwill

Goodwill is tested annually for impairment, or sooner when circumstances indicate an impairment may exist. The Company has elected to first perform a qualitative assessment, based on the entity's events and circumstances, to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. The results of this qualitative assessment determine whether it is necessary to perform an impairment test. There were no impairments recognized during the years ending December 31, 2019 and 2018.

Fair Value Measurements

The Company follows the guidance from FASB ASC 820, Fair Value Measurements and Disclosures, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. The Company applies fair value accounting for all financial assets and liabilities and non-financial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis. The Company defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities, which are required to be recorded at fair value, the Company considers the principal or most advantageous market in which the Company would transact and the market-based risk measurements or assumptions that market participants would use in pricing the asset or liability, such as inherent risk, transfer restrictions and credit risk (See Note 5).

Revenue Recognition

Revenue is measured as the amount of consideration the Company expects to receive in exchange for transferring distinct goods or providing services to customers. The Company's revenue consists substantially of product sales and is reported net of sales discounts, rebates, incentives, returns and other allowances offered to customers. The Company recognizes revenue when performance obligations under the terms of contracts with its customers are satisfied, which occurs when control passes to a customer to enable them to direct the use and obtain benefit from the product.

The Company ships and invoices its sales in accordance with signed purchase orders. The satisfaction of the Company's performance obligation is based upon transfer of control over a product to a customer, which results in sales being recognized upon shipment, in accordance with signed purchase orders, rather than upon delivery for the majority of the Company's sales. Any software imbedded in the products sold is considered incidental to the product being sold.

Some of the Company's sales are sold with a right of return and the Company may provide other credits or incentives, which are accounted for as variable consideration when estimating the amount of revenue to recognize. We have elected to apply the portfolio practical expedient. We estimate the variable consideration using the expected value method when calculating the returns reserve because the difference in applying it to the individual contract would not differ materially. Returns are estimated based on historical experience and are required to be established and presented at the gross sales value with an asset established for the estimated value of the merchandise returned separate from the refund liability. At 12/31/2019 liabilities for return allowances of \$1,405 are included in accrued expenses and other current liabilities and \$805 for the estimated value of the merchandise to be returned is included in prepaid expenses and other current assets on the Consolidated Balance Sheets. At 12/31/2018 a net amount of \$1,456 was included in accrued expenses and other current liabilities .

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

Revenue includes certain shipping and handling costs. Shipping and handling costs associated with outbound freight after control over a product has transferred to a customer are accounted for as a fulfillment cost and are included in cost of goods sold.

The Company offers standard net 30 payments terms, but occasionally offers extended terms. The Company provides an assurance-type warranty that guarantees its product complies with agreed-upon specifications. This requires the Company to remedy deficiencies in quality or performance of our products over a specified period of time, generally twelve to thirty-six months, at no cost to our customers. Warranty liabilities are established at the time the revenue is recognized at levels that represent our estimate of the costs that will be incurred to fulfill those warranty requirements. In addition, the Company maintains reserves for returns and post-invoice sales discounts. Provisions for estimated losses on sales or related receivables are recorded when identified.

Applying the practical expedient, the Company recognizes incremental costs of obtaining contracts as an expense when incurred when the amortization period of the assets that otherwise would have been recognized is one year of less.

The adoption of Topic 606, see Recent Accounting Pronouncements below, did not have a material effect on the consolidated statements of operations during the year ended December 31, 2019.

Product Warranties

The Company provides limited warranties on certain products for periods up to three years. The Company records an accrued liability and expense for estimated future warranty claims based upon historical experience and management's estimate of the level of future claims. Changes in the estimated amounts recognized in prior years are recorded as an adjustment to the accrued liability and expense in the current year. As of December 31, 2019 and 2018, the accrued warranty liability was approximately \$2,411 and \$2,177, respectively.

Leases

At contract inception the Company determines if an arrangement is a lease. Operating leases are included in right of use assets and current maturities of lease liabilities and non-current maturities of lease liabilities in the Consolidated Balance Sheets. Financing leases are included in property and equipment, net and other current and non-current liabilities in the Consolidated Balance Sheets. The gross amount of balances recorded related to finance leases was immaterial as of December 31, 2019. Operating lease expense is recognized on a straight-line basis over the lease term.

Operating lease assets and liabilities are recognized at the commencement date, based on the present value of the future minimum lease payments. A certain number of these leases contain rent escalation clauses that are factored into the Company's determination of lease payments. As the Company's leases do not provide an implicit rate, the Company uses its incremental borrowing rate based on the information available at the lease commencement date to discount payments to the present value. Most operating leases contain renewal options. The exercise of these options is at the Company's discretion. Lease terms include options to extend when it is reasonably certain the Company will exercise that option.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

Recent Accounting Pronouncements

In January 2017, the FASB issued Accounting Standards Update No. 2017-04 (ASU 2017-04): Intangibles – Goodwill and Other, which eliminates step two from the annual goodwill impairment test. ASU 2017-04 is effective in fiscal years beginning after December 15, 2021. The Company is currently evaluating the impact of the pending adoption of ASU 2017-04 on the consolidated financial statements.

In August 2016, the FASB issued Accounting Standards Update No. 2016-15 (ASU 2016-15): Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, a consensus of the Emerging Issues Task Force. ASU 2016-15 provides guidance on how certain transactions are classified in the statement of cash flows. ASU 2016-15 clarifies the classification of debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments, contingent consideration payments subsequent to a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate and bank-owned life insurance policies, distributions received from equity method investments, beneficial interests in securitization transactions and separately identifiable cash flows and application of the predominance principle in the statement of cash flows. ASU 2016-15 requires retrospective application and is effective for financial statements issued for fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019, with early adoption permitted. The Company is currently evaluating the impact of the pending adoption of ASU 2016-15 on the consolidated financial statements.

In May 2016, the FASB issued Accounting Standards Update No. 2016-12 (ASU 2016-12): Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedients. In April 2016, the FASB issued Accounting Standards Update No. 2016-10 (ASU 2016-10): Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing. In March 2016, the FASB issued Accounting Standards Update No. 2016-08 (ASU 2016-08): Revenue from Contracts with Customers: Principal versus Agent Considerations. These amendments provide additional clarification and implementation guidance on the previously issued Accounting Standards Update No. 2014-09: Revenue from Contracts with Customers. ASU 2016-12 provides clarifying guidance on assessing collectability, noncash consideration, presentation of sales taxes and transition. ASU 2016-10 provides additional guidance on materiality of performance obligations, evaluating distinct performance obligations, treatment of shipping and handling costs and determining whether an entity's promise to grant a license provides a customer with either a right to use or access an entity's intellectual property. ASU 2016-08 clarifies how an entity should identify the specified good or service for the principal versus agent evaluation and how it should apply the control principle to certain types of arrangements. ASU 2016-10 and ASU 2016-08 are effective in connection with ASU 2014-09. The Company adopted ASU 2016-12 for the years ending December 31, 2019 and 2018, which did not have a material impact on the consolidated financial statements.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

Recent Accounting Pronouncements (continued)

In February 2016, the FASB issued Accounting Standards Update No. 2016-02 (ASU 2016-02): Leases, effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. ASU 2016-02 was issued in three parts: Section A, "Leases: Amendments to the FASB Accounting Standards Codification," Section B, "Conforming Amendments Related to Leases: Amendments to the FASB Accounting Standards Codification," and Section C, "Background Information and Basis for Considerations." The most significant change for lessees is the requirement under the new guidance to recognize right-of-use assets and lease liabilities on a discounted basis for all leases not considered short-term leases. Other changes in the new guidance include: (a) defining initial direct costs to only include those incremental costs that would not have been incurred if the lease had not been entered into, (b) requiring related party leases to be accounted for based on their legally enforceable terms and conditions, (c) eliminating the additional requirements that must be applied today to leases involving real estate and (d) revising the circumstances under which the transfer contract in a sale-leaseback transaction should be accounted for as the sale of an asset by the seller-lessee and the purchase of an asset by the buyer-lessor. In addition, leases are subject to new disclosure requirements. In July 2018, the FASB issued ASU 2018-11, *Leases (Topic 842): Targeted Improvements*, which provides an optional transition method of applying the new lease standard. Topic 842 can be applied using either a modified retrospective approach at the beginning of the earliest period presented or, as permitted by ASU 2018-11, at the beginning of the period in which it is adopted, i.e., the comparatives under ASC 840 option.

The Company adopted the standard using the comparatives under ASC 840 transition method, which applies Topic 842 at the beginning of the period in which it is adopted. The adoption had a material impact on the Company's Consolidated Balance Sheet but did not materially impact the Consolidated Statement of Operations and Consolidated Statement of Cash Flows. The most significant impact was the recognition of right-of-use assets and lease liabilities of \$2,728 and \$2,866 upon implementation. As part of adopting the standard, previously recognized liabilities for deferred rent of \$139 were reclassified as a component of the right-of-use assets.

In May 2014, the FASB issued Accounting Standards Update 2014-09 (ASU 2014-09): Revenue from Contracts with Customers (Topic 606), to supersede nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity is expected to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than required under existing U.S. GAAP, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each performance obligation. ASU 2014-09 is effective for the Company in the first quarter of fiscal year 2019, with early adoption permitted, using either of two methods: (a) retrospective to each prior reporting period presented with the option to elect certain practical expedients as defined within ASU 2014-09; or (b) retrospective with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application and providing certain additional disclosures as defined in ASU 2014-09. The Company adopted this standard using a full retrospective approach, which required recasting prior year comparative periods to provide comparable financial reporting for all reported fiscal years. The Company has applied the new standard to all contracts. The Company's adoption of ASC 606 on January 1, 2019 did not result in a change to the timing of revenue recognition for 2019 or 2018. Other impacts from the adoption of Topic 606 on the consolidated financial statements were immaterial for the years ending December 31, 2019 and 2018.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

Research and Development

Expenditures for research, development and engineering of software and hardware products, that are included in operating expenses in the consolidated statements of income, are expensed as incurred.

Stock Based Compensation (per share amounts shown in whole numbers)

The Company complies with the accounting and reporting requirements of the Accounting for Stock Based Compensation guidelines which require companies to record compensation expense for share-based awards issued to employees in exchange for services provided. The amount of the compensation expense is based on the estimated fair value of the awards on their grant dates and is generally recognized over the applicable vesting period.

The fair value of stock options is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock, expected dividends, and the risk free interest rate over the expected life of the option.

During the years ended December 31, 2019 and 2018 the Company recognized \$412 and \$227 in stock based compensation expense in its consolidated financial statements relating to the issuance of stock options and stock awards, respectively (See Note 11).

The fair value of the stock options granted during the years ended December 31, 2019 and 2018 was estimated on the date of grant using the Black-Scholes valuation model based on the following assumptions:

	Years Ended December 31,	
	2019	2018
Expected dividend yield	0.00%	0.00%
Expected stock price volatility	64.25% - 65.72%	64.21%
Risk-free interest rate	1.49% - 2.67%	3.17%
Expected life	10 years	10 years
Weighted-average fair value of options granted	\$6.68 - \$7.59	\$8.11

Basic and Diluted Net Income (Loss) per Share (per share amounts shown in whole numbers)

Basic income (loss) per share is computed by dividing income (loss) attributable to common shareholders by the weighted average number of common shares outstanding for the period. Diluted income (loss) per share reflects the dilution of common stock equivalents, such as options, to the extent the impact is dilutive. As the Company incurred a net loss for the years ended December 31, 2019 and December 31, 2018, potentially dilutive securities have been excluded from the diluted net loss per share computation as their effect would be anti-dilutive.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

Basic and Diluted Net Income (Loss) per Share (per share amounts shown in whole numbers) (continued)

The following table reconciles the number of shares utilized in the net loss per share calculations for the years ended December 31, 2019 and 2018:

	Years Ended December 31,	
	2019	2018
Net loss	\$ (2,698)	\$ (2,880)
Shares		
Weighted average shares outstanding - basic	1,568	1,542
Weighted average dilutive share equivalents from stock options		
Weighted average shares outstanding - diluted	1,568	1,542
Net loss per share - basic	\$ (1.72)	\$ (1.87)
Net loss per share - diluted	\$ (1.72)	\$ (1.87)

Income Taxes

The Company complies with GAAP which requires an asset and liability approach to financial reporting for income taxes. Deferred income tax assets and liabilities are computed for differences between the consolidated financial statement and tax basis of assets and liabilities that will result in future taxable or deductible amounts, based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred income tax assets to the amount expected to be realized.

The determination of the Company's provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. Significant judgment is required in assessing the timing and amounts of deductible and taxable items and the probability of sustaining uncertain tax positions. The benefits of uncertain tax positions are recorded in the Company's consolidated financial statements only after determining a more-likely-than-not probability that the uncertain tax positions will withstand challenge, if any, from tax authorities. When facts and circumstances change, the Company reassesses these probabilities and records any changes in the consolidated financial statements as appropriate.

In accordance with GAAP, the Company is required to determine whether a tax position is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The Company files an income tax return in the U.S. federal jurisdiction, and may file income tax returns in various U.S. states and foreign jurisdictions. The tax benefit recognized is measured as the largest amount of benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. De-recognition of a tax benefit previously recognized results in the Company recording a tax liability that increases the accumulated deficit. Generally, the Company is no longer subject to income tax examination by major taxing authorities for the years before 2015.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

2. Summary of Significant Accounting Policies (continued)

Operating Segments

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company recognizes three reportable segments: "Costar Video Systems," "CohuHD Costar" and "Other."

3. Segment Information

Our business segments offer a variety of products (See Note 1) and are managed separately as each business requires different technology and marketing strategies. Our reportable segments are Costar Video Systems (which includes Innotech and Arecont Vision Costar), CohuHD Costar and Other. Costar Video Systems' products and services are largely used in retail security applications whereas CohuHD Costar's products are more focused on transportation, border security and other government applications. The Other segment encompasses the Company's costs associated with income taxes, company-wide financing (including interest expense), executive compensation and other corporate expenses.

Revenues and net income (loss) by reportable segment for the years ending December 31, 2019 and 2018 are as follows:

	Years Ended December 31,	
	2019	2018
Revenues		
Costar Video Systems	\$ 54,075	\$ 39,409
CohuHD Costar	15,451	19,497
	<u>\$ 69,526</u>	<u>\$ 58,906</u>
Net Income (Loss)		
Costar Video Systems	\$ 2,219	\$ (482)
CohuHD Costar	(1,892)	334
Other	(3,025)	(2,732)
	<u>\$ (2,698)</u>	<u>\$ (2,880)</u>

Intercompany sales between the CohuHD Costar and Costar Video Systems operating segments totaled \$93 and \$303 for the years ending December 31, 2019 and 2018, respectively, and have been eliminated upon consolidation.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

3. Segment Information (continued)

The following table reflects depreciation and amortization expense by business segment for the years ending December 31, 2019 and 2018:

	Years Ended December 31,	
	2019	2018
Depreciation		
Costar Video Systems	\$ 234	\$ 138
CohuHD Costar	218	259
	<u>\$ 452</u>	<u>\$ 397</u>
Amortization		
Costar Video Systems	\$ 976	\$ 949
CohuHD Costar	318	321
	<u>\$ 1,294</u>	<u>\$ 1,270</u>

Total assets and goodwill by business segment at December 31, 2019 and 2018 are as follows:

	Years Ended December 31,	
	2019	2018
Total Assets		
Costar Video Systems	\$ 38,042	\$ 35,747
CohuHD Costar	11,403	12,006
Other	5,062	4,297
	<u>\$ 54,507</u>	<u>\$ 52,050</u>
Goodwill		
Costar Video Systems	\$ 4,450	\$ 4,450
CohuHD Costar	2,063	2,063
	<u>\$ 6,513</u>	<u>\$ 6,513</u>

4. Acquisition

Effective July 13, 2018, Costar completed the acquisition of Arecont Vision (the "Arecont Acquisition"), a manufacturer of network cameras and megapixel surveillance cameras pursuant to the terms of the Asset Purchase Agreement dated June 29, 2018 and subsequent amendment dated July 9, 2018. Results from operations for Arecont Vision have been included in the Company's consolidated financial statements beginning July 14, 2018.

Total consideration for the Arecont Acquisition was approximately \$11,647 consisting of an initial cash deposit of \$1,125 and additional cash of \$10,522 upon closing. The Company acquired Arecont Vision to expand its footprint in the security and surveillance industry, cross-selling opportunities, expansion of its product portfolio and its additive value to the Company's future profits.

Certain expenses were incurred relating to the Arecont Acquisition in the amount of \$729 for the year ending December 31, 2018.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

4. Acquisition (continued)

The Arecont Acquisition meets the definition of a business combination under GAAP. The following table presents a summary of the fair value of the assets acquired and liabilities assumed as of July 13, 2018.

Assets acquired:	
Accounts receivable	\$ 4,260
Inventories	9,826
Prepaid expenses	1,178
Property and equipment	126
Trade name	243
Distribution agreements	370
Patents	208
Goodwill	939
Other assets	390
Total assets acquired	<u>17,540</u>
Liabilities assumed:	
Accounts payable	2,005
Accrued expenses	3,888
Total liabilities assumed	<u>5,893</u>
Total assets acquired and liabilities assumed, net	<u>\$ 11,647</u>

The gross contractual value of accounts receivable approximates the fair value of accounts receivable at the time of the transaction.

The weighted average amortization period for the acquired amortizable intangible assets is 9 years.

Goodwill arising from the Arecont Acquisition consists primarily of assembled workforce and other intangible assets that do not qualify for separate recognition. The entire goodwill balance is expected to be deductible for tax purposes.

Included in the consolidated statements of operations are Arecont Vision revenues of \$24,049 and \$13,343 and net losses of \$2,457 and \$3,336 for the years ending December 31, 2019 and December 31, 2018, respectively. Valuing the acquired inventory at net realizable value resulted in an additional \$936 in cost of goods sold for the year ending December 31, 2018. The following pro forma information gives effect to the acquisition as if it had occurred on the first day of each of the years ending December 31, 2019 and December 31, 2018:

	Year Ended December 31,	
	2019	2018
Total revenue	\$ 69,526	\$ 76,158
Pre-tax loss	\$ (3,359)	\$ (14,218)

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

5. Fair Value Measurements

The Company defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities, which are required to be recorded at fair value, the Company considers the principal or most advantageous market in which the Company would transact and the market-based risk measurements or assumptions that market participants would use in pricing the asset or liability, such as inherent risk, transfer restrictions and credit risk.

The Company applies the following fair value hierarchy, which prioritizes the inputs used to measure fair value into three levels and bases the categorization within the hierarchy upon the lowest level of input that is available and significant to the fair value measurement:

Level 1: Quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.

Level 2: Observable inputs other than prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated with observable market data.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies, and similar techniques that use significant unobservable inputs.

Contingent Purchase Price

As of December 31, 2019 and December 31, 2018, the Company had obligations to transfer \$1,490 and \$2,040, respectively, in contingent purchase price to the prior shareholders of Innotech in conjunction with the acquisition if specified future operational objectives are met over the years 2017 through 2019. The Company recorded the acquisition-date fair value of this liability, based on the likelihood of contingent earn-out payments, as part of the consideration transferred. The contingent purchase price is subsequently remeasured to fair value each reporting date. The Company classified the contingent purchase price liability as Level 3, due to the lack of relevant observable inputs and market activity.

Contingent Purchase Price (continued)

Increases or decreases in the fair value of our contingent purchase price liability can result from changes in discount periods and rates, as well as changes in the timing and amount of revenue and EBITDA estimates. The contingent consideration fair market value was estimated using a Monte Carlo simulation. The recurring Level 3 fair value measurement of our contingent purchase price liability included the following unobservable inputs: management's EBITDA forecasts, risk-free interest rate based on the U.S. Treasury Strip rate and volatility based on the average of historical and implied asset volatilities of selected guideline public companies.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

5. Fair Value Measurements (continued)

The following table summarizes financial liabilities measured at fair value on a recurring basis as of December 31, 2019 and December 31, 2018, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

<u>Description</u>	<u>As of December 31, 2019</u>	<u>Fair Value Measurement at Reporting Date Using</u>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Liabilities:				
Contingent purchase price	\$ 1,490	\$	\$	\$ 1,490

<u>Description</u>	<u>As of December 31, 2018</u>	<u>Fair Value Measurement at Reporting Date Using</u>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Liabilities:				
Contingent purchase price	\$ 2,040	\$	\$	\$ 2,040

The following table reflects the activity for liabilities measured at fair value using Level 3 inputs for the period ending December 31, 2019:

Balance as of December 31, 2018	\$ 2,040
Issuances	
Payments	(1,048)
Related change in fair value	498
Balance as of December 31, 2019	<u>\$ 1,490</u>

Related Party Notes Payable

As of December 31, 2019 and December 31, 2018, the Company had obligations to transfer \$0 and \$805, respectively, in notes payable to the prior shareholders of Innotech. The notes payable are due in equal monthly installments over the years 2017 through 2019. The Company recorded the acquisition-date fair value of this liability using a discounted cash flow model. The Company classified the related party notes payable liability as Level 3, due to the lack of relevant observable inputs and market activity. The significant unobservable input included in the Level 3 fair value was the discount rate of 2.8%.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

6. Property and Equipment

Property and equipment at December 31, 2019 and December 31, 2018, were as follows:

	<u>December 31, 2019</u>	<u>December 31, 2018</u>
Furniture, equipment and leasehold improvements	\$ 2,458	\$ 2,144
Less accumulated depreciation	<u>(1,548)</u>	<u>(1,229)</u>
Total property and equipment, net	<u>\$ 910</u>	<u>\$ 915</u>

Depreciation expense for the years ending December 31, 2019 and 2018 was \$452 and \$397, respectively.

7. Intangible Assets

The following is a summary of amortized and unamortized intangible assets at December 31, 2019:

	<u>December 31, 2019</u>	
	<u>Gross Amount</u>	<u>Accumulated Amortization</u>
Amortized intangible assets		
Customer relations - Southern Imaging	\$ 1,599	\$ 1,599
Distribution agreement - Southern Imaging	1,468	991
Customer relations - IVS	125	125
Covenant not to compete - IVS	50	50
Trade name - CohuHD	1,657	1,302
Customer relationships - CohuHD	779	447
Covenant not to compete - CohuHD	20	20
Trade name - Innotech	1,015	305
Customer relations - Innotech	5,762	1,907
Covenant not to compete - Innotech	150	90
Technology - Innotech	469	201
Patents - Innotech	8	4
Trade name - Arecont Vision Costar	243	35
Distribution agreement - Arecont Vision Costar	370	46
Patents - Arecont Vision Costar	208	43
Total amortized intangible assets	<u>13,923</u>	<u>7,165</u>
Unamortized intangible assets		
Trade name - Costar	800	
Trade name - IVS	125	
Goodwill - CohuHD	2,063	
Goodwill - Innotech	3,511	
Goodwill - Arecont Vision Costar	939	
Total unamortized intangible assets	<u>7,438</u>	
Total intangible assets	<u>\$ 21,361</u>	<u>\$ 7,165</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

7. Intangible Assets (continued)

The following is a summary of amortized and unamortized intangible assets at December 31, 2018:

	December 31, 2018	
	Gross Amount	Accumulated Amortization
Amortized intangible assets		
Customer relations - Southern Imaging	\$ 1,599	\$ 1,599
Distribution agreement - Southern Imaging	1,468	917
Customer relations - IVS	125	125
Covenant not to compete - IVS	50	50
Trade name - CohuHD	1,657	1,065
Customer relationships - CohuHD	779	367
Covenant not to compete - CohuHD	20	18
Trade name - Innotech	1,015	203
Customer relations - Innotech	5,762	1,290
Covenant not to compete - Innotech	150	60
Technology - Innotech	469	134
Patents - Innotech	8	2
Trade name - Arecont Vision Costar	243	11
Distribution agreement - Arecont Vision Costar	370	16
Patents - Arecont Vision Costar	208	14
Total amortized intangible assets	13,923	5,871
Unamortized intangible assets		
Trade name - Costar	800	
Trade name - IVS	125	
Goodwill - CohuHD	2,063	
Goodwill - Innotech	3,511	
Goodwill - Arecont Vision Costar	939	
Total unamortized intangible assets	7,438	
Total intangible assets	\$ 21,361	\$ 5,871

The weighted average amortization period for the Company's intangible assets is 11 years. Amortizable intangible assets estimated useful lives are as follows:

Trade names and patents	7 years
Customer relationships	6 and 10 years
Distribution agreements	20 years
Covenants not to compete	3 and 5 years

Amortization expense for the years ended December 31, 2019 and 2018 was \$1,294 and \$1,270, respectively.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

7. Intangible Assets (continued)

Future amortization expense is as follows:

Year Ending December 31,		
2020	\$	1,273
2021		1,137
2022		971
2023		955
2024		835
Thereafter		<u>1,587</u>
Total future amortization expense	\$	<u>6,758</u>

8. Lines of Credit and Long-Term Debt

On December 29, 2016 the Company entered into an Installment Note Agreement, Master Revolving Note Agreement and Revolving Draw Note Agreement with Comerica Bank ("Comerica Agreements"). The Comerica Agreements allow for up to \$3,000 in a revolving line of credit under the Master Revolving Note Agreement, up to \$3,000 in advances under the Revolving Draw Note Agreement, both with maturities of December 30, 2019, and a \$7,000 term loan which matures on December 29, 2023. The term loan is payable in \$250 quarterly payments due the first business day following each quarter end, commencing in April 2017, with any unpaid principal and interest due at maturity.

In connection with the acquisition of Arecont Vision Costar on July 13, 2018 the Company entered into a Loan Agreement with UMB Bank ("Loan Agreement"). The Loan Agreement allows for up to \$18,000 in a revolving line of credit and a \$5,500 term loan which mature on July 6, 2021. The term loan is payable in \$66 monthly payments due on the first of the month with the remaining balance due at maturity. Obligations under the Comerica Agreements were extinguished upon entering into the Loan Agreement. The obligations under the Loan Agreement are secured by a lien on substantially all accounts receivable, inventory and equipment.

The Loan Agreement contains customary representations and warranties, events of default and covenants, including, among other things, covenants that restrict the ability of Costar to incur certain additional indebtedness or to issue distributions or dividends. The Company is also restricted in its mergers and acquisitions activity. The Loan Agreement contains financial covenants calculated on a consolidated basis requiring the Company to maintain a certain Debt Service Coverage Ratio and to not exceed a maximum Senior Cash Flow Leverage Ratio. The Company maintains zero balance accounts, which are swept daily to the revolving line of credit. The Company entered into a modification agreement with UMB Bank effective May 1, 2019 which adjusted the borrowing base and covenant compliance requirements and modified interest rates. The Company entered into a second modification agreement with UMB Bank effective March 24, 2020 which adjusted the borrowing base and covenant compliance requirements and modified interest rates. As of December 31, 2019 the Company was paying interest at 5.46% for the term loan and revolving line of credit.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

8. Lines of Credit and Long-Term Debt (continued)

Future principal payments for the term loan and revolving draw note as of December 31, 2019, are as follows:

Year Ending December 31,	
2020	\$ 789
2021	3,593
Less: deferred financing costs, net	<u>(9)</u>
	<u>\$ 4,373</u>

On June 28, 2019 the Company executed a Promissory Note with UMB Bank for \$1,000 which matures on June 28, 2020. The Promissory Note is payable in \$83 monthly payments due on the first of the month with the remaining balance due at maturity. As of December 31, 2019, the Company owed \$583 on the note and was paying interest at 6.71%

As of December 31, 2019 and December 31, 2018, \$15,953 and \$11,738 was owed to UMB Bank on the revolving line of credit, \$4,373 and \$5,171 on the term loan, and \$583 and \$0 on the Promissory Note, respectively.

The Company paid approximately \$154 in various fees associated with securing the UMB Loan Agreement. The fees are treated as a deferred financing costs asset and will be amortized over the life of the agreement using the straight-line method for the revolving line of credit portion and the effective-interest method for the term note portion.

As of December 31, 2019 the Company was not in compliance with its debt covenants. The Company entered into a modification agreement with UMB Bank effective March 24, 2020 which waived existing defaults, adjusted the borrowing base and covenant compliance requirements and modified interest rates. The revised interest rate is anticipated to be an increase of 0.5%.

9. Income Taxes

ASC 740 *Income Taxes* provides that the tax effects form an uncertain tax position can be recognized in the Company's financial statements only if the position is more-likely-than-not of being sustained on audit, based on the technical merits of the position. Tax positions that meet the recognition threshold are reported at the largest amount that is more-likely-than-not to be realized. This determination requires a high degree of judgment and estimation. The Company periodically analyzes and adjusts amounts recorded for the Company's uncertain tax positions, as events occur to warrant adjustment, such as when the statutory period for assessing tax on a given tax return or period expires or if tax authorities provide administrative guidance or a decision is rendered in the courts. The Company does not reasonably expect the total amount of uncertain tax positions to materially increase or decrease within the next 12 months.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

9. Income Taxes (continued)

As of December 31, 2019, the Company's management determined that it was more likely than not that it will utilize its \$12,821 in NOL carryforwards prior to expiration, which occurs in 2019 through 2030. The Company's management also believes that it is more likely than not that it will utilize \$693 in tax credit carryforwards. In its assessment, management considered whether it was more likely than not that some portion or all of the NOL carryforwards would be realized. The realization of a deferred tax asset is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considered the scheduled reversal of deferred tax liabilities and the projected future taxable income in making this assessment. Based upon the level of projected future taxable income over the period of expiration of the NOL carryforwards when temporary differences that give rise to the deferred tax assets are deductible, management released a portion of its valuation allowance.

The components of income tax (benefit) expense are as follows:

	Years Ended December 31,	
	2019	2018
Current, federal	\$	\$
Current, state	123	115
Deferred, federal	(660)	(735)
Deferred, state	(124)	(188)
Income Tax (Benefit) Expense	<u>\$ (661)</u>	<u>\$ (806)</u>

A reconciliation of the income tax benefit computed at the statutory federal income tax rate consists of the following:

	Years Ended December 31,	
	2019	2018
Income tax benefit at the statutory rate	\$ (705)	\$ (774)
Decrease resulting from:		
State income tax benefit, net of federal tax effect	(1)	(57)
Other	(39)	(19)
Permanent items	84	44
	<u>\$ (661)</u>	<u>\$ (806)</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

9. Income Taxes (continued)

The components of the Company's deferred taxes consist of the following:

	Years Ended December 31,	
	2019	2018
Deferred tax assets		
Accounts receivable	\$ 112	\$ 204
Inventory	756	549
Net operating losses	2,731	2,477
Intangibles		
Stock compensation	192	151
Accrued expenses	1,078	824
Interest	100	16
Lease liability	800	
Tax credits	1,897	1,934
	<u>7,666</u>	<u>6,155</u>
Valuation allowance	<u>(1,861)</u>	<u>(1,861)</u>
Net deferred tax assets	\$ 5,805	\$ 4,294
Deferred tax liabilities		
Property and equipment, net	\$ 146	\$ 157
Prepaid expenses	95	75
Right of use asset	742	
Intangibles	308	296
Net deferred tax liability	<u>1,291</u>	<u>528</u>
	<u>\$ 4,514</u>	<u>\$ 3,766</u>

10. Stockholders' Equity (shown in whole amounts)

At December 31, 2019 and December 31, 2018, the authorized capital stock of the Company consisted of (i) 10,000,000 shares of voting common stock with a par value of \$0.001 per share and (ii) 10,000,000 shares of preferred stock with a par value of \$0.001 per share. As of December 31, 2019 and December 31, 2018, there was no preferred stock issued and outstanding. The Company's Board has the authority to determine the voting powers, designations, preferences, privileges and restrictions of the preferred shares. As of December 31, 2019 and December 31, 2018, there were 1,584,566 and 1,551,316 and shares of common stock outstanding and 1,810,332 and 1,777,082 shares of common stock issued.

11. Stock Option Plan (shown in whole amounts)

The Company's 2000 Stock Option and Incentive Plan (the "2000 Incentive Plan") provides for awards in the form of incentive stock options, non-qualified stock options, restricted stock awards and other forms of awards to officers, directors, employees and consultants of the Company. At December 31, 2019 and December 31, 2018, there were 68,066 and 87,066 share options issued under this plan.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

11. Stock Option Plan (shown in whole amounts) (continued)

The Board of Directors of the Company determines the term of each option, the option price, and the number of shares for which each option is granted and the times at which each option vests. For holders of 10% or more of the Company's outstanding common stock, incentive stock options may not be granted at less than 110% of the fair market value of the common stock at the date of grant.

At the Company's annual meeting on December 16, 2014, the Company's stockholders approved and adopted the Company's 2014 Omnibus Performance Award Plan (the "Plan"). The Board adopted the Plan on November 17, 2014, subject to and effective upon its approval by stockholders. With the adoption of the Plan, no new awards will be granted under the 2000 Incentive Plan, although it will remain in effect for options that are currently outstanding in accordance with their terms. The Plan authorizes the grant of awards relating to 150,000 shares of the Company's Common Stock. As of December 31, 2019 and December 31, 2018 there were 72,000 and 36,000 share options issued under this plan, respectively.

The following table summarizes information about stock options outstanding at December 31, 2019:

Options Outstanding				Options Fully Vested and Exercisable	
Range of Exercise Price Per Share	Number Outstanding	Weighted Average Remaining Contractual Life (In Years)	Weighted Average Exercise Price Per Share	Number Exercisable	Weighted Average Exercise Price Per Share
\$1.05 - \$15.020	140,066	5.74	\$7.83	140,066	\$7.83

Stock option activity for the years ended December 31, 2019 and 2018 is as follows:

	2019		2018	
	Number of Shares	Weighted Average Exercise Price Per Share	Number of Shares	Weighted Average Exercise Price Per Share
Outstanding at beginning of year	123,066	\$6.27	119,466	\$5.72
Granted	36,000	\$10.05	12,000	\$11.00
Exercised	(19,000)	\$1.96	(6,400)	\$5.41
Canceled			(2,000)	\$4.75
Outstanding at period end	140,066	\$7.83	123,066	\$6.27
Options exercisable at period end	140,066	\$7.83	123,066	\$6.27
Weighted average fair value of options granted during the period		\$7.29		\$11.00

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

11. Stock Option Plan (shown in whole amounts) (continued)

On May 16, 2017 an additional grant of 21,000 restricted stock awards ("2017 Awards") was authorized by the Compensation Committee of the Company's Board of Directors. All of the 2017 Awards are subject to a time-vesting schedule and 75% are subject to performance conditions relating to EBITDA growth for the years ending December 31, 2017 and 2018, as stated in the 2017 Awards Agreements. The 25% of the 2017 Awards not subject to performance conditions have a fair market grant date value of approximately \$54,000, with the expense recognized over the two year vesting period. The 2017 Awards subject to the performance conditions have a fair market grant date value of \$161,000, with the expense recognized over the two year vesting period based upon the probability of achievement. Stock based compensation expense of \$0 and \$27,000 was recognized in the Company's financial statements in relation to the 2017 Awards during the years ending December 31, 2019 and December 31, 2018, respectively.

On March 23, 2018 an additional grant of 21,000 restricted stock awards ("2018 Awards") was authorized by the Compensation Committee of the Company's Board of Directors. All of the 2018 Awards are subject to a time-vesting schedule and 75% are subject to performance conditions relating to EBITDA growth for the years ending December 31, 2018 and 2019, as stated in the 2018 Awards Agreements. The 25% of the 2018 Awards not subject to performance conditions have a fair market grant date value of approximately \$45,000, with the expense recognized over the two year vesting period. The 2018 Awards subject to the performance conditions have a fair market grant date value of \$135,000, with the expense recognized over the two year vesting period based upon the probability of achievement. Stock based compensation expense of approximately \$23,000 and \$90,000 was recognized in the Company's financial statements in relation to the 2018 Awards during the years ending December 31, 2019 and December 31, 2018, respectively.

On June 20, 2019, an additional grant of 23,000 restricted stock awards and 7,000 on July 26, 2019 ("2019 Awards") was authorized by the Compensation Committee of the Company's Board of Directors. All of the 2019 Awards are subject to a time-vesting schedule and 75% are subject to performance conditions relating to EBITDA growth for the years ending December 31, 2019 and 2020, as stated in the 2019 Awards Agreements. The 25% of the 2019 Awards not subject to performance conditions have a fair market grant date value of approximately \$63,000, with the expense recognized over the two year vesting period. The 2019 Awards subject to the performance conditions have a fair market grant date value of \$190,000, with the expense recognized over the two year vesting period based upon the probability of achievement. Stock based compensation expense of approximately \$127,000 was recognized in the Company's financial statements in relation to the 2019 Awards during the year ending December 31, 2019.

During the years ended December 31, 2019 and 2018 the Company recognized approximately \$412,000 and \$227,000 in stock based compensation expense in its consolidated financial statements, respectively.

12. Lease Agreements

The Company adopted ASU 2016-02, *Leases*, during the year ended December 31, 2019, using the modified retrospective approach. Prior year financial statements were not recast under the new standard.

The Company has entered into the following lease agreements:

Finance Leases

The Company has one financing lease for a forklift used at the Innotech facility in Pompano Beach, Florida which expires in July 2022.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

12. Lease Agreements (continued)

Operating Leases

All of the Company's office and warehouse facilities are leased under operating leases. These leases expire between 2022 and 2025 and certain leases contain renewal options for periods ranging from three to five years. Lease payments have an escalating fee schedule with 3% increases each year. Termination of the leases is generally prohibited unless there is a violation under the lease agreement.

The Company also leases certain office equipment under operating leases. Lease costs are included within operating expenses in the Consolidated Statements of Operations.

During the years ended December 31, 2019 and December 31, 2018 lease costs included in operating expenses were \$1,333 and \$1,022 respectively.

	<u>2019</u>
Lease cost	
Finance lease cost	
Amortization of right-of-use asset	\$ 1
Interest on lease liabilities	
Operating lease cost (a)	<u>1,333</u>
Total lease cost	\$ 1,334

(a) Operating lease cost include \$318 in rent associated with short-term leases.

	<u>2019</u>
Other information	
Cash paid for amounts included in the measurement of lease liabilities	
Operating cash flows from finance leases	\$ -
Financing cash flows from finance leases	1
Operating cash flows from operating leases	717
Right of use assets obtained in exchange for new finance lease liabilities	10
Right of use assets obtained in exchange for new operating lease liabilities	1,220

The weighted-average remaining lease term and weighted-average discount were as follows:

	<u>December 31, 2019</u>
Lease term and discount rate	
Weighted-average remaining lease term operating leases	3.7 years
Weighted-average discount rate operating leases	5.6%
Weighted-average remaining lease term financing lease	2.6 years
Weighted-average discount rate financing lease	5.6%

Upon adoption of ASU 2016-02, the discount rate used for existing leases was established as of January 1, 2019.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (SEE INDEPENDENT AUDITOR'S REPORT) (AMOUNTS SHOWN IN THOUSANDS)

12. Lease Agreements (continued)

Future minimum lease payments and reconciliation to the Consolidated Balance Sheet at December 31, 2019 are as follows:

Year Ending December 31,	
2020	\$ 1,136
2021	1,159
2022	796
2023	343
2024	188
Thereafter	<u>176</u>
Total lease payments	3,798
Less imputed interest	<u>(419)</u>
Present values of lease liabilities	<u>\$ 3,379</u>

13. Risk Concentrations

Concentration of Cash

The Company maintains its cash balances in financial institutions. These balances are insured by the Federal Deposit Insurance Corporation up to \$250 per institution. The Company is subject to credit risk to the extent any financial institution with which it conducts business is unable to fulfill contractual obligations on its behalf. Management monitors the financial condition of such financial institutions and does not anticipate any losses from these financial institutions.

Concentration of Customers

For the years ended December 31, 2019 and December 31, 2018 the Costar Video Systems operating segment's largest customer, Protection 1 Security Solutions, accounted for approximately \$10,169 or 14.6% and \$6,296 or 10.7%, respectively of the Company's total revenue. Amounts owed by two main customers of the Costar Video Systems' operating segment accounted for \$2,445 or 27.0% and \$2,359 or 25.3% of the Company's outstanding receivable balance as of December 31, 2019 and December 31, 2018, respectively.

Concentration of Suppliers

For the years ended December 31, 2019 and 2018 the Company made purchases from one main supplier of the Costar Video Systems' operating segment of approximately \$5,893 or 12.1% and \$6,322 or 12.7%, respectively. Amounts owed to two main suppliers of the Costar Video Systems' operating segment accounted for \$2,507 or 44.5% and \$2,443 or 42.2% of the Company's accounts payable balance as of December 31, 2019 and December 31, 2018, respectively.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(SEE INDEPENDENT AUDITOR'S REPORT)
(AMOUNTS SHOWN IN THOUSANDS)**

14. Subsequent Events

As a result of the spread of COVID-19 coronavirus, economic uncertainties have arisen which may negatively affect the financial position, results of operations and cash flows of the Company. The duration of these uncertainties and the ultimate financial effects cannot be reasonably estimated at this time. We believe our existing cash and cash equivalents, internally generated funds and our credit facilities, described in Note 8 Lines of Credit and Long-Term Debt, are adequate to meet our operating needs over the next fiscal year, subject to the length and severity of the COVID-19 pandemic.