

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS AND
INDEPENDENT AUDITOR'S REPORT

December 31, 2017 and 2016

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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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 sheet as of December 31, 2017, and the related statements of operations, changes in stockholders' equity and cash flows for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the 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 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 audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit 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 financial statements.

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

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, 2017, and the results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Prior Year Audited by Other Auditors

The 2016 consolidated financial statements were audited by other auditors, and their report thereon, dated April 10, 2017, expressed an unmodified opinion.

BKD, LLP

Dallas, Texas
April 9, 2018

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (AMOUNTS SHOWN IN THOUSANDS)

	December 31, 2017	December 31, 2016
ASSETS		
Current assets		
Cash and cash equivalents	\$ 196	\$ 1,083
Accounts receivable, less allowance for doubtful accounts of \$97 and \$71 in 2017 and 2016, respectively	7,246	5,330
Inventories, net of reserve for obsolescence of \$815 and \$696 in 2017 and 2016, respectively	9,529	10,579
Prepaid expenses and other current assets	790	820
Total current assets	<u>17,761</u>	<u>17,812</u>
Non-current assets		
Property and equipment, net	861	792
Deferred financing costs, net	26	39
Deferred tax asset, net	2,916	6,962
Trade names, net	2,667	3,005
Distribution agreement, net	624	697
Customer relationships, net	5,600	6,354
Covenant not to compete, net	126	160
Patents, net	7	8
Technology, net	402	469
Goodwill	5,574	5,593
Other non-current assets	96	109
Total non-current assets	<u>18,899</u>	<u>24,188</u>
Total assets	<u>\$ 36,660</u>	<u>\$ 42,000</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 3,829	\$ 3,449
Accrued expenses and other	2,532	2,656
Line of credit		1,071
Current maturities of long-term debt	740	738
Contingent purchase price	346	1,367
Current maturities of notes payable, related party	753	804
Total current liabilities	<u>8,200</u>	<u>10,085</u>
Long-Term liabilities		
Long-term debt, net of current maturities	4,476	6,216
Contingent purchase price, net of current portion	1,101	2,152
Notes payable, related party, net of current maturities	805	1,456
Total long-term liabilities	<u>6,382</u>	<u>9,824</u>
Total liabilities	<u>14,582</u>	<u>19,909</u>
Commitments and Contingencies		
Stockholders' Equity		
Preferred stock		
Common stock	3	3
Additional paid-in capital	156,767	156,409
Accumulated deficit	(130,171)	(129,800)
Less common stock held in treasury, at cost	(4,521)	(4,521)
Total stockholders' equity	<u>22,078</u>	<u>22,091</u>
Total liabilities and stockholders' equity	<u>\$ 36,660</u>	<u>\$ 42,000</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,	
	2017	2016
Net revenues	\$ 44,266	\$ 38,560
Cost of revenues	<u>26,422</u>	<u>23,747</u>
Gross profit	17,844	14,813
Selling, general and administrative expenses	12,839	10,903
Engineering and development expense	2,728	2,457
Transaction and related expense	68	322
Change in fair value of contingent purchase price	<u>(2,072)</u>	
	<u>13,563</u>	<u>13,682</u>
Income from operations	<u>4,281</u>	<u>1,131</u>
Other income (expenses)		
Interest expense	(462)	(118)
Other income (expense), net	<u>(74)</u>	<u>39</u>
Total other expenses, net	<u>(536)</u>	<u>(79)</u>
Income before taxes	3,745	1,052
Current income tax expense	70	68
Deferred income tax expense	<u>4,046</u>	<u>350</u>
Net income (loss)	<u>\$ (371)</u>	<u>\$ 634</u>
<u>Net income (loss) per share:</u>		
Basic	\$ (0.25)	\$ 0.43
Diluted	\$ (0.25)	\$ 0.41
Weighted average shares outstanding		
Basic	1,513	1,489
Diluted	1,513	1,541

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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

For the Years Ended December 31, 2017 and 2016

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Treasury Stock		Total Stockholders' Equity
	Shares	Amount			Shares	Amount	
Balances at December 31, 2015	1,711	\$ 3	\$ 156,216	\$ (130,434)	226	\$ (4,521)	\$ 21,264
Net income				634			634
Expiration of stock options			(19)				(19)
Stock based compensation	8		212				212
Balances at December 31, 2016	1,719	\$ 3	\$ 156,409	\$ (129,800)	226	\$ (4,521)	\$ 22,091
Net loss				(371)			(371)
Exercise of stock options	18		90				90
Stock based compensation	21		268				268
Balances at December 31, 2017	1,758	\$ 3	\$ 156,767	\$ (130,171)	226	\$ (4,521)	\$ 22,078

See independent auditor's report and 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,	2017	2016
Cash flows from operating activities		
Net income (loss)	\$ (371)	\$ 634
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss (gain) on asset disposal	10	(19)
Stock based compensation	268	212
Depreciation and amortization	1,528	548
Amortization of deferred financing costs	25	41
Provision for doubtful accounts	26	(7)
Provision for obsolete inventory	119	(304)
Change in fair value of contingent purchase price	(2,072)	
Expiration of stock options		(19)
Deferred tax asset	4,046	350
Changes in operating assets and liabilities		
Accounts receivable, net	(1,942)	699
Inventories, net	869	(1,491)
Prepaid expenses	30	(176)
Other non-current assets	13	(109)
Accounts payable	380	399
Accrued expenses and other	(124)	1,411
Net cash provided by operating activities	2,805	2,169
Cash flows from investing activities		
Purchase of property and equipment	(278)	(523)
Refund of purchase price on the acquisition of Innotech	19	
Proceeds from the sale of property and equipment		27
Acquisition of Innotech, net of cash acquired of \$0 and \$713, respectively		(6,187)
Net cash used in investing activities	(259)	(6,683)
Cash flows from financing activities		
Deferred financing costs		(85)
Repayment of line of credit	(1,071)	(118)
Proceeds from long-term debt		7,000
Repayment of long-term debt	(1,750)	(1,200)
Repayment of notes payable, related party	(702)	
Exercise of stock options	90	
Net cash provided by (used in) financing activities	(3,433)	5,597
Net change in cash and cash equivalents	(887)	1,083
Cash and cash equivalents, beginning of year	1,083	
Cash and cash equivalents, end of year	\$ 196	\$ 1,083
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	\$ 370	\$ 81
Cash paid during the period for taxes	\$ 32	\$ 87
Supplemental disclosure of noncash operating and investing activities:		
Demonstrative equipment transferred from inventory to property and equipment	\$ 62	\$
Subordinated seller notes issued for acquisition of Innotech	\$	\$ 2,260
Contingent purchase price for acquisition of Innotech	\$	\$ 3,519

See independent auditor's report and 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 subsidiary Innotech Security, Inc. ("Innotech"), 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 and high speed domes as well as industrial vision products to observe repetitive production and assembly lines, thereby increasing efficiency by detecting faults in the production process. 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 December 29, 2016 Costar purchased Innotech, a value-added manufacturer of customized video, security surveillance systems and components for major U.S. retailers, restaurant chains and public venues requiring high quality, surveillance security (See Note 4).

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 April 9, 2018. 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 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, 2017 and December 31, 2016, the Company had \$196 and \$1,083 in 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 \$815 and \$696 as of December 31, 2017 and December 31, 2016, respectively. Inventories at December 31, 2017 and December 31, 2016 were comprised of the following:

	<u>December 31, 2017</u>	<u>December 31, 2016</u>
Parts, components, and materials	\$ 3,690	\$ 2,477
Work-in-process	195	767
Finished products	<u>5,644</u>	<u>7,335</u>
Total Inventory	<u>\$ 9,529</u>	<u>\$ 10,579</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 income 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, 2017 and 2016.

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

The Company ships and invoices its sales in accordance with signed purchase orders. The Company only recognizes revenue when it is realized and earned when the following criteria are met: there is evidence of an agreement; delivery has occurred; the selling price is fixed or determinable; and collectability is reasonably assured. The Company considers criteria to have been met when goods are shipped in accordance with signed purchase orders. Any software imbedded in the products sold is considered incidental to the product being sold.

Recent Accounting Pronouncements

In May 2017 the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2017-09 (ASU 2017-09): Compensation – Stock Compensation which provides clarity and reduces both the diversity in practice and cost and complexity when applying the guidance in Topic 718, Compensation – Stock Compensation to a change to the terms or conditions of a share-based payment award. ASU 2017-09 is effective in fiscal years beginning after December 15, 2017. The Company is currently evaluating the impact of the pending adoption of ASU 2017-09 on the consolidated financial statements.

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.

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 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.

In March 2016 the FASB issued Accounting Standards Update No. 2016-09 (ASU 2016-09): Compensation – Stock Compensation: Improvements to Employee Share-Based Payment Accounting, effective for annual periods beginning after December 15, 2017, and interim periods within those annual periods. ASU 2016-09 simplifies several aspects of the stock compensation guidance including income tax consequences, classification of awards as either equity or liabilities, classification on the statement of cash flows, expected term of awards and the intrinsic value election for liability-classified awards. The amendments in ASU 2016-09 are to be applied differently upon adoption with certain amendments being applied prospectively, retrospectively and under a modified retrospective transition method. The Company adopted and applied ASU 2016-09 during the year ended December 31, 2017 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 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. The Company is currently evaluating the impact of the pending adoption of ASU 2016-02 on the consolidated financial statements.

In July 2015, the FASB issued Accounting Standards Update No. 2015-11 (ASU 2015-11): Simplifying the Measurement of Inventory, effective for annual and interim periods beginning after December 15, 2016. ASU 2015-11 changes the inventory measurement principle for entities using the first-in, first out (FIFO) or average cost methods. For entities utilizing one of these methods, the inventory measurement principle will change from lower of cost or market to the lower of cost and net realizable value. The Company adopted and applied ASU 2015-11 during the year ended December 31, 2017 which did not have a material impact on the consolidated financial statements.

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 has selected the modified retrospective transition method and is currently evaluating the impact of the pending adoption of ASU 2014-09 on the consolidated financial statements.

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.

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)

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, 2017 and 2016 the Company recognized \$268 and \$212 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, 2017 and 2016 was estimated on the date of grant using the Black-Scholes valuation model based on the following assumptions:

	Years Ended December 31,	
	2017	2016
Expected dividend yield	0.00%	0.00%
Expected stock price volatility	66.55% - 67.75%	68.85% - 69.77%
Risk-free interest rate	2.00%	2.00%
Expected life	10 years	10 years
Weighted-average fair value of options granted	\$7.77	\$6.36

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 net loss for the year ended December 31, 2017, potentially dilutive securities have been excluded from the diluted net loss per share computation as their effect would be anti-dilutive. As the Company incurred net income for the year ended December 31, 2016, potentially dilutive securities have been included in the diluted net income per share computations and any potentially anti-dilutive shares have been excluded and are shown in the table below.

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 income (loss) per share calculations for the years ended December 31, 2017 and 2016:

	Years Ended December 31,	
	2017	2016
Net income (loss)	\$ (371)	\$ 634
Shares		
Weighted average shares outstanding - basic	1,513	1,489
Weighted average dilutive share equivalents from stock options		52
Weighted average shares outstanding - diluted	1,513	1,541
Net income (loss) per share - basic	\$ (0.25)	\$ 0.43
Net income (loss) per share - diluted	\$ (0.25)	\$ 0.41

The number of potentially dilutive shares from stock options excluded from the diluted net income (loss) per share calculation as of December 31, 2017 and December 31, 2016 was 40.

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 2014.

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), 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, 2017 and 2016 are as follows:

	Years Ended December 31,	
	2017	2016
Revenues		
Costar Video Systems	\$ 24,342	\$ 21,023
CohuHD Costar	19,924	17,537
	<u>\$ 44,266</u>	<u>\$ 38,560</u>
Net Income (Loss)		
Costar Video Systems	\$ 4,858	\$ 2,682
CohuHD Costar	1,200	1,086
Other	(6,429)	(3,134)
	<u>\$ (371)</u>	<u>\$ 634</u>

Intercompany sales between the CohuHD Costar and Costar Video Systems operating segments totaled \$49 and \$47 for the years ending December 31, 2017 and 2016, 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, 2017 and 2016:

	Years Ended December 31,	
	2017	2016
Depreciation		
Costar Video Systems	\$ 88	\$ 47
CohuHD Costar	173	83
	<u>\$ 261</u>	<u>\$ 130</u>
Amortization		
Costar Video Systems	\$ 945	\$ 94
CohuHD Costar	322	324
	<u>\$ 1,267</u>	<u>\$ 418</u>

Total assets and goodwill by business segment at December 31, 2017 and 2016 are as follows:

	Years Ended December 31,	
	2017	2016
Total Assets		
Costar Video Systems	\$ 20,986	\$ 23,663
CohuHD Costar	11,992	10,844
Other	3,682	7,493
	<u>\$ 36,660</u>	<u>\$ 42,000</u>
Goodwill		
Costar Video Systems	\$ 3,511	\$ 3,530
CohuHD Costar	2,063	2,063
	<u>\$ 5,574</u>	<u>\$ 5,593</u>

4. Acquisition

Effective December 29, 2016, Costar completed the acquisition of Innotech (the "Acquisition"), a value-added manufacturer of customized video, security surveillance systems and components for major U.S. retailers, restaurant chains and public venues, pursuant to the transactions contemplated by the Share Purchase Agreement ("Purchase Agreement"), dated December 29, 2016, by and among Costar Technologies, Inc., Costar Video Systems, LLC, and the shareholders of Innotech Security, Inc. Results from operations for Innotech have been included in the Company's consolidated financial statements since December 29, 2016.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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

4. Acquisition (continued)

Total consideration for the Acquisition was approximately \$12,779, consisting of a cash payment of \$6,900, net of an estimated working capital holdback of \$100, assumption of \$2,500 in subordinated seller notes and deferred consideration of up to \$6,000 in cash, contingent upon Innotech Security achieving certain EBITDA targets. The fair value of the seller notes and deferred consideration was estimated to be \$2,260 and \$3,519 at December 31, 2016. During the year ending December 31, 2017 the estimated working capital holdback was settled for the final total of \$81 which resulted in the recognition of a measurement period adjustment to goodwill for \$19.

The Company acquired Innotech to expand its footprint in the security and surveillance industry, cross-selling opportunities and its additive value to the Company's profits.

Certain expenses were incurred related to the Acquisition in the amount of \$68 and \$322 for the years ended December 31, 2017 and 2016, respectively.

The Acquisition meets the definition of a business combination under GAAP. The following table presents a summary of the fair value of assets acquired and liabilities assumed as of December 29, 2016, including the measurement period adjustment recognized during the year ending December 31, 2017.

Assets acquired:	
Cash	\$ 713
Accounts receivable	513
Inventories	793
Property and equipment	9
Trade name	1,015
Customer relationships	5,762
Covenant not to compete	150
Patents	8
Technology	469
Goodwill	3,511
Total assets acquired	<u>12,943</u>
Liabilities assumed:	
Accounts payable	55
Accrued expenses	128
Total liabilities assumed	<u>183</u>
Total assets acquired and liabilities assumed, net	<u>\$ 12,760</u>

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

Goodwill arising from the 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.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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

4. Acquisition (continued)

Included in the consolidated statements of income are Innotech revenues of \$4,781 and \$11 and net income of \$2,489 and net loss of \$5 for the years ended December 31, 2017 and 2016, respectively. The following pro forma information gives effect to the acquisition as if it had occurred on the first day of each of the years ended December 31, 2017 and 2016:

	Year Ended December 31	
	2017	2016
Total revenue	\$ 44,266	\$ 45,321
Pre-tax income	\$ 3,745	\$ 3,335

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, 2017 and December 31, 2016, the Company had obligations to transfer \$1,447 and \$3,519, 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 next two and three years, respectively. 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.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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

5. Fair Value Measurements (continued)

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.

The following table summarizes financial liabilities measured at fair value on a recurring basis as of December 31, 2017 and December 31, 2016, 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, 2017</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	\$ 1,447	\$	\$	\$ 1,447

<u>Description</u>	<u>As of December 31, 2016</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	\$ 3,519	\$	\$	\$ 3,519

The following table reflects the activity for liabilities measured at fair value using Level 3 inputs for the period ending December 31, 2017:

Balance as of December 31, 2016	\$ 3,519
Issuances	
Payments	
Related change in fair value	(2,072)
Balance as of December 31, 2017	<u>\$ 1,447</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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

5. Fair Value Measurements (continued)

Related Party Notes Payable

As of December 31, 2017 and December 31, 2016, the Company had obligations to transfer \$1,558 and \$2,260, respectively, in notes payable to the prior shareholders of Innotech. The notes payable are due in equal monthly installments over the next three years. 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%.

Future payments on the related party notes are as follows:

Year Ending December 31,	
2018	\$ 753
2019	805
	<hr/>
	\$ 1,558

6. Property and Equipment

Property and equipment at December 31, 2017 and December 31, 2016, were as follows:

	December 31, 2017	December 31, 2016
Furniture, equipment and leasehold improvements	\$ 1,704	\$ 1,298
Less accumulated depreciation	<hr/> (843)	<hr/> (506)
Total property and equipment, net	<hr/> \$ 861	<hr/> \$ 792

Depreciation expense for the years ending December 31, 2017 and 2016 was \$261 and \$130, respectively.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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

7. Intangible Assets

The following is a summary of amortized and unamortized intangible assets at December 31, 2017:

	December 31, 2017	
	Gross Amount	Accumulated Amortization
Amortized intangible assets		
Customer relations - Southern Imaging	\$ 1,599	\$ 1,599
Distribution agreement - Southern Imaging	1,468	844
Customer relations - IVS	125	125
Covenant not to compete - IVS	50	50
Trade name - CohuHD	1,657	828
Customer relationships - CohuHD	779	286
Covenant not to compete - CohuHD	20	14
Trade name - Innotech	1,015	102
Customer relations - Innotech	5,762	655
Covenant not to compete - Innotech	150	30
Technology - Innotech	469	67
Patents - Innotech	8	1
Total amortized intangible assets	13,102	4,601
Unamortized intangible assets		
Trade name - Costar	800	
Trade name - IVS	125	
Goodwill - CohuHD	2,063	
Goodwill - Innotech	3,511	
Total unamortized intangible assets	6,499	
Total intangible assets	\$ 19,601	\$ 4,601

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, 2016:

	December 31, 2016	
	Gross Amount	Accumulated Amortization
Amortized intangible assets		
Customer relations - Southern Imaging	\$ 1,599	\$ 1,599
Distribution agreement - Southern Imaging	1,468	771
Customer relations - IVS	125	107
Covenant not to compete - IVS	50	50
Trade name - CohuHD	1,657	592
Customer relationships - CohuHD	779	205
Covenant not to compete - CohuHD	20	10
Trade name - Innotech	1,015	
Customer relations - Innotech	5,762	
Covenant not to compete - Innotech	150	
Technology - Innotech	469	
Patents - Innotech	8	
Total amortized intangible assets	<u>13,102</u>	<u>3,334</u>
Unamortized intangible assets		
Trade name - Costar	800	
Trade name - IVS	125	
Goodwill - CohuHD	2,063	
Goodwill - Innotech	3,530	
Total unamortized intangible assets	<u>6,518</u>	
Total intangible assets	<u>\$ 19,620</u>	<u>\$ 3,334</u>

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, 2017 and 2016 was \$1,267 and \$418, 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,	
2018	\$ 1,230
2019	1,209
2020	1,187
2021	1,049
2022	882
Thereafter	<u>2,944</u>
Total future amortization expense	<u>\$ 8,501</u>

8. Lines of Credit and Long-Term Debt

Effective June 3, 2014, the Company entered into an Amended Loan and Security Agreement ("Accord") with Bank of Texas. The Accord allows for up to \$7,000 in a revolving line of credit and a \$3,000 term loan with maturities of June 3, 2016 and June 3, 2019, respectively. Upon expiration of the revolving line of credit under the Accord the Company entered into a Business Loan Agreement ("Agreement") with Bank of Texas for a revolving line of credit up to \$3,000 subject to borrowing base requirements detailed in the Agreement. The Agreement specified a maturity date of June 3, 2018.

In connection with the acquisition of Innotech 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. Obligations under the Accord and Agreement with Bank of Texas were extinguished upon entering into the Comerica Agreements. The obligations under the Comerica Agreements are secured by a lien on substantially all accounts receivable, inventory and equipment. As of December 31, 2017 the Company was paying interest at 4.07% for the term loan.

Future principal payments for the term loan and revolving draw note as of December 31, 2017, are as follows:

Year Ending December 31,	
2018	\$ 750
2019	1,000
2020	1,000
2021	1,000
2022	1,000
Thereafter	500
Less: deferred financing costs, net	<u>(34)</u>
	<u>\$ 5,216</u>

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)

The Comerica Agreements contain 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 Comerica Agreements contain 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. As of December 31, 2017 and December 31, 2016, \$0 and \$1,071 was owed to Comerica Bank on the revolving line of credit, \$0 on the revolving draw note and \$5,250 and \$7,000 on the term loan, respectively.

The Company paid approximately \$85 in various fees associated with securing the Comerica Agreements. The fees are treated as a deferred financing costs asset and will be amortized over the life of the accord using the straight-line method for the revolving line of credit portion and the effective-interest method for the term note portion.

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.

As of December 31, 2017, the Company's management determined that it was more likely than not that it will utilize its \$12,633 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 \$685 in tax credit carryforwards prior to expiration, which occurs in 2018 through 2021. 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 expense are as follows:

	Years Ended December 31,	
	2017	2016
Current, federal	\$ 15	\$ 13
Current, state	55	55
Deferred, federal	3,976	364
Deferred, state	70	(14)
Income Tax Expense	<u>\$ 4,116</u>	<u>\$ 418</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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

9. Income Taxes (continued)

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

	Years Ended December 31,	
	2017	2016
Income tax expense at the statutory rate	\$ 1,273	\$ 358
Decrease resulting from:		
State income tax, net of federal tax effect	83	27
Change in valuation allowance	952	
Other	54	14
Permanent items	29	19
Federal tax rate change	1,725	
	<u>\$ 4,116</u>	<u>\$ 418</u>

On December 22, 2017 the United States enacted tax reform legislation through the Tax Cuts and Jobs Act, which significantly changes the existing U.S. tax laws, including a reduction in the corporate income tax rate from 35% to 21% as well as other changes. As a result of enactment of the legislation, the Company incurred additional one-time income tax expense of \$1,725 during the year ended December 31, 2017 primarily related to the remeasurement of certain deferred tax assets and liabilities.

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

	Years Ended December 31,	
	2017	2016
Deferred tax assets		
Accounts receivable	\$ 23	\$ 25
Inventory	108	307
Net operating losses	2,868	5,091
Intangibles	(377)	300
Stock compensation	111	178
Accrued expenses	217	330
Tax credits	2,004	1,990
	<u>4,954</u>	<u>8,221</u>
Valuation allowance	(1,861)	(909)
Net deferred tax assets	<u>\$ 3,093</u>	<u>\$ 7,312</u>
Deferred tax liabilities		
Property and equipment, net	\$ 117	\$ 168
Intangibles, indefinite lived		149
Prepaid expenses	60	33
Net deferred tax liability	<u>177</u>	<u>350</u>
	<u>\$ 2,916</u>	<u>\$ 6,962</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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

10. Stockholders' Equity (shown in whole amounts)

At December 31, 2017 and December 31, 2016, 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, 2017 and December 31, 2016, 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, 2017 and December 31, 2016, there were 1,531,791 and 1,492,991 and shares of common stock outstanding and 1,757,557 and 1,718,757 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, 2017 and December 31, 2016, there were 95,466 and 119,066 share options issued under this plan.

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, 2017 and December 31, 2016 there were 24,000 and 16,000 share options issued under this plan, respectively.

The following table summarizes information about stock options outstanding at December 31, 2017:

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
\$0.725-\$15.020	119,466	4.94	\$5.72	117,820	\$5.64

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)

Stock option activity for the years ended December 31, 2017 and 2016 is as follows:

	2017		2016	
	Number of Shares	Weighted Average Exercise Price Per Share	Number of Shares	Weighted Average Exercise Price Per Share
Outstanding at beginning of year	135,066	\$5.45	131,282	\$5.46
Granted	8,000	\$10.50	8,000	\$8.44
Exercised	(17,800)	\$5.03		
Canceled	(5,800)	\$8.13	(4,216)	\$11.21
Outstanding at period end	<u>119,466</u>	<u>\$5.72</u>	<u>135,066</u>	<u>\$5.45</u>
Options exercisable at period end	<u>117,820</u>	<u>\$5.64</u>	<u>127,420</u>	<u>\$5.23</u>
Weighted average fair value of options granted during the period at fair value		<u>\$7.77</u>		<u>\$6.36</u>

On October 7, 2015 the Compensation Committee of the Company's Board of Directors authorized the grant of 13,250 restricted stock awards ("2015 Awards") to certain employees pursuant to the provisions of the Plan. The 2015 Awards were granted on October 16, 2015. All of the 2015 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, 2015 and 2016, as stated in the 2015 Awards Agreements. The 25% of the 2015 Awards not subject to performance conditions have a fair market grant date value of approximately \$30,000, with the expense recognized over the two year vesting period. Stock based compensation expense of \$0 and \$60,000 was recognized in the Company's financial statements in relation to the 2015 Awards during the years ending December 31, 2017 and 2016, respectively.

On June 1, 2016 an additional grant of 13,250 restricted stock awards ("2016 Awards") was authorized by the Compensation Committee of the Company's Board of Directors. All of the 2016 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, 2016 and 2017, as stated in the 2016 Awards Agreements. The 25% of the 2016 Awards not subject to performance conditions have a fair market grant date value of approximately \$28,000, with the expense recognized over the two year vesting period. The 2016 Awards subject to the performance conditions have a fair market grant date value of \$85,000, with the expense recognized over the two year vesting period based upon the probability of achievement. Stock based compensation expense of \$57,000 was recognized in the Company's financial statements in relation to the 2016 Awards during the years ending December 31, 2017 and 2016, respectively.

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. As of December 31, 2017 the fair value of the vested awards was approximately \$108,000 and the fair value of the non-vested awards was \$108,000. Stock based compensation expense of \$108,000 was recognized in the Company's financial statements in relation to the 2017 Awards during the year ending December 31, 2017.

During the years ended December 31, 2017 and 2016 the Company recognized approximately \$268,000 and \$212,000 in stock based compensation expense in its consolidated financial statements, respectively.

12. Lease Agreements and Related Party Transactions

On January 31, 2011 the Company entered into a new lease agreement for certain facilities that will expire in 2018. Rent expense under the agreement for the years ended December 31, 2017 and 2016 was approximately \$104 and \$172, respectively.

On June 6, 2014 the Company signed a three-year lease with Cohu, Inc. in Poway, CA for the CohuHD Costar business. On December 4, 2015 the Company received a notice of lease termination from Cohu, Inc. terminating the lease effective December 31, 2016. Rent expense under the agreement for the year ended 2016 was approximately \$550.

On May 20, 2016 the Company signed a seventy-eight month lease for the new CohuHD Costar facilities which commenced in December 2016 and will expire in 2023. Rent expense under the agreement for the years ending December 31, 2017 and 2016 was \$341 and \$28, respectively.

On December 29, 2016 the Company signed a three-year lease with a related party for the Innotech facilities which commenced on January 1, 2017. Rent expense under the agreement for the year ending December 31, 2017 was \$106.

During the year ending December 31, 2016 the Company made a one-time catchup adjustment to properly reflect straight line rent on the commenced leases described above. This adjustment resulted in an additional \$84 of rent expense for the year ending December 31, 2016.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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

12. Lease Agreements and Related Party Transactions (continued)

Future minimum annual rent payments as of December 31, 2017 are approximately as follows:

Year Ending December 31,	3rd Party	Related Party	Total
2018	\$ 435	\$ 106	\$ 541
2019	341	109	450
2020	352		352
2021	362		362
2022	373		373
Thereafter	160		160
Total future minimum lease commitments	<u>\$ 2,023</u>	<u>\$ 215</u>	<u>\$ 2,238</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 year ended December 31, 2017 the Costar Video Systems operating segment's largest customer, Protection 1 Security Solutions, accounted for approximately \$6,290 or 14.2% of the Company's total revenue. For the year ended December 31, 2016 Costar Video Systems' two largest customers, Wal-Mart Stores, Inc. and Protection 1 Security Solutions, accounted for approximately \$10,299 or 26.7% of the Company's total revenue. Amounts owed by Costar Video Systems' largest customer accounted for \$1,098 or 15.2% of the Company's outstanding receivable balance as of December 31, 2017. Amounts owed by two main customers of the Costar Video Systems' operating segment accounted for \$996 or 18.7% of the Company's outstanding receivable balance as of December 31, 2016.

Concentration of Suppliers

For the years ended December 31, 2017 and 2016 the Company made purchases from one main supplier of the Costar Video Systems' operating segment of approximately 19.1% and 24.7%, respectively. Amounts owed to one main supplier of the Costar Video Systems' operating segment accounted for 22.9% and 41.0% of the Company's accounts payable balance as of December 31, 2017 and December 31, 2016, respectively.