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TELESTREAM, INC. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

For the Years Ended December 31, 2009 and 2008

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**INDEPENDENT AUDITOR'S REPORT**

Board of Directors and Management  
Telestream, Inc. and Subsidiaries  
Nevada City, California

We have audited the accompanying consolidated balance sheet of Telestream, Inc. and Subsidiaries (the "Company") as of December 31, 2009 and 2008, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2009 and 2008, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

*Perry-Smith LLP*

June 29, 2010

**TELESTREAM, INC. AND SUBSIDIARIES - f0025351**

**CONSOLIDATED BALANCE SHEET**

**December 31, 2009 and 2008**

<b>ASSETS</b>	<b>2009</b>	<b>2008</b>
Current assets		
Cash and cash equivalents	\$ 4,487,034	\$ 3,072,480
Accounts receivable, net of allowance for doubtful accounts of \$37,240 and \$25,626, respectively	2,651,366	3,122,773
Deferred income taxes (Note 11)	1,024,000	794,000
Prepaid expenses and other current assets	366,367	356,681
Inventories, net (Note 2)	<u>601,101</u>	<u>920,744</u>
Total current assets	<u>9,129,868</u>	<u>8,266,678</u>
Equipment, net (Note 3)	851,326	980,219
Goodwill	142,713	129,595
Other intangible assets, net (Note 4)	5,116,272	5,570,356
Deferred income taxes (Note 11)	<u>3,662,000</u>	<u>4,079,000</u>
Total assets	<u>\$ 18,902,179</u>	<u>\$ 19,025,848</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable	\$ 317,860	\$ 183,316
Accrued liabilities (Note 5)	447,666	639,686
Accrued compensation and other benefits	1,618,947	997,126
Deferred revenue (Note 6)	2,695,607	2,394,123
Current portion of capital lease obligation (Note 7)	5,504	5,236
Income taxes payable	384,390	307,508
Related party notes payable (Note 8)	<u>979,746</u>	<u>1,881,013</u>
Total current liabilities	<u>6,449,720</u>	<u>6,408,008</u>
Capital lease obligation, less current portion (Note 7)	15,557	21,060
Related party notes payable (Note 8)	<u>          </u>	<u>979,746</u>
Total liabilities	<u>6,465,277</u>	<u>7,408,814</u>
Commitments and contingencies (Note 13)		
Stockholders' equity (Notes 9 and 10)		
Series A through E convertible preferred stock, \$0.001 par value, noncumulative, 10,271,075 shares authorized and 10,144,962 shares issued and outstanding, total liquidation preference of outstanding shares in 2009 and 2008, \$19,287,193	10,145	10,145
Common stock, \$0.001 par value, 16,125,000 shares authorized, 3,325,691 and 3,193,891 shares issued and outstanding at December 31, 2009 and 2008, respectively	3,326	3,194
Additional paid-in capital	19,470,796	19,413,007
Accumulated deficit	(7,037,923)	(7,780,039)
Accumulated other comprehensive loss	<u>(9,442)</u>	<u>(29,273)</u>
Total stockholders' equity	<u>12,436,902</u>	<u>11,617,034</u>
Total liabilities and stockholders' equity	<u>\$ 18,902,179</u>	<u>\$ 19,025,848</u>

The accompanying notes are an integral part of these consolidated financial statements

**TELESTREAM, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INCOME**

**For the Years Ended December 31, 2009 and 2008**

	<u>2009</u>	<u>2008</u>
Revenues		
Net sales	\$ 22,996,377	\$ 20,813,382
Cost of sales	<u>6,049,942</u>	<u>4,918,464</u>
Gross profit	<u>16,946,435</u>	<u>15,894,918</u>
Operating expenses		
Sales and marketing	6,010,890	5,745,894
Administrative	2,586,132	2,668,208
Engineering	5,074,835	5,010,328
International development	<u>2,034,737</u>	<u>2,552,197</u>
Total operating expenses	<u>15,706,594</u>	<u>15,976,627</u>
Income (loss) from operations	1,239,841	(81,709)
Other (expense) income		
Interest (expense) income, net	(113,882)	13,217
Other, net	<u>(843)</u>	<u>(7,041)</u>
Total other (expense) income	<u>(114,725)</u>	<u>6,176</u>
Income (loss) before income tax expense (benefit)	1,125,116	(75,533)
Income tax expense (benefit) (Note 11)	<u>383,000</u>	<u>(141,000)</u>
Net income	<u>\$ 742,116</u>	<u>\$ 65,467</u>

The accompanying notes are an integral  
part of these consolidated financial statements

TELESTREAM, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

For the Years Ended December 31, 2009 and 2008

	Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated Deficit	Other Compre- hensive Loss	Total Stockholders' Equity	Compre- hensive Income
	Shares	Amount	Shares	Amount					
Balance, January 1, 2008	10,144,962	\$ 10,145	3,109,776	\$ 3,110	\$ 19,380,636	\$ (7,845,506)	\$ (5,480)	\$ 11,542,905	\$ 1,289,033
Issuance of common stock under stock option plan (Note 10)			84,115	84	12,188			12,272	
Share-based compensation (Note 10)									
Foreign currency translation					20,180			20,180	
Net income						126,329		126,329	126,329
Balance, December 31, 2008, as previously stated	10,144,962	10,145	3,193,891	3,194	19,413,004	(7,719,177)	(29,273)	11,677,893	102,536
Restatement (Note 14)					3	(60,862)		(60,859)	
Balance, December 31, 2008, as restated (Note 14)	10,144,962	10,145	3,193,891	3,194	19,413,007	(7,780,039)	(29,273)	11,617,034	\$ 102,536
Issuance of common stock under stock option plan (Note 10)			131,800	132	34,619			34,751	
Share-based compensation (Note 10)									
Foreign currency translation					23,170		19,831	19,831	\$ 19,831
Net income						742,116		742,116	742,116
Balance, December 31, 2009	10,144,962	\$ 10,145	3,325,691	\$ 3,326	\$ 19,470,796	\$ (7,037,923)	\$ (9,442)	\$ 12,436,902	\$ 761,947

The accompanying notes are an integral part of these consolidated financial statements

**TELESTREAM, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**  
**For the Years Ended December 31, 2009 and 2008**

	<u>2009</u>	<u>2008</u>
Cash flows from operating activities		
Net income	\$ 742,116	\$ 65,467
Adjustments to reconcile net income to net cash provided by (used in) operating activities		
Depreciation and amortization	1,053,262	614,101
Loss (gain) on disposals of equipment	1,044	(7,945)
Share-based compensation	23,170	20,180
Deferred income taxes	187,000	(225,000)
Changes in operating assets and liabilities		
Accounts receivable	471,407	61,541
Prepaid expenses	(9,686)	(112,100)
Inventories	319,643	(55,889)
Accounts payable	134,544	(129,228)
Accrued expenses	(192,020)	(363,202)
Accrued compensation and other benefits	621,821	(851,573)
Deferred revenue	301,484	416,625
Taxes payable	76,882	307,508
Net cash provided by (used in) operating activities	<u>3,730,667</u>	<u>(259,515)</u>
Cash flows from investing activities		
Purchase of property and equipment	(358,281)	(547,970)
Business acquisition, net		(5,685,272)
Other	(4,376)	(2,369)
Net cash used in investing activities	<u>(362,657)</u>	<u>(6,235,611)</u>
Cash flows from financing activities		
Proceeds from new related party borrowings		3,360,759
Dividends paid		(2,028,992)
Payments on related party borrowings	(2,000,000)	(500,000)
Increase in capital lease obligations		28,401
Payments on capital lease obligations	(8,038)	(7,377)
Proceeds from issuances of common stock	34,751	12,272
Foreign currency translation	19,831	(23,793)
Net cash (used in) provided by financing activities	<u>(1,953,456)</u>	<u>841,270</u>
Net increase (decrease) in cash	1,414,554	(5,653,856)
Cash, beginning of year	<u>3,072,480</u>	<u>8,726,336</u>
Cash, end of year	<u>\$ 4,487,034</u>	<u>\$ 3,072,480</u>
Supplemental disclosure of cash flow information		
Cash paid during the year for		
Interest	\$ 101	\$ 45,916
Taxes	\$ 230,617	\$ 114,920

The accompanying notes are an integral  
part of these consolidated financial statements

**TELESTREAM, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Organization

Founded in 1998, Telestream, Inc (the "Company"), a Delaware corporation, specializes in products that simplify the access and exchange of high-quality video and audio over data networks. The Company's software applications, encoding components, and hardware appliances provide content owners, creators, and distributors with fast, efficient digital alternatives to handling, dubbing and shipping tape. Telestream, Inc. products are used by the world's leading media and entertainment companies, as well as a growing number of government, education and corporate enterprises.

Company headquarters are located in Nevada City, California. With the 2006 acquisition of encoding specialist Popwire AB, Telestream added a development center in Stockholm, Sweden.

On August 26, 2008, the Company acquired 100 percent of the stock of VARA Software Ltd in exchange for \$2,000,000 in cash and \$3,500,000 in notes payable (Note 8). VARA Software Ltd is located in England and was founded in 2003. VARA Software Ltd is in the business of selling webcast tools that allow users to combine multiple types of media to make a web-based broadcast. The total acquisition cost of \$5,685,272 was allocated to intellectual property. The acquisition cost is comprised of the purchase price of \$5,500,000 plus transaction costs less the discount for the imputed interest on the related note payable.

Consolidation

The consolidated balance sheet, statement of income and statement of cash flows include the accounts of the Company and its wholly-owned subsidiaries, Popwire AB and VARA Software Ltd. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

Cash and Cash Equivalents

All highly liquid investments with an original remaining maturity at the date of purchase of three months or less are considered to be cash equivalents. The Company maintains its cash in bank deposit or money market accounts which, from time to time, exceed the federally insured limit of \$250,000. The Company has not experienced any such losses and believes it is not exposed to significant risks due to uninsured accounts.

## TELESTREAM, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Concentration of Credit Risk

Financial instruments which subject the Company to potential credit risk consist of its cash and cash equivalents and accounts receivable. The Company invests with high-credit quality financial institutions. Collection terms of 30 days are extended upon issuance of an invoice, but the Company does not require collateral and provides reserves for potential credit losses. The Company believes the financial risks associated with these financial instruments are minimal.

##### Revenue and Cost Recognition

Revenues are generated from the sale of hardware products and software licenses, which include maintenance and support activities, training services and consulting services. Software license revenues are primarily generated from licensing the Company's software to end-user customers. The nature of each licensing arrangement determines how revenues and the related costs are recognized.

Software license revenues are recognized when a noncancelable license agreement has been signed, the license has been delivered electronically to the customer, the fees are fixed or determinable and collectibility is probable. Hardware product revenues are recognized when a purchase order has been received, the product has been shipped and collectibility is probable.

Customer license contracts are generally multiple element arrangements that may include a software license, maintenance and support, customer training and consulting services. Elements that are undelivered at the time of product delivery typically include professional services, maintenance and training.

The fees for services and maintenance are unbundled from the software license fees using objective evidence of fair value for each of these undelivered elements. This objective evidence of fair value consists of the customary rates for maintenance and the customary rates charged for consulting and training services when they are sold separately. The contract value is allocated to the undelivered elements of the contract based on the objective evidence of fair value described above, and then the remaining balance is allocated to the delivered elements, regardless of any separate prices stated within the contract.

Services are performed on a "best efforts" basis and are generally billed under fixed-fee arrangements. The resultant revenues and expenses are recognized as services are performed. Revenues from maintenance activities, which consist of fees for ongoing support and maintenance and management services, are recognized over the term of the maintenance contract and the associated costs are expensed as incurred.



## TELESTREAM, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Revenue and Cost Recognition (Continued)

Customers are generally not offered the right to return software products. The Company has a fifteen working days right of return on hardware products. Historically, returns of hardware products have been minimal, therefore, the Company does not have an allowance against these returns.

##### Deferred Revenue

Cash received in advance of sales or services provided is recorded as deferred revenue. Revenues from these advance payments is recognized upon the sale when hardware products are shipped or over the period services are provided on a straight-line basis.

##### Accounts Receivable

Receivables are recorded when billed or accrued and represent claims against third parties that will be settled in cash. The carrying value of receivables, net of the allowance for doubtful accounts, represents their estimated net realizable value. The allowance for doubtful accounts is based on historical collection trends, age of outstanding receivables and existing economic conditions. If events or changes in circumstances indicate that a specific receivable balance may be impaired, further consideration is given to the collectibility of those balances and the allowance is adjusted accordingly. Past-due receivable balances are written-off when internal collection efforts have been unsuccessful in collecting the amount due. During 2009, there was an increase of \$11,614 in the allowance for doubtful accounts.

##### Inventories

Inventories are recorded at the lower of cost or market using the first-in first-out method. An inventory reserve is recorded for 100% of obsolete inventory.

##### Research and Development

Research and development costs related to software products are expensed to operations as incurred and consist primarily of employee compensation and related costs incurred in connection with software development activities.

##### Software Development Costs

Costs for the development of new software products and substantial enhancements to existing software products are expensed as incurred until technological feasibility has been established, at which time any additional development costs are capitalized. The Company believes its current process for developing software is essentially completed concurrently with the establishment of technological feasibility and, accordingly, no internal costs have been capitalized to date.

## TELESTREAM, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Equipment and Improvements and Software Licenses

Equipment and improvements and software licenses are stated at cost. Depreciation and amortization is computed using the straight-line method over the estimated useful lives of three to seven years. Leasehold improvements and equipment under capital lease obligations are amortized over the shorter of the lease term or the useful lives of the improvements or equipment. Repairs and maintenance costs are expensed as incurred. Upon disposition, the cost and related accumulated depreciation or amortization are removed from the account and the resulting gain or loss is reported in income for the period.

##### Impairment of Long-Lived Assets

Long-lived assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. As of December 31, 2009, management believes that there was no impairment of long-lived assets.

##### Other Intangible Assets

Identifiable intangible assets with finite lives are amortized over their expected useful lives, ranging from one to fifteen years using the straight-line method.

##### Goodwill

Goodwill is recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net assets acquired, including identified intangible assets. Goodwill is not amortized, rather it is evaluated at least annually for impairment. The Company performs an annual review in the fourth quarter of each year, or more frequently if indicators of potential impairment exist, to determine if the carrying value of goodwill is impaired by comparing the fair value of the reporting unit in which goodwill resides to its carrying value. Reporting units may be operating segments as a whole or an operation one level below an operating segment, referred to as a component. At December 31, 2009, management determined that goodwill was not impaired.

## TELESTREAM, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Income Taxes

Deferred income taxes are recorded based on the difference between financial statement and income tax basis of assets and liabilities and available loss and credit carryforwards. A valuation allowance is established to reduce deferred tax assets if it is more likely than not that all, or some portions of such deferred tax assets will not be realized. Realization of deferred income tax assets is dependent upon sufficient future taxable income during the period that deductible temporary differences and carryforwards are expected to be available to reduce taxable income. At December 31, 2009, management recorded a valuation allowance of \$235,000 for estimated unused state loss carryforwards, which expire beginning in 2010. Management believes it is more likely than not that the remaining net deferred income tax assets will be used before their expiration.

##### Foreign Currency

The financial statements of the foreign subsidiary are translated using the exchange rate in effect at year end for balance sheet accounts and the average rate in effect during the period for revenue and expense accounts. Translation gains and losses are excluded from the statement of operations and are instead reported as a currency translation adjustment component of accumulated other comprehensive loss.

Foreign currency transaction gains and losses arising from differences between the functional and billing currencies are recognized in the consolidated statement of income.

##### Royalties

Royalties payable to outside parties are governed by contracts signed with licensing authorities representing the owners of key video format patents. Royalties are recognized on a per-unit sold basis and are expensed in the month the product is sold.

##### Stock Options

The Company's Stock Option Plan (the "Option Plan") provides for a maximum of 2,525,313 shares, as amended, of authorized but unissued common stock to be available for grant to eligible employees, non-employee Directors and consultants at an exercise price of at least fair market value as determined by the Board of Directors at the date of grant. As determined by the Board of Directors' Compensation Committee, shares vest over a period from one to four years from the date of grant. At December 31, 2009 and 2008, the Company has 266,319 and 366,319 shares, respectively, available for granting under the Option Plan.

## TELESTREAM, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### Stock Options (Continued)

Management estimates the fair value of each option award as of the date of grant using a Black-Scholes-Merton option pricing formula and the following assumptions noted in the following table. Dividend yield is based on an assumed \$ 20 dividend multiplied by management's estimate of the stock price shares at grant date. Expected volatility is based on historical volatility of similar entities over a preceding period commensurate with the expected term of the option because the Company's common stock is not publicly traded. Historical data is used to estimate options exercised and employee terminations within the valuation model. The risk-free rate is based on the United States of America Treasury yield curve in effect at the time of grant with substantially the same remaining term as the expected term of the option. In addition to these assumptions, management makes estimates regarding forfeitures that will impact total compensation expense recognized under the Plan.

The fair value of each option is estimated on the date of grant using the Black-Scholes-Merton option-pricing model with the following assumptions at December 31, 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Dividend yield	None	None
Expected volatility	43.6%	45.2%
Risk-free interest rate	2.5%	3.0%
Expected option life	6 years	6 years

##### Subsequent Events

The Company performed a search for subsequent events and noted no subsequent events occurred through June 29, 2010.

##### New Financial Accounting Standards

###### *Accounting for Uncertainty in Income Taxes*

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement 109* (FIN 48) as codified in ASC 740. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. The Company presently recognizes income tax positions based on management's estimate of whether it is reasonably possible that a liability has been incurred for unrecognized income tax benefits by applying FASB Statement No. 5, *Accounting for Contingencies*. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. The Company adopted FIN 48 effective January 1, 2009. The adoption did not have a material impact on the Company's financial position or results of operations.

## TELESTREAM, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

#### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

##### New Financial Accounting Standards (Continued)

###### *Business Combinations*

In December 2007, the FASB issued Statement of Financial Accounting Standards No 141 (revised 2007), *Business Combinations* (SFAS No 141R) as codified in ASC 805. SFAS No 141(R), among other things, establishes principles and requirements for how the acquirer in a business combination (i) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquired business, (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (iii) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The Company adopted SFAS No 141(R) effective January 1, 2009. This Standard changes the Company's accounting treatment for business combinations occurring on or after January 1, 2009.

###### *Subsequent Events*

In May 2009, the FASB issued FASB Statement No 165 (SFAS No 165), *Subsequent Events* as codified in ASC 855. SFAS No 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, SFAS No 165 defines, (1) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (3) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. SFAS No 165 was adopted by the Company effective January 1, 2009. The adoption of SFAS No 165 has resulted in the reporting of the date to which management's search for subsequent events was performed.

###### *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Principles, a replacement of FASB Statement No 162*

In June 2009, the FASB issued FASB Statement No 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No 162*. This statement modifies the Generally Accepted Accounting Principles (GAAP) hierarchy by establishing only two levels of GAAP, authoritative and nonauthoritative accounting literature. Effective July 2009, the FASB Accounting Standards Codification (ASC), also known collectively as the "Codification," is considered the single source of authoritative U.S. accounting and reporting standards. The Codification was developed to organize GAAP pronouncements by topic so that users can more easily access authoritative accounting guidance. The Company adopted SFAS 168 effective for the fiscal year ended December 31, 2009. All accounting references have been updated, and therefore SFAS references throughout the financial statements are noted with Topic (ASC) reference.

# TELESTREAM, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

#### Reclassifications

Certain reclassifications have been made to prior year balances to conform to classifications used in the current year

### 2. INVENTORIES

Inventories at December 31, 2009 and 2008 are comprised of the following

	<u>2009</u>	<u>2008</u>
Raw materials		\$ 66
Work-in-process	\$ 31,974	2,942
Finished goods	634,584	1,035,220
Inventory reserve	<u>(65,457)</u>	<u>(117,484)</u>
	<u>\$ 601,101</u>	<u>\$ 920,744</u>

### 3. EQUIPMENT

Equipment at December 31, 2009 and 2008 is comprised of the following:

	<u>2009</u>	<u>2008</u>
Equipment		
Furniture and office equipment	\$ 1,067,186	\$ 1,028,130
Computer hardware	1,146,692	849,907
Computer software	421,857	411,220
Leasehold improvements	<u>110,371</u>	<u>107,120</u>
	2,746,106	2,396,377
Less accumulated depreciation	<u>(1,894,780)</u>	<u>(1,416,158)</u>
Equipment, net	<u>\$ 851,326</u>	<u>\$ 980,219</u>

Depreciation expense for the years ended December 31, 2009 and 2008 was \$489,595 and \$444,260, respectively

**TELESTREAM, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**4. OTHER INTANGIBLE ASSETS**

Other intangible assets at December 31, 2009 and 2008 is comprised of the following

	<u>2009</u>	<u>2008</u>
Computer software and licenses	\$ 5,800,374	\$ 5,750,792
Other	<u>116,915</u>	<u>56,914</u>
	5,917,289	5,807,706
Less accumulated amortization	<u>(801,017)</u>	<u>(237,350)</u>
	<u>\$ 5,116,272</u>	<u>\$ 5,570,356</u>

Software and licenses are amortized based on a percentage of projected revenue relative to total projected sales revenues expected over the estimated total revenue expected to be earned over the life of the asset

Amortization expense for the years ended December 31, 2009 and 2008 was \$563,667 and \$169,841, respectively

Estimated annual amortization expense for the periods indicated is as follows:

<u>Years Ending December 31,</u>	
2010	\$ 426,749
2011	382,324
2012	382,324
2013	382,324
2014	382,324
Thereafter	<u>3,160,227</u>
	<u>\$ 5,116,272</u>

**5. ACCRUED LIABILITIES**

Accrued liabilities at December 31, 2009 and 2008 is comprised of the following

	<u>2009</u>	<u>2008</u>
Royalty related liabilities	\$ 360,068	\$ 473,958
Other	<u>87,598</u>	<u>165,728</u>
	<u>\$ 447,666</u>	<u>\$ 639,686</u>

**TELESTREAM, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**6. DEFERRED REVENUE**

Deferred revenue represents cash received in advance of sales or services provided. It includes both the sales of warranty for products greater than one year of age plus the first year of warranty that is included in the selling price. The table below summarizes the activity and balance in deferred revenue for the years ended December 31, 2009 and 2008.

	<u>2009</u>	<u>2008</u>
Balance, January 1	\$ 2,394,123	\$ 1,977,498
Cash additions	2,470,984	2,270,631
Revenue recognized	<u>(2,169,500)</u>	<u>(1,854,006)</u>
Balance, December 31	<u>\$ 2,695,607</u>	<u>\$ 2,394,123</u>

**7. CAPITAL LEASE OBLIGATION**

The Company leases certain office equipment accounted for as a capital lease. The cost of equipment under capital lease obligations aggregated is \$28,401 and net book value aggregated is \$20,354 at December 31, 2009.



**TELESTREAM, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**7. CAPITAL LEASE OBLIGATION (Continued)**

Future minimum lease payments under the capitalized lease obligation are as follows

<u>Years Ending December 31,</u>	<u>Capital Lease</u>
2010	\$ 6,432
2011	6,432
2012	6,432
2013	<u>3,751</u>
Future minimum lease payments	23,047
Less amounts representing interest	<u>(1,986)</u>
Present value of future minimum lease payments	21,061
Less current maturities	<u>(5,504)</u>
Capital lease obligation, net of current portion	<u>\$ 15,557</u>

**8. RELATED PARTY NOTES PAYABLE**

In connection with the acquisition of the stock of VARA Software Ltd, the Company issued notes payable totaling \$3,500,000 to the former stockholders. The notes have an imputed effective interest rate of 5.50% and require quarterly payments of \$500,000 beginning November 24, 2008 with final quarterly payments to be made in May 2010.

The notes payable at December 31, 2009 and 2008 are comprised of the following

	<u>2009</u>	<u>2008</u>
Notes payable	\$ 1,000,000	\$ 3,000,000
Less unamortized discount	<u>(20,254)</u>	<u>(139,241)</u>
Notes payable less unamortized discount	979,746	2,860,759
Less current portion	<u>(979,746)</u>	<u>(1,881,013)</u>
Notes payable, net of current portion	<u>\$ -</u>	<u>\$ 979,746</u>

**TELESTREAM, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**9. PREFERRED STOCK**

The Company has five classes of preferred stock Series A preferred stock (Series A), Series B preferred stock (Series B), Series C preferred stock (Series C), Series D preferred stock (Series D) and Series E preferred stock (Series E) The number of preferred shares outstanding as of December 31, 2009 and 2008, is as follows

<u>Class</u>	<u>Common Shares Represented</u>
Series A Preferred Stock	4,920,000
Series B Preferred Stock	1,622,661
Series C Preferred Stock	2,159,970
Series D Preferred Stock	1,124,000
Series E Preferred Stock	<u>318,331</u>
	<u>10,144,962</u>

The rights, preferences and privileges granted to the Series A, Series B, Series C, Series D, and Series E preferred stock holders are as follows

Dividend Provisions

The holders of shares of Series A through E preferred stock are entitled to receive dividends at the rate of \$0.10, \$0.15, \$0.28, \$0.40 and \$0.45 per share respectively, when and if declared by the Board of Directors. Such dividends are not cumulative No dividends were declared for the year ended December 31, 2009

Liquidation Preference

The Series A through E preferred stock rank equally with each other In the event of a liquidation, the holders of Series A, Series B, Series C, Series D, and Series E preferred stock are entitled to receive prior to and in preference to any distribution of the assets of the Company at \$1.00, \$1.50, \$2.78, \$4.00 and \$4.50 per share, respectively If the assets to be distributed are insufficient to permit the payment to Series A, Series B, Series C, Series D, and Series E shareholders, then the assets available for distribution are to be distributed ratably in proportion to the preferential amount each holder is otherwise entitled to receive After payment is made to the holders of Series A, Series B, Series C, Series D, and Series E preferred stock, the remaining assets, if any, will be paid to all preferred and common shareholders ratably by share

Redemption Rights

The Series A through E preferred stock holders have the right to submit a request from a majority of preferred stock holders to redeem their securities for cash consideration for a price equal to the liquidation preference of each class

# TELESTREAM, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### 9. PREFERRED STOCK (Continued)

#### Conversion

The Series A through E preferred stock are convertible, at the holder's option, into shares of common stock at a conversion price equal to the initial liquidation preference price

#### Anti-dilution Privileges

The Series A through E preferred stock holders are entitled to receive an adjustment to their conversion price should additional shares be issued at a price below the purchase price of a class of preferred stock

#### Voting Rights

The holders of Series A through E preferred stock have the right to one vote for each share of common stock into which such preferred stock could then be converted

### 10. STOCK OPTIONS

Options activity for the years ended December 31, 2009 and 2008 is as follows

	<u>Outstanding Options</u>		
	<u>Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term (Years)</u>
Options outstanding, January 1, 2008	1,797,256	\$ 0.43	<u>5.87</u>
Options granted	140,000	\$ 0.84	
Options exercised	(84,120)	\$ 0.15	
Options canceled/forfeited	<u>(79,336)</u>	\$ 0.47	
Options outstanding, December 31, 2008	<u>1,773,800</u>	\$ 0.46	<u>5.40</u>
Options granted	25,000	\$ 0.53	
Options exercised	(131,800)	\$ 0.26	
Options canceled/forfeited	<u>(55,000)</u>	\$ 0.69	
Options outstanding, December 31, 2009	<u>1,612,000</u>	\$ 0.49	<u>5.06</u>
Options exercisable, December 31, 2009	<u>1,396,936</u>	\$ 0.46	<u>5.06</u>

# TELESTREAM, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### 10. STOCK OPTIONS (Continued)

The weighted average fair value of options granted during 2009 and 2008 was \$0.53 and \$0.40 per share, respectively. As of December 31, 2009, the unrecognized compensation cost related to non-vested stock option awards totaled \$40,583. That cost is expected to be amortized on a straight-line basis over a weighted average period of 3.1 years and may be adjusted for subsequent changes in estimated forfeitures. The total fair value of options vested was \$23,170 for the year ended December 31, 2009. The total intrinsic value of options at time of exercise was \$35,100 and \$55,229 for the years ended December 31, 2009 and 2008, respectively.

### 11. PROVISION FOR INCOME TAXES

The income tax expense (benefit) is comprised of the following for the years ended December 31, 2009 and 2008:

	<u>Federal</u>	<u>State and Other</u>	<u>Total</u>
<u>2009</u>			
Current	\$ 3,000	\$ 193,000	\$ 196,000
Deferred	362,000	(137,000)	225,000
Valuation allowance		(38,000)	(38,000)
Total income tax expense	<u>\$ 365,000</u>	<u>\$ 18,000</u>	<u>\$ 383,000</u>
<u>2008</u>			
Current	\$ (29,000)	\$ 113,000	\$ 84,000
Deferred	(158,000)	(150,000)	(308,000)
Valuation allowance		83,000	83,000
Total income tax benefit	<u>\$ (187,000)</u>	<u>\$ 46,000</u>	<u>\$ (141,000)</u>

**TELESTREAM, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**11. PROVISION FOR INCOME TAXES (Continued)**

Deferred tax assets is comprised of the following at December 31, 2009 and 2008

	<u>2009</u>	<u>2008</u>
Deferred tax assets		
Net operating loss carryforwards	\$ 1,843,000	\$ 2,602,000
Research tax credits and deductions	1,950,000	1,638,000
Deferred revenue	1,115,000	937,000
Accrued expenses	193,000	59,000
Other, net	211,000	282,000
Foreign tax credits	41,000	
Valuation allowance	<u>(235,000)</u>	<u>(273,000)</u>
Total deferred tax assets	<u>5,118,000</u>	<u>5,245,000</u>
Deferred tax liabilities		
State deferred taxes	<u>(432,000)</u>	<u>(372,000)</u>
Net deferred tax assets	<u>\$ 4,686,000</u>	<u>\$ 4,873,000</u>

Net deferred tax assets included in the consolidated balance sheet at December 31, 2009 and 2008 are classified as follows

	<u>2009</u>	<u>2008</u>
Deferred tax assets – current	\$ 1,024,000	\$ 794,000
Deferred tax assets – noncurrent	<u>3,662,000</u>	<u>4,079,000</u>
Net deferred tax assets	<u>\$ 4,686,000</u>	<u>\$ 4,873,000</u>

The Company's 2009 effective tax rate is 34.0%. The Company's 2008 effective tax rate of 186.6% differs from the Federal statutory rate of 34% primarily as a result of tax credits, state taxes and other permanent differences. The 2008 effective tax rate is a result of adjustments made to the deferred tax asset balances as of December 31, 2008 relating to the 2007 and 2006 tax years. The tax provision for foreign taxes is included within the current "State and Other" provision.

At December 31, 2009, the Company has Federal and state loss carryforwards for tax purposes of approximately \$4,711,000 and \$1,685,000, respectively, which expire beginning in 2019 for Federal purposes and 2010 for state purposes.

At December 31, 2009 and 2008, the Company has recorded a valuation allowance of \$235,000 and \$273,000, respectively, for estimated unused state loss carry forwards. Management believes it is more likely than not that all other tax assets will be realized in full.

**TELESTREAM, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Continued)

**11. PROVISION FOR INCOME TAXES (Continued)**

At December 31, 2009, the Company had Federal and state research tax credit carryforwards of approximately \$1,179,000 and \$771,000, respectively, which expire beginning in 2013

The Company files U S Federal and California state tax returns. The Company is generally no longer subject to tax examinations for years prior to the fiscal year 2003 for federal purposes and fiscal year 2005 for California purposes, except in certain limited circumstances. The Company does not have any tax audits or other issues pending. The total amount of unrecognized tax benefits, including interest and penalties, at December 31, 2009 is not material. The Company does not anticipate any significant changes with respect to unrecognized tax benefits within the next twelve months.

**12. EMPLOYEE BENEFIT PLAN**

The Company has a 401(k) Savings Plan (the "Plan"), which covers all full time employees. Participants may contribute a portion of their earnings to the Plan, up to the maximum allowed under the law. The Company contributes a match of 50% of the employee's first 6% of compensation contributed. For the years ended December 31, 2009 and 2008, the Company contributed \$159,558 and \$152,446, respectively, to the Plan.

**13. COMMITMENTS AND CONTINGENCIES**

Operating Leases

Future minimum rental payments under all noncancelable operating leases with initial or remaining lease terms in excess of one year as of December 31, 2009 are as follows:

Year Ending December 31,	
2010	\$ 443,391
2011	443,391
2012	<u>319,572</u>
	<u>\$ 1,206,354</u>

Contingencies

The Company is subject to legal proceedings and claims which arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to such actions will not materially affect the financial position or results of operations of the Company.

**TELESTREAM, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Continued)

**14. PRIOR PERIOD ADJUSTMENT**

Management has determined that certain accounts of a subsidiary acquired in 2008 were incorrectly omitted. The financial statement balances for the year ended December 31, 2008 have been restated to properly reflect the inclusion of these accounts.

	2008 Balances as Previously Stated	Adjustments	2008 Balances as Restated
Cash	\$ 2,808,022	\$ 264,458	\$ 3,072,480
Accounts receivable	3,120,846	1,927	3,122,773
Income taxes payable		307,508	307,508
Deferred revenue	2,374,387	19,736	2,394,123
Accumulated deficit	(7,719,177)	(60,862)	(7,780,039)
Administrative expenses	2,489,354	178,854	2,668,208
Engineering expenses	5,177,205	(166,877)	5,010,328
Interest income	8,102	5,115	13,217
Income tax benefit	(195,000)	54,000	(141,000)
Net income	126,329	(60,862)	65,467