SBE INC
Form 10-K
January 29, 2007

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS
PURSUANT TO SECTIONS 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

(Mark One)

ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended October 31, 2006

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _________ to ___________

Commission File No. 0-8419

SBE, INC.
(Exact name of Registrant as specified in its charter)

Delaware	94-1517641
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

4000 Executive Parkway, Suite 200, San Ramon, California 94583
(Address of principal executive offices and Zip Code)

(925) 355-2000
(Registrant's Telephone Number, including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock
(Title of Class)

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No ý

Indicate by check mark whether the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No ý

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ¨ No ý

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

The approximate aggregate market value of the common stock of the registrant held by non-affiliates of the registrant, based on the closing price for the registrant's common stock on April 30, 2006 as reported on the Nasdaq Capital Markets, was $8,336,445. Shares of Common Stock held by each executive officer, director and stockholder whose ownership exceeds five percent of Common Stock outstanding have been excluded because such persons may be deemed to be affiliates of the registrant. This determination of affiliate status for purposes of the foregoing calculation is not necessarily a conclusive determination of affiliate status for other purposes.

The number of shares of the registrant's common stock outstanding as of January 23, 2007 was 11,130,831.

SBE, INC.

FORM 10-K

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SPECIAL NOTE ON FORWARD LOOKING STATEMENTS

Certain statements set forth in or incorporated by reference in this Annual Report on Form 10-K constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements include, without limitation, our expectations regarding our sales of storage software, our expectations regarding the market for client server networking products, the adequacy of anticipated sources of cash, planned capital expenditures, the effect of interest rate increases, and trends or expectations regarding our operations. Words such as "may," "will," "should," "believes," "anticipates," "expects," "intends," "plans," "estimates" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Such statements are based on currently available operating, financial and competitive information and are subject to various risks and uncertainties. Readers are cautioned that the forward-looking statements reflect management's estimates only as of the date hereof, and we assume no obligation to update these statements, even if new information becomes available or other events occur in the future. Actual future results, events and trends may differ materially from those expressed in or implied by such statements depending on a variety of factors, including, but not limited to those set forth under "Item 1A Risk Factors" on page 12 and elsewhere in this Annual Report on Form 10-K.

PART I

ITEM 1. BUSINESS

Overview

SBE designs, manufactures and sells embedded hardware products including wide area network (WAN) and local area network (LAN) network interface cards (NICs) and central processing units (CPUs) to OEMs who embed our hardware products into their products for the communications markets. Our embedded hardware products perform critical, computing and Input/Output (I/O) tasks in diverse markets such as high-end enterprise level computing servers, Linux super-computing clusters, workstations, media gateways, routers and Internet access devices.

We also design and provide software based storage networking solutions for an extensive range of business critical applications, including Disk-to-Disk Back-up and Disaster Recovery. We deliver an affordable, expandable, and easy-to-use portfolio of software solutions designed to enable optimal performance and rapid deployment across a wide range of next generation storage systems We sell standards-based storage software solutions to original equipment manufacturers (OEMs), system integrators and value added resellers (VARs) who embed our software into their IP storage area network (IP SAN) and network attached storage (NAS) systems to provide data storage solutions for the small and medium business (SMB) enterprise storage markets.

We experienced a decline in our sales volume of our embedded hardware products and a lack of market acceptance for our storage software that dramatically effected our operating cash flow for fiscal 2006. Because of the continuing decline of our cash balance, we have been evaluating strategic alternatives to return the company to cash flow positive and unlock value for our shareholders. In September 2006, our Board of Directors and management believed that the best course of action was to consider selling our embedded hardware and storage software businesses and to consider seeking a viable merger candidate.

On January 11, 2007, we signed an asset purchase agreement with One Stop Systems, Inc., a private California corporation, to purchase our embedded hardware business for $2.2 million cash plus the assumption of our corporate headquarters office lease and a lease for certain engineering equipment. When the divesture of our embedded hardware business is completed we will no longer participate in the embedded hardware markets. We will transfer all our inventor and the engineering and test equipment associated with the embedded hardware business to One Stop.

On January 19, 2007, we entered into an Agreement and Plan of Merger and Reorganization, with Neonode Inc., a Delaware corporation. Neonode is a Swedish based developer and manufacturer of multimedia mobile handsets. With over five years of research and development Neonode is today a leader and trendsetter in buttonless touch screen mobile phones and gesture-based user interfaces. Neonode mobile phones are based on patented technologies. With Neonode's open Microsoft based platform consumers can themselves upgrade and customize their handsets similar to a PC. It is anticipated that our name will be changed to “Neonode Inc.” in connection with the completion of the merger.

We intend to file a proxy statement in connection with the merger with Neonode. The proxy statement, when it becomes available, will contain important information about the merger transaction. Free copies of the proxy statement will be available at the SEC's web site at www.sec.gov.

We are evaluating strategic alternatives regarding our storage software business.

Products & Technologies

Storage Products

Storage Software Management Solutions

Managing, growing, and protecting storage is regarded as one of the most burdensome and expensive responsibilities of a company’s data center management. In the direct-attached storage (DAS) environments that most small to mid-sized companies deploy, the process of managing storage is made more difficult by the number of physical connection points and the number of storage systems in the organization. Imagine an environment with ten computers, each with its own storage system. That creates ten storage systems that need to be managed and maintained, which then equates to ten times the effort normally required in order to handle storage expansion, reallocation and repairs. One of the main driving forces behind a transition from DAS to a SAN is often high data growth and the need for operations efficiency. In these circumstances the legacy DAS environment becomes increasingly complex, backup/restore operations become increasingly unreliable, and the storage environment is unable to support the demands of the business.

Developed to extend the reach of SANs by enabling SAN functionality over the IP network, Internet Small Computer System Interface (iSCSI) technology uses the SCSI command set over Transmission Control Protocol/ Internet Protocol (TCP/IP), enabling any requesting node on the IP network (the initiator) to contact any remote storage server (the target) and perform block I/O on the target as if it was a local hard drive. Because of the ubiquity of IP networks, iSCSI can be used to transmit data over LANs, WANs, or the Internet and can enable location independent data storage and retrieval. iSCSI has no distance limitations, can utilize existing network infrastructure, does not require specialized training, and takes advantage of Ethernet’s economies of scale. With the immediate availability of 10G adapters and switches, we believe that iSCSI SANs can more than double the performance levels of leading-edge Fibre Channel implementations, while mass adoption continues to drive costs down.

On top of all that, regulatory compliance pressures, the need to integrate geographically dispersed data assets, and the availability of effective information life-cycle management solutions create further issues and serve as drivers behind the move to IP SANs. Another significant driver behind IP SANs is the availability of data center staff. Most smaller, regional, and departmental data centers have to operate with limited staff. Often, the decision to move to a SAN environment hinges on whether the existing staff can handle it. In these cases an IP SAN solution becomes a viable alternative, since it can almost always be more easily managed by existing staff and skill sets.

Our IP SAN Director Suite addresses the need for easy-to-manage, inexpensive storage and data protection through our iSCSI transport stack, storage management features, and data protection modules.

The iSCSI transport stack is the foundation of our IP SAN Director Suite and is scalable from Wi-Fi to 10 Gigabit Ethernet. It delivers the same level of reliability, quality of service and system robustness as alternative solutions, such as Fibre Channel, but at a fraction of the cost. We believe that the advanced features designed into the architecture of our iSCSI protocol stack enables highly efficient and cost-effective storage transport by optimizing bandwidth usage, enabling unlimited storage to be attached to each target device, and leveraging existing network technologies.

Our iSCSI protocol stack provides multipathing I/O functionality for maximum redundancy and reliability, aggregation of bandwidth to reduce service costs, as well as multiple connections per session to increase bandwidth efficiency and data integrity. Enterprise-level quality of service functionality enables traffic to be consistently classified, prioritized, and queued at line rate. We believe that the Error Recovery Level 2 (ERL2) featured in our iSCSI protocol stack increases system reliability, availability and adaptability. ERL2 supports active/active task migration, which prevents session and data loss. Our iSCSI stack is fully tested and compliant with IETF RFC-3720 iSCSI standards, including all mandatory and optional feature sets. Our SBE iSCSI target supports most Linux distributions and is compatible with any compliant iSCSI initiator under any OS distribution, including Linux, Windows and Solaris. An additional benefit of using iSCSI transport is its interoperability with any storage protocol disk drive interfaces (SCSI, Serial Attached SCSI (SAS), Serial ATA (SATA), Fiber Channel drives).

On top of our foundation iSCSI protocol stack, we have developed and manufactured a wide variety of storage management features and data protection modules. While the iSCSI protocol stack provides for a robust, inexpensive, and highly scalable transport infrastructure, modules included in our IP SAN Director Suite such as iSNS (Internet Storage Name Service), SNMP (Simple Network Management Protocol), Snapshot, High Availability, and Replication seamlessly address the needs and requirements of today’s IT storage managers.

The iSNS feature set provides similar functionality as a DHCP (Dynamic Host Configuration Protocol) server. As new storage subsystems are brought online, iSNS allows automatically names and adds them to the storage pool. Consistent with our integrated approach to system design, both an iSNS client and iSNS server are provided. To further ease the burdens of large-scan storage administration, the SNMP module allows the user to monitor the status of a large SAN from a single console.

As a component of our IP SAN Director Suite, the Snapshot add-in module provides critical data protection by creating point-in-time images of iSCSI data volumes. As a standalone application the snapshot module provides maximum protection; users may access data at discrete times in history when a combination of application error and user error overwrites, or corrupts critical data. In the event of a catastrophic event such as virus infection, the rollback feature allows the IT administrator to recover the entire data volume to a previously known healthy state. The Snapshot module conjoined with backup software running on an application server allows mainline, primary data access to continue, while the backup process copies the snapshot image to a secondary and offline storage.

Replication across storage subsystems is a critical part of any IP SAN data protection solution. Multiple versions of replication exist and are required for different purposes and application environments. To effectively address the wide spectrum of needs, we are developing 3 distinct Replication add-in modules that are seamlessly integrated into our IP SAN Director Suite. The first two add-in modules in our Replication portfolio address the need for data mirrors for primary storage within a SAN. With the Synchronous Online Replication module, both the local target and remote target must complete any writes from iSCSI initiators before an acknowledgment is sent. This guarantees data integrity and works well in low-latency SAN environments for primary storage.

There are some instances where performance is the top priority. In these cases, the Asynchronous Online Replication module is appropriate. Writes completed on the primary target are immediately acknowledged in parallel with writes that are sent to the mirror target, thus the latency associated with waiting for the mirror target to acknowledge a write are avoided. This is also beneficial in higher latency environments for backup when the mirror target may be on a WAN connection.

In a disaster recovery scenario, the mirror target is often located several hundred miles from the primary target and accessible only through a bandwidth-limited WAN connection. In this situation, the Offline Replication module is most appropriate. This module allows the system administrator to schedule replication events during discrete periods of time.

A complete IP SAN solution requires data availability and access features as well as data protection features. While SBE's Snapshot and Replication add-in modules support data protection, SBE is proud to offer High Availability as an additional module to directly address the need for uninterruptible access to missing critical data. In the event of failure at the primary storage director, the mirror storage director automatically takes over with no disruption and interruption of service to the initiators accessing the underlying storage. The high availability functionality is transparent to the initiators requiring zero additional configuration.

Hardware Products

Upon closing the sale of our embedded hardware business to One Stop Systems, estimated to take place in the second quarter of fiscal 2007, we will no longer have a hardware product line and the terms and conditions of the asset sale agreement prohibit us from competing in the embedded hardware markets for at least four year after the transaction is completed.

Network Interface Cards

Wide Area Networking Adapters. A WANis a computer or communications network that spans a relatively large geographical area. Computers attached to a WAN are often connected through dedicated networks, such as the telephone system, leased lines or satellites. Our series of WAN adapter products is designed to address the need for WAN interfaces in data communication products, such as those used in Internet and other communications routers, security firewalls, Virtual Private Network (VPN) servers and Voice over Internet Protocol (VoIP) gateways. We provide a broad range of standards-based interfaces that can be easily integrated into our OEM customers' products.

Local Area Networking Adapters. A LAN is a computer network spanning a relatively small geographical area. Often confined to a single building or group of buildings, most LANs connect workstations and personal computers in an office environment. Each computer in the LAN is able to access data and devices, such as printers, located anywhere on the LAN. There are many different types of LANs but Ethernet is the one that is most commonly deployed. Ethernet LAN connectivity is utilized by virtually every market segment in both the embedded and enterprise space.

Our LAN adapter products are focused on LAN connectivity using high speed Ethernet technology. We offer single, dual or quad port LAN adapters that feature connectivity speeds of up to 10 Megabits (Mb)/second, 100 Mb/second or 1000 Mb/second. Our Gigabit Ethernet NICs include trunking and failover features. These features allow our customers' systems to take advantage of static load balancing and failure recovery within a user-defined communications trunk. Our Gigabit Ethernet NICs are designed to distribute traffic across the aggregated links, detect port failures, and increase throughput. In the event of a system failure, the software will automatically redistribute outgoing loads across the remaining links.

Storage Network Interface Cards. Our storage NICs are comprised of SCSI products. SCSI is a parallel interface standard used by personal computers and many UNIX systems for attaching peripheral devices, such as printers and disk drives, to computers. SCSI interfaces are designed to allow for faster transmission rates than standard serial ports, which transfer data one bit at a time, and parallel ports, which simultaneously transfer data more than one bit at a time. Our series of SCSI host bus adapters are specifically designed for the enterprise Sun UNIX market. With transfer rates ranging from 40 Megabytes (MB)/sec to 320 MB/sec, our SCSI adapters have been utilized in data centers and enterprise environments within the financial, government, manufacturing, and healthcare sectors. These SCSI boards are also utilized in UNIX-based SCSI tape backup systems.

Encryption Adapters. Our securePMC series of high-performance security offload solutions is designed for integration into Linux-based systems. Advanced encryption processors accelerate SSL and IPsec cryptographic operations, significantly improving security, performance, and availability of networking applications. Designed to enable quick integration by OEMs, VARs and end users, our securePMC adapters can be used in a wide variety of networking equipment, including routers, switches, web servers, server load balancers, firewalls, SANs and VPN gateways.

TCP/IP Offload Engine (TOE). A TOE is a highly specialized TCP/IP protocol accelerator. Typically, in the form of a NIC, it is designed to reduce the amount of host CPU cycles required for TCP/IP processing and maximize Ethernet throughput. This is accomplished by offloading TCP/IP protocol processing from the host processor to the hardware on the TOE. It is designed to provide fast, reliable, and secure access to networked storage devices via the Internet without seriously impacting the host CPU.

Intelligent Communications Controllers

Our HighWire products are "intelligent," containing their own microprocessors and memory. This architecture allows our communications controllers to offload many of the lower-level communications tasks that would typically be performed by the host platform.

In the telecommunications market, the HighWire series of communications controller products provide high bandwidth intelligent connectivity to servers designed to act as gateways and signaling points within communication networks and network devices. The HighWire co-processing controllers enable operators of wireline and wireless networks to deliver Intelligent Network and Advanced Intelligent Network services such as Caller ID, voice messaging, personal number calling, Service Provider Local Number Portability, and customized routing and billing, as well as digital wireless services such as Personal Communications Systems (PCS) and Global System for Mobile Telecommunications (GSM). The HighWire products are designed for integration with standard server platforms that enable traditional carriers and new telecommunications entrants to pursue cost-reduced and performance-enhanced network architectures based on IP, broadband or other "packet" technologies.

Other

Although we continue to sell and manufacture legacy products such as Multibus, Versa Module Europa (VME) bus, and ISA, we emphasize three principal lines of products: storage software solutions, WAN/LAN adapter products, and carrier platforms (also known as our “HighWire” line).

The following table shows sales by major product type as a percentage of net sales for fiscal 2006, 2005 and 2004:

	Year Ended October 31,		
	2006	2005	2004
	(percentage of net sales)		
VME	8%	20%	43%
Adapters	59	48	46
HighWire	32	32	11
Storage Software	1	---	---
100%	100%	100%	

Distribution, Sales, and Marketing

We sell and license our products, both domestically and internationally, using a direct sales force as well as independent manufacturers' representatives, resellers, and distributors. We have a network of 8 manufacturers' representatives covering the United States and Canada. In addition, we have 12 distributors and resellers covering the United States, Canada, Western and Eastern Europe and Asia. We believe that our direct sales force is well suited to communicate how our products differ from those of our competitors. Since our products represent a complex and technical sale, our sales force is supported by field application engineers who provide customers with pre-sale technical assistance.

Our internal sales and marketing organization supports our channel marketing partners by providing sales collateral, such as product data sheets, presentations, and other sales/marketing resource tools. Our sales staff solicits prospective customers, provides technical advice with respect to our products, and works closely with marketing partners to train and educate their staffs on how to sell, install, and support our product lines.

We have focused our sales and marketing efforts in North America, Europe and Asia. All of our international sales are negotiated and executed in U.S. dollars. International sales constituted 43%, 37% and 12% of net sales in fiscal 2006, 2005 and 2004, respectively. . International sales are primarily executed in Europe with 31% to customers in the United Kingdom.

Our direct sales force is based in three locations in the United States and we conduct our marketing activities from our corporate headquarters in San Ramon, California.

Research and Development

We continue to invest in research and development of current and emerging technologies that we deem critical to maintaining our competitive position in the storage software market. Many factors are involved in determining the strategic direction of our product development focus, including trends and developments in the marketplace, competitive analyses, market demands, business conditions, and feedback from our customers and strategic partners. Our product development efforts are focused principally on our storage software products, providing advanced storage software features.

Subsequent to year-end, we entered into an Agreement for the Purchase and Sale of Assets with One Stop Systems, Inc., a manufacturer of industrial-grade computing systems and components, pursuant to which we agreed to sell all of the assets associated with our embedded hardware business. In addition, we entered into an Agreement and Plan of Merger and Reorganization, with Neonode Inc., a designer and manufacturer of mobile telephones in which we agreed to merge the two companies.

Although we are evaluating strategic alternatives for our storage software business including selling the business, we continued development of our storage software products to bring a broader spectrum of IP storage solutions to market. In fiscal 2006, we completed the development of some key storage networking solutions that enable an extensive range of business critical applications, including Disk-to-Disk Back-up and Disaster Recovery to complement our iSCSI based transport software.

During fiscal 2006, 2005 and 2004, we incurred $3.9 million, $2.7 million and $2.4 million, respectively, in product research and development expenses.

Manufacturing

We do not engage in any manufacturing operations. Instead, we utilize third-party manufacturers to build our embedded hardware products. We currently have non-exclusive manufacturing agreements with ProWorks, Inc., United Manufacturing, Inc. and Sonic Manufacturing Technology. We believe that ProWorks, United and Sonic are equipped to provide cost-efficient and timely product delivery, thus allowing us to focus on our core competencies of product development and technology innovation. The use of external manufacturing partners allows us to respond more quickly and effectively to fluctuations in customer demand.

Competition

The market for both storage and communications interface products is highly competitive. Many of our competitors have greater financial resources and are well established in the space. Competition within the communications market varies principally by application segment. Our storage software product competes with products designed and/or manufactured by Lefthand Networks, Wasabi Systems, OpenE Software, FalconStor Software and UNH. Our intelligent communications products compete with offerings from Radisys Corp, Performance Technologies, Interphase Corp, Artesyn Technologies, and Adax, along with various other platform and controller product providers. Our WAN/LAN products compete primarily with products from Performance Technologies, Motorola, Interphase Corp., Themis Computers, GE Fanuc and various other companies on a product-by-product basis. Our SCSI products compete with LSI, Adaptec, Qlogic and Sun Microsystems, Inc. Our TOE products compete with Qlogic and Adaptec. To compete and differentiate ourselves in our markets, we emphasize the functionality, engineering support, quality and price of our products in relation to the products of our competitors, as well as our ability to customize our products to meet the customers’ specific application needs.

Additionally, we compete with the internal engineering resources of our customers. Typically, as our customers become successful with their products, they seek to reduce costs and integrate functions. To compete with the internal engineering resources of our customers, we position ourselves as an extension of our customers’ engineering teams, focusing on satisfying their price/performance and time-to-market challenges through product innovation, technological expertise, and comprehensive support. By doing so, we emphasize the advantages and efficiencies of outsourcing embedded hardware and software, and keeping internal engineering resources focused on their core competencies and value-added services.

Intellectual Property

We believe that innovation in product engineering, sales, marketing, support, and customer relations, and protection of this proprietary technology and knowledge impacts our future success. Subsequent to year-end we entered into separate agreements to sell our embedded hardware business and to merge with a designer of mobile telephones. We rely on a combination of copyright, trademark, trade secret laws and contractual provisions to establish and protect our proprietary rights in our products. We typically enter into confidentiality agreements with our employees, strategic partners, channel partners and suppliers, and enforce strict limitations and access to our proprietary information.

Backlog

On October 31, 2006, we had a sales backlog of product orders of approximately $1.1 million, compared to a sales backlog of product orders of approximately $1.2 million as of October 31, 2005. Because customer purchase orders are subject to changes in customer delivery schedules, cancellation, or price changes, our backlog as of any particular date may not be representative of actual sales for any succeeding fiscal period. We do not anticipate any problems in fulfilling our current backlog.

Employees

Our employees represent one of our most valuable assets. We believe that our future success will depend, in part, on our ability to attract and retain qualified technical (particularly engineering), marketing and management personnel. We promote employee-focused programs designed to foster a positive and productive work environment, including specialized training/development, in-house seminars, and team-building activities.

On December 31, 2006, we had 34 employees. None of our employees are represented by a labor union. We have experienced no work stoppages. We believe our employee relations are positive.

ITEM 1A. RISK FACTORS

In addition to the other information in this Annual Report on Form 10-K, stockholders or prospective investors should carefully consider the following risk factors:

Risks Related to Our Business

Our future capital needs will require us to seek a merger partner and sell all or portions of our operating assets.

Our existing cash balances and our anticipated cash flow from operations will not satisfy our working capital needs for the foreseeable future. Because of the decline in our sales volume and the lack of market acceptance for our storage software, we evaluated strategic alternatives to enhance shareholder value. As a result of our evaluation, we entered into an agreement to sell our embedded hardware business to One Stop Systems, Inc. for $2.2 million in cash and the assumption of the lease on our headquarters building. We also signed an agreement to merge with Neonode, Inc. Both of these transactions are subject to the approval of our shareholders. After the sale of the embedded business and merger transactions are completed, we will no longer be active in the embedded hardware business and will change our name to “Neonode, Inc” and be active in the design and manufacturing of mobile telephones. Historically, the overwhelming majority of our cash flow from operations has been generated from our embedded hardware business that we are selling and after the sale of that business our future cash flow will be wholly dependent on Neonode’s ability to execute on its business plan.

Our future capital needs may exceed our ability to raise capital.

We do not believe that our existing cash balances and our anticipated cash flow from our currently operations will satisfy our working capital needs for the foreseeable future. Failure to sell our embedded hardware business to One Stop Systems and merge with Neonode will require us to seek additional financing in fiscal 2007. There can be no assurance that additional financing, if required, will be available on reasonable terms or at all. To the extent that additional capital is raised through the sale of additional equity or convertible debt securities, the issuance of such securities could result in additional dilution to our stockholders.

If our storage software products contain undetected errors, we could incur significant unexpected expenses and experience product returns and lost sales.

Our storage software products are highly technical and complex. While our storage software products have been tested, because of their nature, we can not be certain of their performance either as stand-alone products or when integrated with our customer’s product lines. There can be no assurance that defects or errors may not arise or be discovered in the future. Any defects or errors in our storage software products discovered in the future could result in a loss of customers or decrease in net revenue and market share.

We depend upon a small number of OEM customers. The loss of any of these customers, or their failure to sell their products, could limit our ability to generate revenues.

Orders by our OEM customers are affected by factors such as new product introductions, product life cycles, inventory levels, manufacturing strategies, contract awards, competitive conditions and general economic conditions. Our sales to any single OEM customer are also subject to significant variability from quarter to quarter. Such fluctuations may have a material adverse effect on our operating results. A significant reduction in orders from any of our OEM customers, could have a material adverse effect on our operating results, financial condition and cash flows.

Because of our dependence on single suppliers for some components, we may be unable to obtain an adequate supply of such components, or we may be required to pay higher prices or purchase components of lesser quality.

The chip sets used in some of our products are currently available only from a single supplier. If these suppliers discontinue or upgrade some of the components used in our products, we could be required to redesign a product to incorporate newer or alternative technology. The inability to obtain sufficient key components as required, or to develop alternative sources if and as required in the future, could result in delays or reductions in product shipments or margins that, in turn, would have a material adverse effect on our business, operating results, financial condition and cash flows. If enough components are unavailable, we may have to pay a premium in order to meet customer demand. Paying premiums for parts, building inventories of scarce parts and obsolescence of existing inventories could lower or eliminate our profit margin, reduce our cash flow and otherwise harm our business. To offset potential component shortages, we have in the past, and may in the future, carry an inventory of these components. As a result, our inventory of components parts may become obsolete and may result in write-downs.

If we fail to develop and produce new products, we may lose sales and our reputation may be harmed.

The markets for our products are characterized by rapidly changing technologies, evolving industry standards and frequent new product introductions. Our future success will depend on our ability to enhance our existing products and to introduce new products and features to meet and adapt to changing customer requirements and emerging technologies such as VoIP, third generation wireless services (3G Wireless), SATA, iSCSI, SAS, Gigabit Ethernet, 10G and TOE. There can be no assurance that we will be successful in identifying, developing, manufacturing and marketing new products or enhancing our existing products. In addition, there can be no assurance that services, products or technologies developed by others will not render our products obsolete.

We have focused a significant portion of our research and development, marketing and sales efforts on HighWire, WAN and LAN adapters and storage software products. The success of these products is dependent on several factors, including timely completion of new product designs, achievement of acceptable manufacturing quality and yields, introduction of competitive products by other companies, market acceptance of our products and our ability to sell our products. If the HighWire, adapter products, storage software or other new products developed by us do not gain market acceptance, our business, operating results, financial condition and cash flows would be materially adversely affected.

Our storage software products will require a substantial product development investment by us and we may not realize any return on our investment.

The development of new or enhanced products is a complex and uncertain process. As we develop new features for our storage software, our customers may experience design, manufacturing, marketing and other difficulties that could delay or prevent the development, introduction or marketing of new products and enhancements. Development costs and expenses are incurred before we generate any net revenue from sales of the products resulting from these efforts. We expect to incur additional research and development expenses relating to our storage software product lines, which could have a negative impact on our earnings in future periods.

The storage and embedded products market is intensely competitive, and our failure to compete effectively could reduce our revenues and margins.

We compete directly with traditional vendors of storage software and hardware devices, including Fibre Channel SAN products, open source “free” software, TOE and application-specific storage solutions. We compete with communications suppliers of routers, switches, gateways, NICs and other products that connect to the Public Switched Telephone Network (PSTN) and the Internet. In the future, we expect competition from companies offering client/server access solutions based on emerging technologies such as Fibre Channel, switched digital telephone services, iSCSI, SAS, TOE and other technologies. In addition, we may encounter increased competition from operating system and network operating system vendors to the extent that such vendors include full communications and storage capabilities in their products. We may also encounter future competition from telephony service providers (such as AT&T or the regional Bell operating companies) and storage product providers (such as EMC Corporation, Network Appliance, Inc. and Qlogic Corporation).

Increased competition with respect to any of our products could result in price reductions and loss of market share, which would adversely affect our business, operating results, financial condition and cash flows. Many of our current and potential competitors have greater financial, marketing, technical and other resources than we do. There can be no assurance that we will be able to compete successfully with our existing competitors or will be able to compete successfully with new competitors.

We signed an agreement to sell our embedded hardware business and that business generates substantially all our revenue and gross margin. We also risk the loss of customers for our embedded hardware products by announcing the sale of the embedded hardware business.

We depend on our key personnel. If we are unable to retain our current personnel and hire additional qualified personnel as needed, our business will be harmed.

We are highly dependent on the technical, management, marketing and sales skills of a limited number of key employees. We do not have employment agreements with, or life insurance on the lives of, any of our key employees. The loss of the services of any key employees could adversely affect our business and operating results. Our future success will depend on our ability to continue to attract and retain highly talented personnel to the extent our business grows. Competition for qualified personnel in the networking and software industries, and in the San Francisco Bay Area, is intense. There can be no assurance that we will be successful in retaining our key employees or that we can attract or retain additional skilled personnel as required.

We may be unable to protect our software, which could reduce any competitive advantage we have.

Although we believe that our future success will depend primarily on continuing innovation, sales, marketing and technical expertise and the quality of product support and customer relations, we must also protect the proprietary technology contained in our products. We do not currently hold any patents and rely on a combination of copyright, trademark, trade secret laws and contractual provisions to establish and protect proprietary rights in our products. There can be no assurance that steps taken by us in this regard will be adequate to deter misappropriation or independent third-party development of our technology. Although we believe that our products and technology do not infringe on the proprietary rights of others, there can be no assurance that third parties will not assert infringement claims against us.

Risks Associated with Ownership of Our Common Stock

The market price of our common stock is likely to continue to be volatile. You may not be able to resell your shares at or above the price at which you purchased such shares.

The trading price of our common stock is subject to wide fluctuations in response to quarter-to-quarter fluctuations in operating results, the failure to meet analyst estimates, announcements of technological innovations or new products by us or our competitors, general conditions in the computer and communications industries and other events or factors. Our common stock has historically had relatively small trading volumes. As a result, small transactions in our common stock can have a disproportionately large impact on the quoted price of our common stock.

If we continue to experience losses we could experience difficulty meeting our business plan, and our stock price could be negatively affected.

We experienced a decline in our sales volume of our embedded hardware products and a lack of market acceptance for our storage software that dramatically effected our operating cash flow for fiscal 2006. If we are unable to gain market acceptance of tour storage software solutions, we will experience continuing operating losses and negative cash flow from our operations. Any failure to achieve or maintain profitability could negatively impact the market price of our common stock. We anticipate that we will continue to incur product development, sales and marketing and administrative expenses. As a result, we will need to generate significant quarterly revenues if we are to achieve and maintain profitability. A substantial failure to achieve profitability could make it difficult or impossible for us to grow our business. Our business strategy may not be successful, and we may not generate significant revenues or achieve profitability. Any failure to significantly increase revenues would also harm our ability to achieve and maintain profitability. If we do achieve profitability in the future, we may not be able to sustain or increase profitability on a quarterly or annual basis.

Our merger with Neonode, Inc. may not produce the desired results.

In September 2006, our Board of Directors and management believed the best course of action was to consider selling our embedded hardware and storage software businesses and to consider seeking a viable merger candidate. On January 11, 2007, we signed an asset purchase agreement with One Stop Systems, Inc., a private California corporation, to purchase our embedded hardware business for $2.2 million cash plus the assumption of our corporate headquarters office lease and a lease for certain engineering equipment. When the divesture of our embedded hardware business is completed we will no longer participate in the embedded hardware markets. On January 19, 2007, we entered into an Agreement and Plan of Merger and Reorganization, with Neonode Inc., a Delaware corporation. Neonode is a Swedish based developer and manufacturer of multimedia mobile handsets. It is anticipated that our name will be changed to “Neonode Inc.” in connection with the completion of the merger.

There can be no assurance that we will be successful in obtaining the required approval of our shareholders, and if we do, we may not be successful in increasing shareholder value and our stock price may be negatively affected.

Our common stock is at risk for delisting from the Nasdaq Capital Market. If it is delisted, our stock price and your liquidity may be impacted.

Our common stock is currently listed on the Nasdaq Capital Market. Nasdaq has requirements that a company must meet in order to remain listed on the Nasdaq Capital Market. These requirements include maintaining a minimum closing bid price of $1.00 and minimum stockholders’ equity of $2.5 million. Our stockholders’ equity as of October 31, 2006 was approximately $3.3 million and our closing bid price on October 31, 2006 was $0.37.

On July 14, 2006, we received a notice from The Nasdaq Stock Market (Nasdaq) indicating that for 30 consecutive business days prior to the notification date, the bid price of our common stock closed below the $1.00 minimum bid price required for continued listing by Nasdaq Marketplace Rule 4310(c)(4) (the Rule). On January 11, 2007, we received a notice from Nasdaq that our stock is subject to delisting and that we would not be given an additional 180 day compliance period indicating that we did not meet Nasdaq’s initial listing criteria as set forth in Nasdaq Marketplace Rule 4310(c). Our shareholders’ equity is less than the required $5.0 million and the market value of our public float is less than the required $5.0 million. We filed an appeal of the staff’s determination to a Listings Qualifications Panel (Panel). Delisting of our stock from Nasdaq is stayed pending the determination of the Listings Qualifications Panel. We have an appeals hearing with the Panel scheduled for February 22, 2007.

If we fail to regain compliance with the standards necessary to be quoted on Nasdaq or we are unsuccessful in our appeal of the delisting determination and our common stock is delisted, trading in our common stock would be conducted on the OTC Bulletin Board as long as we continue to file reports required by the Securities and Exchange Commission. The OTC Bulletin Board is generally considered to be a less efficient market than Nasdaq, and our stock price, as well as the liquidity of our common stock, may be adversely impacted as a result.

Our certificate of incorporation and bylaws and the Delaware General Corporation Law contain provisions that could delay or prevent a change in control.

Our board of directors has the authority to issue up to 2,000,000 shares of preferred stock and to determine the price, rights, preferences and privileges of those shares without any further vote or action by the stockholders. The rights of the holders of common stock will be subject to, and may be materially adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. Furthermore, certain other provisions of our certificate of incorporation and bylaws may have the effect of delaying or preventing changes in control or management, which could adversely affect the market price of our common stock. In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law, an anti-takeover law.

ITEM 2. PROPERTIES

We lease 22,000 square feet of office space to house our engineering and administrative headquarters located in San Ramon, California. The lease expires in 2010. . In connection with the sale of our hardware business, on January 10, 2007, we signed a definitive agreement providing for the assumption of the lease of our San Ramon office space effective with the closing of the transaction. We will continue to be secondary guarantor on the lease for the term of the lease.

ITEM 3. LEGAL PROCEEDINGS

We are not a party to any pending legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of our stockholders in the fourth quarter of 2006.

IDENTIFICATION OF EXECUTIVE OFFICERS

Our executive officers and their respective ages and positions as of October 31, 2006 are set forth in the following table. There are no familial relationships between our directors or our executive officers and any other director or executive officer.

Name	Age	Position
Kenneth G. Yamamoto	51	President and Chief Executive Officer
David W. Brunton	56	Vice President, Finance, Chief Financial Officer, Treasurer and Secretary
Leo Fang	35	Executive Vice President
Nelson Abal	49	Vice President, Sales

Mr. Yamamoto was appointed President and CEO on March 3, 2006. Mr. Yamamoto joined SBE as Vice President and General Manager of the Storage Group following the acquisition of PyX Technologies, Inc in July 2005, where he had served as Chief Executive Officer since January 2005. Prior to PyX Technologies, Mr. Yamamoto was Co-Founder and COO of DataPath Systems, Inc., a developer of mixed-signal communication integrated circuits, which was acquired by LSI Logic, Inc. in July 2000. Mr. Yamamoto was Senior Director of Business Development for the Storage and Communications Division of LSI Logic, Inc. from July 2000 until December 2004.

Mr. Brunton joined us in November 2001 as Vice President, Finance, Chief Financial Officer, Secretary and Treasurer. From 2000 to 2001 he was the Chief Financial Officer for NetStream, Inc., a telephony broadband network service provider. From 1997 to 2000, Mr. Brunton was the Chief Financial Officer and Senior Vice President - Operations for ReSourcePhoenix.com, a financial services outsource provider. From 1987 to 1997, Mr. Brunton was the Corporate Controller for the Phoenix American Companies, an equipment leasing, cable TV, telecommunications and software development company. Mr. Brunton is a certified public accountant.

Mr. Fang was appointed Executive Vice President on May 22, 2007. He joined SBE as Vice President, Engineering following the acquisition of PyX Technologies in August 2005, where Mr. Fang served as COO. From 2000 through 2005, Mr. Fang was Director of SERDES and USB Development at LSI Logic, where he led a large, multi-disciplinary engineering department that developed an industry-leading transceiver product line. Before LSI Logic, Mr. Fang held several senior design engineering positions within storage-centric companies such as Quantum Corporation and DataPath Systems, Inc.

Mr. Abal joined us in November 2003 a our Western Region Sales Manager. Mr. Abal was appointed Vice President, Sales in July 2005. Prior to joining us, from 2001 to 2002, Mr. Abal was self employed as a network consultant. Prior to 2001 Mr. Abal was Director of Strategic Development for Peak XV, a network consulting business.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is quoted on the Nasdaq Capital Market under the symbol SBEI. The following table presents quarterly information on the price range of our common stock, indicating the high and low bid prices reported by the Nasdaq Capital Market. These prices do not include retail markups, markdowns or commissions. As of December 31, 2006, there were approximately 427 holders of record of our common stock.

Fiscal 2006	Fiscal quarter ended January 31	April 30	July 31	October 31
High	$ 1.44	$ 1.08	$ 0.40	$ 0.38
Low	1.33	1.05	0.36	0.35
Fiscal 2005				
High	$ 4.59	$ 3.55	$ 3.65	$ 3.50
Low	3.03	2.30	2.09	2.17

There are no restrictions on our ability to pay dividends; however, it is currently the intention of our Board of Directors to retain all earnings, if any, for use in our business and we do not anticipate paying cash dividends in the foreseeable future. Any future determination as to the payment of dividends will depend, among other factors, upon our earnings, capital requirements, operating results and financial condition.

The following table includes information regarding our equity incentive plans as of the end of fiscal 2006:

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	3,661,087(1)	$ 2.53	108,750
Equity compensation plans not approved by security holders	388,785(2)	$ 2.24	135,699
Total	4,049,872	$ 2.50	244,449

(1) Includes options to purchase 1,021,200 shares our common stock at $2.17 per share pursuant to the PyX 2005 Employee Stock Option Plan assumed by us as part of the PyX acquisition.

(2) See Footnote 11 "Stock Option and Stock Purchase Plans" to the SBE, Inc. financial statements.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Financial Statements and the Notes thereto included elsewhere in this Form 10-K.

For years ended October 31, and at October 31 (in thousands, except for per share amounts and number of employees)	2006	2005	2004	2003	2002
Net sales	$ 6,127	$ 8,056	$ 11,066	$ 7,456	$ 6,898
Net income (loss)	$ (16,183)	$ (4,230)	$ (1,679)	$ 563	$ (1,731)
Net income (loss) per share - basic	$ (1.57)	$ (0.66)	$ (0.33)	$ 0.13	$ (0.46)
Net income (loss) per share - diluted	$ (1.57)	$ (0.66)	$ (0.33)	$ 0.12	$ (0.46)
Product research and development Expenses	$ 3,979	$ 2,694	$ 2,411	$ 1,330	$ 3,027
Working capital	$ 1,701	$ 5,520	$ 3,939	$ 3,945	$ 2,985
Total assets	$ 4,868	$ 18,832	$ 6,173	$ 6,975	$ 5,321
Long-term liabilities	$ 255	$ 241	$ 139	$ 217	$ 10
Stockholders' equity	$ 3,321	$ 17,348	$ 4,303	$ 5,387	$ 3,696
Number of employees	34	37	36	32	24

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

We experienced a decline in our sales volume of our embedded hardware products and a lack of market acceptance for our storage software that dramatically effected our operating cash flow for fiscal 2006. Because of the continuing decline of our cash balance, we have been evaluating strategic alternatives to return the company to cash flow positive and unlock value for our shareholders. In September 2006, our Board of Directors and management believed that the best course of action was to consider selling our embedded hardware and storage software businesses and to consider seeking a viable merger candidate.

We design, manufacture and sell embedded hardware products including wide area network (WAN) and local area network (LAN) network interface cards (NICs) and central processor units (CPUs) to OEMs who embed our hardware products into their products for the communications markets. Our hardware products perform critical, computing and, Input/Output (I/O) tasks in diverse markets such as high-end enterprise level computing servers, Linux super-computing clusters, workstations, media gateways, routers and Internet access devices.

We also design and provide software based storage networking solutions for an extensive range of business critical applications, including Disk-to-Disk Back-up and Disaster Recovery. We deliver an affordable, expandable and easy-to-use portfolio of software solutions designed to enable optimal performance and rapid deployment across a wide range of next generation storage systems. We sell standards-based storage software solutions to original equipment manufacturers (OEMs), system integrators and value added resellers (VARs) who embed our software into their IP storage area network (IP SAN) and network attached storage (NAS) systems to provide data storage solutions for the small and medium business (SMB) enterprise storage markets.

Our products are distributed worldwide through a direct sales force, distributors, independent manufacturers' representatives and value-added resellers.

Our business is characterized by a concentration of sales to a small number of OEMs and distributors who provide products and services to the communications and data storage markets. Consequently, the timing of significant orders from major customers and their product cycles cause fluctuation in our operating results. Data Connection Limited (DCL) was the largest of our customers representing 31% of our sales in fiscal 2006. The Hewlett Packard Company (HP) has historically been one of our largest customer and represented 13% and 45% of net sales in fiscal 2005 and 2004 respectively. We shipped the last $1.0 million of VME products to HP in the first quarter of fiscal 2005. We do not expect to receive any future purchase orders from HP.

During the year ended October 31, 2006, $257,000 or 4% of our sales were sold to distributors compared to $640,000 or 8% and $874,000 or 8% in fiscal 2005 and 2004, respectively. Our reserves for distributor programs total approximately $13,000 and $22,000 as of October 31, 2006 and 2005, respectively.

On January 11, 2007, we entered into an asset purchase Agreement for the Purchase and Sale of Assets (the Purchase Agreement) with One Stop Systems, Inc., a manufacturer of industrial-grade computing systems and components (One Stop), pursuant to which we agreed to sell all of the assets associated with our embedded hardware business (excluding cash, accounts receivable and other excluded assets specified in the asset purchase agreement) to One Stop for approximately $2.2 million in cash plus One Stop’s assumption of the lease of our corporate headquarters building and certain equipment leases. Substantially all our revenue has been generated from our embedded hardware business. Upon closing the sale of our embedded hardware business to One Stop Systems we will no longer have a hardware product line and the terms and conditions of the asset sale agreement prohibit us from competing in the embedded hardware markets for at least four year after the transaction is completed.

On January 19, 2007, we entered into an Agreement and Plan of Merger and Reorganization, with Neonode Inc., a Delaware corporation. Neonode is a Swedish based developer and manufacturer of multimedia mobile handsets. With over five years of research and development, Neonode is today a leader and trendsetter in buttonless touch screen mobile phones and gesture based user interfaces. Neonode mobile phones are based on patented technologies. With Neonode's open Microsoft based platform, consumers can themselves upgrade and customize their handsets similar to a PC. It is anticipated that our name will be changed to “Neonode Inc.” in connection with the completion of the merger.

We intend to file a proxy statement in connection with the merger with Neonode. The proxy statement, when it becomes available, will contain important information about the merger transaction. Free copies of the proxy statement will be available at the SEC's web site at www.sec.gov.

We are evaluating strategic alternatives regarding our storage software business.

In the future, if any of our major customers reduces orders for our products, we could lose revenues and suffer damage to our business reputation. Orders by our OEM customers are affected by factors such as new product introductions, product life cycles, inventory levels, manufacturing strategy, contract awards, competitive conditions and general economic conditions.

On October 31, 2006, we had a sales backlog of product orders of approximately $1.1 million compared to a sales backlog of product orders of approximately $1.2 million as of October 31, 2005.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include levels of reserves for doubtful accounts, obsolete inventory, warranty costs and deferred tax assets. Actual results could differ from those estimates.

Our critical accounting policies and estimates include the following:

Revenue Recognition:

Hardware Products

Our policy is to recognize revenue for hardware product sales when title transfers and risk of loss has passed to the customer, which is generally upon shipment of our hardware products to our customers. We defer and recognize service revenue over the contractual period or as services are rendered. We estimate expected sales returns and record the amount as a reduction of revenue and cost of hardware and other revenue at the time of shipment. Our policy complies with the guidance provided by the Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements*. Judgments are required in evaluating the credit worthiness of our customers. Credit is not extended to customers and revenue is not recognized until we have determined that collectibility is reasonably assured. Our sales transactions are denominated in U.S. dollars. The software component of our hardware products is considered incidental. Therefore, we do not recognize software revenue related to our hardware products separately from the hardware product sale.

When selling hardware, our agreements with OEMs, such as DCL and Nortel Networks Corp. (Nortel), typically incorporate clauses reflecting the following understandings:

- all prices are fixed and determinable at the time of sale;
- title and risk of loss pass at the time of shipment (FOB shipping point);
- collectibility of the sales price is probable (the OEM is creditworthy, the OEM is obligated to pay and such obligation is not contingent on the ultimate sale of the OEM's integrated solution);
- the OEM's obligation to us will not be changed in the event of theft or physical destruction or damage of the product;
- we do not have significant obligations for future performance to directly assist in the resale of the product by the OEMs; and
- there is no contractual right of return other than for defective products.

Our agreements with our distributors include certain product rotation and price protection rights. All distributors have the right to rotate slow moving products once each fiscal quarter. The maximum dollar value of inventory eligible for rotation is equal to 25% of our products purchased by the distributor during the previous quarter. In order to take advantage of their product rotation rights, the distributors must order and take delivery of additional products of ours equal to at least the dollar value of the products that they want to rotate.

Each distributor is also allowed certain price protection rights. If and when we reduce or plan to reduce the price of any of our products and the distributor is holding any of the affected products in inventory, we will credit the distributor the difference in price when they place their next order with us. We record an allowance for price protection at the time of the price reduction, thereby reducing our net sales and accounts receivable. The allowance is based on the price difference of the inventory held by our stocking distributors at the time we expect to reduce selling prices. We believe we are able to fully evaluate potential returns and adjustments and continue to recognize the sale based on shipment to our distributors. Reserves for the right of return and restocking are established based on the requirements of Statement of Financial Accounting Standards (SFAS) SFAS 48, *Revenue Recognition when Right of Return Exists.*

During the year ended October 31, 2006, $257,000 or 4% of our sales were sold to distributors compared to $640,000 or 8% and $874,000 or 8% in fiscal 2005 and 2004, respectively. Our reserves for distributor programs total approximately $13,000 and $22,000 as of October 31, 2006 and 2005, respectively.

Software Products

We derive revenues from the following sources: (1) software, which includes new iSCSI software licenses and (2) services, which include consulting. We account for the licensing of software in accordance with of American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition.* SOP 97-2 requires judgment, including whether a software arrangement includes multiple elements, and if so, whether vendor-specific objective evidence (VSOE) of fair value exists for those elements. These documents include post delivery support, upgrades and similar services. We typically charge software maintenance equal to 20% of the software license fees.

For software license arrangements that do not require significant modification or customization of the underlying software, we recognize new software license revenues when: (1) we enter into a legally binding arrangement with a customer for the license of software; (2) we deliver the products; (3) customer payment is deemed fixed or determinable and free of contingencies or significant uncertainties; and (4) collection is reasonably assured. We initially defer all revenue related to the software license and maintenance fees until such time that we are able to establish VSOE for these elements of our software products. Revenue deferred under these arrangements is recognized to revenue over the expected contract term. We will also continue to defer revenues that represent undelivered post-delivery engineering support until the engineering support has been completed and the software product is accepted.

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For one customer we began recognizing software license fee revenue and related engineering support revenue by amortizing previously deferred revenue related to engineering services over 36-months beginning in March 2006, which was the month the first software license for this customer was activated. The 36-month amortization period is the estimated life of the related software product for this customer. We also amortize all fees related to the licensing of our software to this customer over 36-months beginning with the month the software license is activated. In the fiscal year ended October 31, 2006, we recognized $16,800 of software license fees for this customer and $26,000 of deferred revenue related to engineering services to this customer.

Certain software arrangements include consulting implementation services sold separately under consulting engagement contracts. For the fiscal year ended October 31, 2006, we recognized $10,000 of software consulting revenue.

Allowance for Doubtful Accounts:

Our policy is to maintain allowances for estimated losses resulting from the inability of our customers to make required payments. Credit limits are established through a process of reviewing the financial history and stability of each customer. Where appropriate, we obtain credit rating reports and financial statements of the customer when determining or modifying their credit limits. We regularly evaluate the collectibility of our trade receivable balances based on a combination of factors. When a customer’s account balance becomes past due, we initiate dialogue with the customer to determine the cause. If it is determined that the customer will be unable to meet its financial obligation to us, such as in the case of a bankruptcy filing, deterioration in the customer’s operating results or financial position or other material events impacting their business, we record a specific allowance to reduce the related receivable to the amount we expect to recover. Should all efforts fail to recover the related receivable, we will write-off the account.

We also record an allowance for all customers based on certain other factors including the length of time the receivables are past due and historical collection experience with customers. We believe our reported allowances are adequate. If the financial conditions of those customers were to deteriorate, however, resulting in their inability to make payments, we may need to record additional allowances which would result in additional general and administrative expenses being recorded for the period in which such determination was made.

Warranty Reserves:

We accrue the estimated costs to be incurred in performing warranty services at the time of revenue recognition and shipment of the products to the OEMs. Because there is no contractual right of return other than for defective products, we can reasonably estimate such returns and record a warranty reserve at the point of shipment. Our estimate of costs to service our warranty obligations is based on historical experience and expectation of future conditions. To the extent we experience increased warranty claim activity or increased costs associated with servicing those claims, the warranty accrual will increase, resulting in decreased gross margin.

Inventories:

Inventories are stated at the lower of cost, using the first-in, first-out method, or market value. We utilize standard cost, which approximates actual costs for certain indirect costs.

We are exposed to a number of economic and industry factors that could result in portions of our inventory becoming either obsolete or in excess of anticipated usage, or subject to lower of cost or market issues. These factors include, but are not limited to, technological changes in our markets, our ability to meet changing customer requirements, competitive pressures in products and prices, and the availability of key components from our suppliers. Our policy is to establish inventory reserves when conditions exist that suggest that our inventory may be in excess of anticipated demand or is obsolete based upon our assumptions about future demand for our products and market conditions. We regularly evaluate our ability to realize the value of our inventory based on a combination of factors including the following: historical usage rates, forecasted sales or usage, product end-of-life dates, estimated current and future market values and new product introductions. Purchasing practices and alternative usage avenues are explored within these processes to mitigate inventory exposure. When recorded, our reserves are intended to reduce the carrying value of our inventory to its net realizable value. If actual demand for our products deteriorates, or market conditions are less favorable than those that we project, additional inventory reserves may be required.

Income Taxes:

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes.* SFAS 109 requires recognition of deferred tax liabilities and assets for the expected future tax consequences of items that have been included in the financial statements or tax returns. Deferred income taxes represent the future net tax effects resulting from temporary differences between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Valuation allowances are recorded against net deferred tax assets where, in our opinion, realization is uncertain. Based on the uncertainty of future pre-tax income, we fully reserved our deferred tax assets as of October 31, 2006 and 2005. In the event we were to determine that we would be able to realize our deferred tax assets in the future, an adjustment to the deferred tax asset would increase income in the period such determination was made. The provision for income taxes represents the net change in deferred tax amounts, plus income taxes payable for the current period.

Long-lived Assets:

We assess any impairment by estimating the future cash flow from the associated asset in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. If the estimated undiscounted cash flow related to these assets decreases in the future or the useful life is shorter than originally estimated, we may incur charges for impairment of these assets. The impairment is based on the estimated discounted cash flow associated with the asset. Capitalized software costs consist of costs to purchase software and costs to internally develop software. Capitalization of software costs begins upon the establishment of technological feasibility. All capitalized software costs are amortized as related sales are recorded on a per-unit basis with a minimum amortization to cost of goods sold based on a straight-line method over the estimated useful life, generally two to three years. We evaluate the estimated net realizable value of each software product and record provisions to the asset value of each product for which the net book value is in excess of the net realizable value.

During fiscal 2006, we evaluated the current expected cash flow from the sale of storage software and determined that the net book value was in excess of the net realizable value. In the year ended October 31, 2006, we recorded asset impairment charges of $6.5 million against our earnings for the period, reducing our capitalized storage software asset to $1.3 million, which represents the present value of the expected future sales of our storage software products less costs. This asset impairment charge is included in amortization of purchased software in the Statements of Operations for the fiscal year ended October 31, 2006. Prior to the write-down, we amortized our storage software over 36 months at the rate of $339,000 per month. We will amortize the remaining $1.3 million software asset over the remaining 21-month amortization period at the rate of $63,000 per month.

New Accounting Pronouncements:

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 will be effective for us beginning November 1, 2007. We are currently evaluating this interpretation to determine if it will have a material impact on our financial statements.

In September 2006, the SEC issued SAB 108, *Considering the Effects of Prior Year Misstatements in Current Year Financial Statements.* SAB 108 expresses the SEC Staff's views regarding the process of quantifying financial statement misstatements. SAB 108 addresses the diversity in practice in quantifying financial statement misstatements and the potential under current practice for the build up of improper amounts on the balance sheet. SAB 108 will be effective for the year beginning November 1, 2006. The cumulative effect of the initial application of SAB 108 will be reported in the carrying amounts of assets and liabilities as of the beginning of the fiscal year, with the offsetting balance to retained earnings. We do not expect the adoption of SAB 108 to have a material impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value as required by other accounting pronouncements and expands fair value measurement disclosures. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of SFAS 157 on our financial statements.

Results of Operations

The following table sets forth, as a percentage of net sales, certain statements of operations data for the fiscal years ended October 31, 2006, 2005 and 2004. These operating results are not necessarily indicative of our operating results for any future period.

	Year Ended October 31,		
	2006	**2005**	**2004**
Net sales	100%	100%	100%
Operating expenses:			
Amortization and impairment of acquired			
software and intellectual property	161	13	11
Cost of hardware and other revenue	66	54	49
Product research and development	65	33	22
Sales and marketing	36	28	19
General and administrative	37	24	16
Loan loss recovery	---	---	(2)
Total operating expenses	365	85	55
Operating loss before income taxes	(265)	(52)	(15)
Income tax (provision) benefit	---	---	---
Net loss	(265)%	(52)%	(15)%

Net Sales

Net sales for fiscal 2006 were $6.1 million, a 25% decrease from $8.1 million in fiscal 2005. Our net sales for fiscal 2005 represents a 27% decrease from $11.1 million in fiscal 2004. The decrease in fiscal 2006 sales as compared to fiscal 2005 were primarily attributable to a decrease in sales to what was our largest customer, HP. We did not have any sales to HP in fiscal 2006 compared to $1.0 million in fiscal 2005. In addition, sales to other customers also decreased in fiscal 2006 as compared to 2005, most notably a $400,000 reduction in the sales of our Antares products to our distributors, a $300,000 year over year reduction in sales to DCL and a $100,000 reduction in sales to Nortel The decrease in fiscal 2005 net sales as compared to fiscal 2004 was primarily attributable to a decrease in sales to HP. Sales to HP were $1.0 million in fiscal 2005 compared to $4.9 million in fiscal 2004. We shipped our final order for $1.0 million of VME products to HP in the first quarter of fiscal 2005. Sales to HP, primarily of VME products, represented 0% of net sales in fiscal 2006 compared to 13% of net sales for fiscal 2005 and 45% during fiscal 2004. Sales to individual customers in excess of 10% of net sales for the year ended October 31, 2006 included sales to DCL located in the United Kingdom of $1.9 million, or 31% of net sales, Nortel of $1.3 million, or 21% of net sales and Raytheon of $750,000, or 12% of net sales. In fiscal 2005, sales to DCL were $2.2 million, or 28% of net sales and to were Nortel of $1.4 million, or 18% of net sales. Sales to Nortel were $1.5 million, or 13% of net sales in fiscal 2004.

Sales of our adapter products were $4.0 million for fiscal 2006, as compared to $4.0 million in fiscal 2005 and $4.9 million in fiscal 2004. Sales of our HighWire products were $2.0 million in fiscal 2006, as compared to $2.5 million in fiscal 2005 and $1.3 million in fiscal 2004. Our adapter products are used primarily in edge-of-the-network applications such as VPN and other routers, VoIP gateways and security devices, whereas our HighWire products are primarily targeted at core-of-the-network applications used primarily by telecommunications central offices.

Revenue from software license fees was $16,700 and from software consulting services $36,100 in fiscal 2006 compared to none in prior years.

Our sales backlog at October 31, 2006 was $1.1 million compared to $1.2 million at October 31, 2005. Most of our backlog at October 31, 2006 will be shipped to customers in the first quarter of fiscal 2007.

While we anticipated an increase in the sales volume of our storage software, adapter and HighWire products over the course of fiscal 2006 as certain of our prior design wins went into production and our software products gained market acceptance, the expected sales growth did not occur. Because of the decline in our sales volume and the lack of market acceptance for our storage software, we evaluated strategic alternatives to enhance shareholder value. As a result of our evaluation, we entered into an agreement to sell our embedded hardware business to One Stop Systems, Inc., a manufacturer of industrial-grade computing systems and components and an agreement to merge the company with Neonode, Inc., a designer and manufacturer of mobile multi-media telephones. After the sale of the embedded business and merger transactions are completed, we will no longer be active in the embedded hardware business and will change our name to “Neonode, Inc” and be active in the design and manufacturing of mobile multi-media telephones with patented buttonless touch screen mobile phones and gesture-based user interfaces.

We are evaluating strategic alternatives regarding our storage software business.

International sales constituted 43%, 37% and 12% of net sales in fiscal 2006, 2005 and 2004, respectively. International sales are primarily executed in Europe with 31% to customers in the United Kingdom. All international sales are executed in U.S. dollars.

Amortization and Impairment of Purchased Software and Intellectual Property

We recorded a software asset totaling $12.4 million when we acquired PyX and capitalized $256,000 related to the development of the now discontinued VoIP products. We also continually upgrade our software by enhancing the existing features of our products and by adding new features and products. We often evaluate whether to develop these new offerings in-house or whether we can achieve a greater return on investment by purchasing or licensing software from third parties. Based on our evaluations we have purchased or licensed various software for resale since 1996.

Recurring amortization of capitalized software and intellectual property costs totaled $3.4 million for the fiscal year ended October 31, 2006 compared to $1.0 million for the fiscal year ended October 31, 2005 and $408,000 for the fiscal year ended October 31, 2004 and is included in amortization of purchased software and intellectual property in our Statements of Operations. The increase in 2006 over 205 and 2004 was due to the amortization of the software asset acquired in the PyX acquisition.

In the fiscal year ended October 31, 2006 we discontinued our VoIP product development and as a result wrote-off $256,000 of capitalized software development costs related to the VoIP products. This write-off is included in our product research and development expense in our Statements of Operations.

In the fiscal year ended October 31, 2006, we recorded an asset impairment charge of $6.5 million against our earnings for the year, reducing our storage software asset to $1.3 million. This asset impairment charge is included in amortization and impairment of purchased software and intellectual property in our Statements of Operations. Prior to the write-down, we amortized our storage software over 36 months at the rate of $339,000 per month. We will amortize the remaining $1.3 million software asset over the remaining 21 month amortization period at the rate of $63,000 per month.

In the fiscal ended October 31, 2004 we recorded an asset impairment charge of $713,000 against our earnings for the year. We wrote off the remaining balance of the intellectual property asset related to our acquisition of Antares Microsystems, Inc. This asset impairment charge is included in amortization and impairment of purchased software and intellectual property in our Statements of Operations.

Cost of Hardware Products and Other Revenue

Cost of hardware products and other revenues consists of the direct and indirect costs of our manufactured hardware products and the cost of personnel in our operations and production departments including share-based payment compensation expense associated with the implementation of SFAS No. 123(R) *Share Based Payment*. Cost of hardware products and other revenues for the year ended October 31, 2006 decreased by 7% to $4.0 million compared with $4.4 million for the fiscal year ended October 31, 2005. Cost of hardware products and other revenues for the fiscal year ended October 31, 2005 decreased by 19.8% compared with $5.4 million the fiscal year ended October 31, 2004. The decrease in cost of hardware products and other revenue in absolute dollars for both the comparative fiscal periods was principally due to a lower volume of hardware sales that decreased the total direct and indirect cost of our manufactured products.

Included in cost of hardware products and other revenue expense for the fiscal year ended October 31, 2006 is $80,000 of non-cash stock-based compensation expense related to the stock-for-pay program, stock option expense under SFAS 123R and the issuance of restricted stock to employees compared to none in 2005 and 2004.

Gross profit is calculated as net sales less the cost of hardware and other revenue. Gross profit as a percentage of net sales was 34%, 46% and 51% in fiscal 2006, 2005 and 2004, respectively. The decrease in our gross profit margin in fiscal 2006 as compared to 2005 is related to the reduction in sales of higher gross margin products to HP combined with a change to the product mix of our sales and a lower sales volume not efficiently absorbing our second line production costs. The decrease in our gross profit margin in fiscal 2005 as compared to 2004 is related to the reduction in sales of higher gross margin products to HP. In fiscal 2004 we sold $4.9 million of product to HP and in fiscal 2005 we sold $1.0 million. The gross profit on the HP sales was approximately 70% as compared to the average gross profit on HighWire products, which was approximately 60%, and adapter products, which was approximately 55%.

Product Research and Development

Product research and development (R&D) expenses were $3.9 million, a 48% increase over $2.7 million in fiscal 2006. R&D expense for fiscal 2005 increased by 11% over $2.4 million in fiscal 2004.

The increase in R&D in fiscal 2006 as compared to fiscal 2005 is primarily the result of three factors:

- the inclusion of $543,300 of non-cash compensation expense related to stock option expense under SFAS 123(R) compared to none in 2005 and 2004;
- an increase in engineering design projects related expenditures related to the development of our storage software; and
- a $256,000 asset impairment write-off of previously capitalized VoIP development expense that was written-off to expense in fiscal 2006 due to the cancellation of the VoIP development project.

The increase in R&D in fiscal 2005 as compared to fiscal 2004 is primarily the result of two factors:

- the inclusion of increases related to our Storage business segment when we hired seven employees in conjunction with the PyX acquisition; and
- an increase in engineering design project related expenditures related to the development of our storage software and VoIP/DSP gateway products.

In fiscal 2006, we continued development of our PyX storage software. During fiscal 2006 we developed a wide variety of storage software management features and data protection modules. While the iSCSI protocol stack provides for a robust, inexpensive, and highly scalable transport infrastructure, modules included in our IP SAN Director Suite such as iSNS (Internet Storage Name Service), SNMP (Simple Network Management Protocol), Snapshot, High Availability, and Replication seamlessly address the needs and requirements of today's IT storage managers.

Included in R&D expense for the fiscal year ended October 31, 2006, in addition to the $543,300 stock option expense previously mentioned, is $282,000 of non-cash stock-based compensation expense related to the stock-for-pay program and the issuance of restricted stock to employees compared to none in 2005 and 2004.

With the planned sale of our embedded hardware business and lack of market acceptance for our storage software products, we reduced our R&D budget significantly and have focused our R&D efforts on key storage management features to enhance the value of our storage software business.

We did not capitalize any internal software development costs in fiscal 2006, 2005 or 2004 and do not expect to capitalize internal software development costs in the future .

Sales and Marketing

Sales and marketing expenses for fiscal 2006 were $2.3 million, a 5% decrease from fiscal 2005. This decrease is primarily related to a decrease in headcount and decreased travel and product marketing activities. We decreased our marketing expenditures by 30% in fiscal 2006 as we reduce cash expenditures across the company.

Fiscal 2005 sales and marketing expense was $2.2 million, a 5% increase over fiscal 2004. This increase is primarily related to an increase in headcount due to the acquisition of PyX and an increase travel and product marketing activities. We increased our marketing expenditures by 58% in fiscal 2005 as we attended more industry trade shows and increased our advertising and public relations efforts to reach our target prospects more effectively.

Included in sales and marketing expense for the fiscal year ended October 31, 2006 is $234,000 of non-cash stock-based compensation expense related to the stock-for-pay program, stock option expense under SFAS 123(R) and the issuance of restricted stock to employees compared to none in 2005 and 2004.

We are not currently planning to attend trade shows or engage in product marketing activities other than via our Web site and word of mouth.

General and Administrative

General and administrative expenses for fiscal 2006 increased approximately $340,000 to $2.2 million in fiscal 2005. General and administrative expenses for fiscal 2006 include $592,000 of non-cash compensation expense related to stock option expense under SFAS 123(R) compared to none in 2005 and 2004. General and administrative expenses for fiscal 2005 increased approximately $150,000 to $1.9 million as compared to fiscal 2004. We assumed the PyX employee stock option plan as part of our acquisition of PyX and recorded $2,484,000 of deferred compensation. Included in general and administrative expense for fiscal 2005 is $173,000 amortization expense related to the deferred compensation.

Included in general and administrative expense for the fiscal year ended October 31, 2006, in addition to the $592,000 stock option expense previously mentioned, is $357,000 of non-cash stock-based compensation expense related to the stock-for-pay program and the issuance of restricted stock to employees compared to none in 2005 and 2004.

Loan Reserve Benefit

On November 6, 1998, we made a loan to our former president and chief executive offer, who retired as of December 31, 2004. The loan was used by him to exercise an option to purchase 139,400 shares of our common stock and pay related taxes. The loan, as amended, was collateralized by shares of our common stock, bore interest at a rate of 2.48% per annum and was due on December 14, 2003.

On October 31, 2002, we determined that it was probable that we would be unable to fully recover the balance of the loan on its due date of December 14, 2003. Accordingly, a valuation allowance of $474,000 was recorded against the loan at October 31, 2002.

During the fourth quarter of fiscal 2003, the officer repaid $362,800 of the loan and, as a result, we recognized a benefit of $235,000 related to the reversal of the loan impairment charge taken by us in fiscal 2002. During the first quarter of fiscal 2004, the officer repaid the remaining loan balance in full and, as a result, we recorded a benefit of $239,000 relating to the reversal of the remaining loan impairment charge.

Income Taxes

Our effective tax rate was 0% in fiscal 2006, 2005 and 2004, respectively. We recorded valuation allowances in fiscal 2006 and 2005 for deferred tax assets due to the uncertainty of realization. In the event of future taxable income, our effective income tax rate in future periods could be lower than the statutory rate as such tax assets are realized.

Net Loss

As a result of the factors discussed above, we recorded a net loss of $16.2 million in fiscal 2006 compared to a net loss of $4.2 million in fiscal 2005 and $1.7 in fiscal 2004.

Contractual Obligations and Commercial Commitments

The following table sets forth a summary of our material contractual obligations and commercial commitments as of October 31, 2006:

	Payments due by period (in thousands)				
Contractual Obligations	Total	Less than 1 year	1-2 Years	3-5 Years	More than 5 Years
Building leases	$ 2,223	$ 580	$ 1,160	$ 483	$ —
Capital leases	255	74	149	32	—
Total net lease payments	$ 2,478	$ 654	$ 1,309	$ 515	$ —

One Stop Systems, Inc. agreed to the assumption of our corporate headquarters office lease and a lease for certain engineering equipment as part of the consideration related to the purchase of our embedded hardware business. One Stop will assume approximately $2.2 million of future lease payments. The sale transaction to One Stop is expected to be completed in our second quarter of fiscal 2007.

In addition to salary, each of our directors and executive officers is eligible to receive a bonus pursuant to our Director and Officer Bonus Plan adopted September 21, 2006 and each of our executive officers have severance agreements that provide for 6 months salary and accelerated vesting of all unvested stock options upon certain events triggered by a change in control. The total estimated amounts due under the Bonus and severance agreements is approximately $530,000. The amounts due will be paid to the directors and executive officers upon completion of the asset sale and merger.

Substantially all our sales backlog at October 31, 2007 of $1.1 million is scheduled for shipment to customers prior to the projected closing of the sale of our embedded hardware business to One Stop Systems, Inc.

Off-Balance Sheet Arrangements

We do not have any transactions, arrangements, or other relationships with unconsolidated entities that are reasonably likely to affect our liquidity or capital resources other than the operating leases noted above. We have no special purpose or limited purpose entities that provide off-balance sheet financing, liquidity, or market or credit risk support; or engage in leasing, hedging, research and development services, or other relationships that expose us to liability that is not reflected on the face of the financial statements.

Liquidity and Capital Resources

We experienced a decline in our sales volume of our embedded hardware products and a lack of market acceptance for our storage software that dramatically effected our operating cash flow for fiscal 2006. Because of the continuing decline of our cash balance, we have been evaluating strategic alternatives to return the company to cash flow positive. We determined the best way to enhance shareholder value and preserve the remaining cash balance was to sell our embedded hardware business to One Stop Systems, Inc. and to merge with Neonode, Inc. The sale of the embedded hardware business will provide cash of $2.2 million plus relieve us of a $2.2 million real estate lease burden. After the sale of the embedded business and merger transactions are completed, we will no longer be active in the embedded hardware business and future cash will have to be derived from the operations of Neonode.

Our liquidity is dependent on many factors, including sales volume, operating profit and the efficiency of asset use and turnover. Our future liquidity after the merger with Neonode is completed will be affected by, among other things:

- actual versus anticipated sales of Neonode's products;
- our actual versus anticipated operating expenses;
- the timing of Neonode's product shipments;
- our actual versus anticipated Neonode's gross profit margin;
- our ability to raise additional capital, if necessary; and
- our ability to secure credit facilities, if necessary.

We had cash and cash equivalents of $1.2 million and $3.6 million on October 31, 2006 and October 31, 2005, respectively. In fiscal 2006, $2.3 million of cash was used by operating activities, primarily as a result of net losses. Our cash used was reduced by the inclusion of $6.5 million impairment write-down of the PyX software plus $3.9 million of amortization and depreciation expense related to property and equipment and capitalized software and $2.1 million of stock based compensation expense that are included in the $16.2 million net loss but did not require cash. Cash was generated by a $625,000 decrease in our accounts receivable and a $544,000 decrease in our inventory. The decrease in trade accounts receivable is due to a general decrease in overall sales activity in fiscal 2006 as compared to the end of fiscal 2005. The decrease in inventory is due to reducing our inventory from $1.3 million at the beginning of the year to $740,000 at year-end. The current inventory level better matches our current sales levels. Our working capital (current assets less current liabilities) at October 31, 2006 was $1.7 million, as compared to $5.2 million at October 31, 2005.

In fiscal 2006, we purchased $176,000 of fixed assets, consisting primarily of computers and engineering equipment. Purchased software amounted to $40,000, primarily for engineering and product design activities and payments related to our cancelled VoIP products.

We received $37,000 in fiscal 2006 from proceeds associated with the exercise of employee stock options.

In mid-January 2006, we took steps to reduce our cash flow break-even point. We changed the formula for paying all officers and employees and our Board of Directors (Board) for their services. For the January 31, 2006 through March 31, 2006 payrolls, officer and employees were paid 70% in cash and 30% in shares of our common stock. Beginning with our April 15, 2006 payroll, the formula was changed to a range of 62% to 90% in cash and 10% to 38% in shares of our common stock. Our Board's monthly fees were paid entirely in our common stock. On August 21, 2006, the Board suspended the stock-for-pay program for all members of the Board and officers. The suspension was effective August 1, 2006 for members of the board and effective August 16, 2006 for officers. Despite the suspension of the stock-for-pay program, the previously-announced salary reductions for officers and cessation of cash Board compensation will remain in effect until such time as the Board shall determine. The stock-for-pay program has continued for our non-officer employees.

As of October 31, 2006, we had $1.2 million in cash and we are not operating at cash breakeven. Unless we are able to increase our sales to get to cash breakeven, we will not have sufficient cash generated from our business activities to support our operations for the next twelve months. We have embarked on a strategy to sell all or a portion of our business and signed a definitive agreement to sell our embedded hardware business. The overwhelming majority of our cash flow from operations has been generated from the embedded hardware business that we are selling. We expect to close the sale of our embedded hardware business in our second quarter of fiscal 2007. We also signed a definitive agreement to merge with Neonode and have been reducing our staffing levels and other cash expenditures to sustainable levels. We expect the $2.2 million cash proceeds from the sale of our embedded hardware business to be sufficient to support our remaining operations until the merger transaction closes, or for at least the next twelve months if the merger is delayed. We are also seeking other strategic alternatives including selling our storage software business.

If our projected sales of our storage software products do not materialize or we are unable to consummate the sale of our embedded hardware business and the merger transaction, we will need to reduce expenses further and raise additional capital through customer prepayments or the issuance of debt or equity securities. If we raise additional funds through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of common stock, and debt covenants could impose restrictions on our operations. The sale of equity or debt could result in additional dilution to current stockholders, and such financing may not be available to us on acceptable terms, if at all.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our cash and cash equivalents are subject to interest rate risk. We invest primarily on a short-term basis. Our financial instrument holdings at October 31, 2006 were analyzed to determine their sensitivity to interest rate changes. The fair values of these instruments were determined by net present values. In our sensitivity analysis, the same change in interest rate was used for all maturities and all other factors were held constant. If interest rates increased by 10%, the expected effect on net loss related to our financial instruments would be immaterial. We hold no assets or liabilities denominated in a foreign currency and all sales are denominated in U.S. dollars.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and supplementary data required under Item 8 are provided under Item 15.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

An evaluation as of October 31, 2006 was carried out under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our “disclosure controls and procedures,” which are defined under SEC rules as controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Securities Exchange Act of 1934, or the Exchange Act, is recorded, processed, summarized and reported within required time periods. In our financial reporting process, our Chief Financial Officer, in discussions with our independent registered public accounting firm, identified a certain “material weakness” (as such term is defined under Public Company Accounting Oversight Board Auditing Standard No. 2) in disclosure controls and procedures. As a result of this material weakness, our Chief Executive Officer and Chief Financial Officer have determined that our disclosure controls and procedures are ineffective.

During the year ended October 31, 2006, our independent registered public accounting firm communicated to management and the audit committee a material weakness arising out of an adjustment to revenue related to our software contracts which they identified during their review of our interim condensed consolidated financial statements. The material weakness identified pertains to our revenue recognition policies and procedures for software arrangements, which is new to us, and not adequately robust to identify vendor specific objective evidence and separate multiple element arrangements. We are working to establish policies and procedures in this area.

Limitations on the Effectiveness of Controls

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the controls are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within a company, if any, have been detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure control system are met and, as set forth above, our Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of the end of the period covered by this annual report on Form 10-K, that our disclosure controls and procedures were not sufficiently effective to provide reasonable assurance that the objectives of our disclosure control system were met.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Identification of Directors; Audit Committee Financial Expert; Section 16(a) Beneficial Ownership Reporting Compliance; Code of Ethics

The information required by Item 10 concerning our executive officers is set forth in the section entitled "Identification of Executive Officers" appearing in Part I of this annual report.

Board of Directors

The Board is divided into three classes. Each class consists, as nearly as possible, of one-third of the total number of directors, and each class has a three-year term. Vacancies on the Board may be filled only by persons elected by a majority of the remaining directors. A director elected by the Board to fill a vacancy in a class shall serve for the remainder of the full term of that class, and until the director’s successor is elected and qualified. This includes vacancies created by an increase in the number of directors.

The Board presently has five members. The following is a brief biography of each director

Kenneth G. Yamamoto

Mr. Yamamoto, 51, was appointed as President, CEO and director on March 3, 2006. Mr. Yamamoto joined SBE as Vice President and General Manager of the Storage Group following the acquisition of PyX Technologies, Inc in July 2005, where he had served as Chief Executive Officer since January 2005. Prior to PyX, Mr. Yamamoto was Co-Founder and COO of DataPath Systems, Inc., a developer of mixed-signal communication integrated circuits, which was acquired by LSI Logic, Inc. in July 2000. Mr. Yamamoto was Senior Director of Business Development for the Storage and Communications Division of LSI Logic, Inc. from July 2000 until December 2004.

Ronald J. Ritchie

Mr. Ritchie, 64, has served as a director since 1997 and as Chairman since 2004. Mr. Ritchie has served as president of Ritchie Associates, a business and management consulting firm. From October 1999 to June 2002, Mr. Ritchie also served as director of PixTech, Inc., a provider of field emission displays to worldwide customers, and he served as interim Chief Executive Officer of PixTech from August 2001 to June 2002. Mr. Ritchie served as Chairman of the Board of VXI Electronics, Inc., a supplier of power conversion components, from February 1998 until its acquisition by Celestica Inc. in September 1999. Mr. Ritchie was President and CEO of Akashic Memories Corporation, a firm supplying thin film hard disk media to manufacturers of disk drive products, from November 1996 to January 1998. From May 1994 to November 1996, Mr. Ritchie also served as President of Ritchie Associates. From August 1992 to April 1994, Mr. Ritchie was President and Chief Operating Officer of Computer Products, Inc., a supplier of power conversion components and system applications for the computer and networking industry.

Marion M. (Mel) Stuckey

Mr. Stuckey, 66, has served as a director since December 2003. Since 2003, Mr. Stuckey has served as Chief Executive Officer of the DECAF Company LLC, a high-tech polymer company. Since 2001, Mr. Stuckey has served as Chief Executive Officer of CEO Jumpstart LLC, a management consulting firm. From 1983 to 2001, Mr. Stuckey was the Chairman of the Board and Chief Executive Officer of Fourth Shift Corporation, a provider of supply chain and customer management software. From 1978 to 1982, Mr. Stuckey was the President of the CPI subsidiary of Control Data Corporation. From 1962 to 1978, Mr. Stuckey held various IBM prior to being named the Northern California and Nevada Manager for IBM Corporation.

John Reardon

Mr. Reardon, 44, has served as a director since February 2004. Mr. Reardon has served as President and member of the Board of Directors of The RTC Group, a technical publishing company since 1990. In 1994, Mr. Reardon founded a Dutch corporation, AEE, to expand the activities of The RTC Group into Europe. Mr. Reardon continues to serve on the Board of Directors of One Stop Systems, Inc., a computing systems and manufacturing company.

John D'Errico

Mr. D'Errico has served as a director since April 2006. Mr. D'Errico is the former Executive Vice President of LSI Logic Corp's Storage Component Business, a business unit providing solutions for the storage market. Mr. D'Errico began his career at LSI Logic in 1984 in LSI's worldwide manufacturing organization. During his 21 year career at LSI, Mr. D'Errico served as Vice-President of U.S. Manufacturing, Vice-President and General Manager of LSI Logic's Japanese subsidiary and Vice-President and General Manager of LSI Logic's Pan Asia Marketing and Sales. From 1998 to 2003 he was a member of the Colorado Governor's Commission on Science and Technology.

Information Regarding the Board of Directors and its Committees

Independence of the Board of Directors

As required under the Nasdaq listing standards, a majority of the members of a listed company's board of directors must qualify as "independent," as affirmatively determined by the board of directors. The Board consults with our counsel to ensure that the Board's determinations are consistent with all relevant securities and other laws and regulations regarding the definition of "independent," including those set forth in pertinent listing standards of Nasdaq, as in effect time to time.

Consistent with these considerations, after review of all relevant transactions or relationships between each director, or any of his or her family members, and SBE, our senior management and its independent auditors, the Board affirmatively has determined that all of our directors are our independent directors within the meaning of the applicable Nasdaq listing standards.

Board Committees

The Board has three committees: an Audit Committee, a Compensation Committee, and a Nominating and Governance Committee.

Audit Committee. The Audit Committee of the Board oversees our corporate accounting and financial reporting process. For this purpose, the Audit Committee performs several functions. The Audit Committee evaluates the performance of and assesses the qualifications of the independent auditors; determines and approves the engagement of the independent auditors; determines whether to retain or terminate the existing independent auditors or to appoint and engage new independent auditors; reviews and approves the retention of the independent auditors to perform any proposed permissible non-audit services; monitors the rotation of partners of the independent auditors on our audit engagement team as required by law; confers with management and the independent auditors regarding the effectiveness of internal controls over financial reporting; establishes procedures, as required under applicable law, for the receipt, retention and treatment of complaints received by us regarding accounting, internal accounting controls or auditing matters and the confidential and anonymous submission by employees of concerns regarding questionable accounting or auditing matters; reviews the financial statements to be included in our Annual Report on Form 10-K; and discusses with management and the independent auditors the results of the annual audit and the results of our quarterly financial statements. Three directors comprise the Audit Committee: Messrs. Stuckey, Reardon and Ritchie. The Audit Committee has adopted a written Audit Committee Charter.

The Board annually reviews the Nasdaq listing standards definition of independence for Audit Committee members and has determined that all members of our Audit Committee are independent (as independence is currently defined in Rule 4350(d)(2)(A)(i) and (ii) of the Nasdaq listing standards). All members of the Audit Committee meet Nasdaq’s audit committee financial sophistication requirements. We do not have an “audit committee financial expert” (as defined in the rules of the SEC) serving on the Audit Committee but the Board believes that the background and financial sophistication of its members are sufficient to satisfy the requirements of Rule 4350(d)(z)(A) of the Nasdaq listing standards and to fulfill the duties of the Audit Committee. Nasdaq does not currently require that audit committees include an “audit committee financial expert” Only that they meet certain requirements as to financial sophistication.

Compensation Committee. The Compensation Committee of the Board reviews and approves our overall compensation strategy and policies. The Compensation Committee reviews and approves corporate performance goals and objectives relevant to the compensation of our executive officers and other senior management; reviews and approves the compensation and other terms of employment of our Chief Executive Officer; reviews and approves the compensation and other terms of employment of the other executive officers; and administers our stock option and purchase plans, pension and profit sharing plans, stock bonus plans, deferred compensation plans and other similar programs. Three directors comprise the Compensation Committee: Messrs. Stuckey, Reardon and Ritchie. All members of the our Compensation Committee are independent (as independence is currently defined in Rule 4200(a)(15) of the Nasdaq listing standards.

Nominating and Governance Committee. The Nominating and Governance Committee of the Board is responsible for identifying, reviewing and evaluating candidates to serve as our directors (consistent with criteria approved by the Board), reviewing and evaluating incumbent directors, recommending to the Board for selection candidates for election to the Board and making recommendations to the Board regarding the membership of the committees of the Board. Our Nominating and Governance Committee charter can be found on our corporate website at www.sbei.com. Three directors comprise the Nominating and Governance Committee: Messrs. Stuckey, Reardon and Ritchie. All members of the Nominating and Governance Committee are independent (as independence is currently defined in Rule 4200(a)(15) of the Nasdaq listing standards).

The Nominating and Governance Committee believes that candidates for director should have certain minimum qualifications, including being able to read and understand basic financial statements, being over 21 years of age and having the highest personal integrity and ethics. The committee also intends to consider such factors as possessing relevant expertise upon which to be able to offer advice and guidance to management, having sufficient time to devote to our affairs, demonstrated excellence in his or her field, having the ability to exercise sound business judgment and having the commitment to rigorously represent the long-term interests of our stockholders. However, the committee retains the right to modify these qualifications from time to time. Candidates for director nominees are reviewed in the context of the current composition of the Board, our operating requirements and the long-term interests of stockholders. In conducting this assessment, the committee considers diversity, age, skills, and such other factors as it deems appropriate given the current needs of the Board, SBE, to maintain a balance of knowledge, experience and capability. In the case of incumbent directors whose terms of office are set to expire, the Nominating and Governance Committee reviews such directors' overall service to SBE during their term, including the number of meetings attended, level of participation, quality of performance, and any other relationships and transactions that might impair such directors' independence. In the case of new director candidates, the committee also determines whether the nominee must be independent for Nasdaq purposes, which determination is based upon applicable Nasdaq listing standards, applicable SEC rules and regulations and the advice of counsel, if necessary. The committee then uses its network of contacts to compile a list of potential candidates, but may also engage, if it deems appropriate, a professional search firm. The committee conducts any appropriate and necessary inquiries into the backgrounds and qualifications of possible candidates after considering the function and needs of the Board. The committee meets to discuss and consider such candidates' qualifications and then selects a nominee for recommendation to the Board by majority vote. To date, the Nominating and Governance Committee has not paid a fee to any third party to assist in the process of identifying or evaluating director candidates.

Compensation of Directors

In January 2006, as part of a company-wide reduction in salaries and other expenses, we revised our director compensation policy to suspend all cash fees and retainers payable to our directors. The Board approved a Stock-for-Pay plan that included all our employees as well as members of the Board. The number of shares of stock issued to employees and Board member in-lieu of their cash compensation is calculated at a 15% reduction from the market price on the date of issuance. Effective August 1, 2006, the Board approved the suspension of all cash payments of Board and Board committee fees, until further notice. A total of 158,295 shares of our common stock has been issued to Board members in lieu of such fees under the stock-for-pay plan since January 1, 2006. For the fiscal year ended October 31, 2006, we recorded approximately $126,000 of stock-based compensation and director expense associated with the stock-for-pay plan.

Prior to adoption of the company-wide reduction in salaries and other expenses, each of our non-employee directors received an annual retainer of $30,000, payable monthly in arrears. The Chairman of the Board received an annual retainer of $45,000, payable monthly in arrears. No director has been entitled to receive a per-meeting fee since March 2004, when our director compensation policy was revised to eliminate such fees and replace them with the annual retainers described above. In the fiscal year ended October 31, 2006, the total cash compensation paid to non-employee directors was $33,750. The members of the Board are also eligible for reimbursement for their expenses incurred in attending Board meetings in accordance with Company policy.

Each of our non-employee directors also receives stock option grants under the 2001 Directors' Stock Option Plan (Directors' Plan). Only our non-employee directors are eligible to receive options under the Directors' Plan. Options granted under the Directors' Plan do not qualify as incentive stock options under the Internal Revenue Code. Option grants under the Directors' Plan are non-discretionary. Upon a non-employee director's initial appointment or election to the Board, he or she is automatically granted an option to purchase 15,000 shares of common stock under the Directors' Plan. On April 1 of each year (or the next business day if that date is a legal holiday), each non-employee director is automatically granted an additional option to purchase 10,000 shares of common stock under the Directors' Plan. No other options may be granted at any time under the Directors' Plan. The exercise price of options granted under the Directors' Plan is 100% of the fair market value of the common stock subject to the option on the date of the option grant. Options granted under the Directors' Plan may not be exercised until the date upon which the optionee (or the affiliate of the optionee) has provided one year of continuous service as a non-employee director following the date of grant of such option, at which point 100% of the option becomes exercisable. The options will fully vest upon a change of control, as defined in the Directors' Plan, unless the acquiring company assumes the options or substitutes similar options. The term of options granted under the Directors' Plan is seven years.

During the last fiscal year, we granted options covering 65,000 shares to our non-employee directors, of which 40,000 were granted at an exercise price of $1.08 per share and 25,000 were granted at an exercise price of $1.10 per share. The fair market value of such common stock on the dates of grant was $1.08 and $1.10 per share, respectively (based on the closing sales price reported on Nasdaq for the date of grant).

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 (the "1934 Act") requires our directors and executive officers, and persons who own more than ten percent of a registered class of our equity securities, to file with the SEC initial reports of ownership and reports of changes in ownership of our common stock and other equity securities. Officers, directors and greater than ten percent stockholders are required by SEC regulation to furnish us with copies of all Section 16(a) forms they file.

To our knowledge, based solely on a review of the copies of such reports furnished to us and written representations that no other reports were required, during the fiscal year ended October 31, 2006, all Section 16(a) filing requirements applicable to our officers, directors and greater than ten percent beneficial owners were complied with.

Code Of Ethics

We have adopted the SBE, Inc. Code of Business Conduct that applies to all officers, directors and employees. All of our employees must carry out their duties in accordance with the policies set forth in the Code of Business Conduct and with applicable laws and regulations. The Code of Business Conduct contains a separate Code of Ethics that applies specifically to our Chief Executive Officer and senior financial officers. The Code of Business Conduct and Code of Ethics is available on our website at www.sbei.com. If we make any substantive amendments to the Code of Business Conduct or grants any waiver from a provision of the Code to any executive officer or director, we will promptly disclose the nature of the amendment or waiver on our website.

ITEM 11. EXECUTIVE COMPENSATION

Summary of Compensation

The following table shows for the fiscal years ended October 31, 2004, 2005 and 2006, compensation awarded or paid to, or earned by, our Chief Executive Officer and our other four most highly compensated executive officers at October 31, 2006 (the “Named Executive Officers”):

Summary Compensation Table

		Annual Compensation			Long-Term Compensation Awards		
Name and Principal Position	**Year**	**Salary ($)**	**Bonus ($)**	**Other Annual Compen-sation ($)(1)**	**Stock Awards (#)(8)**	**Securities Underlying Options (#)**	**All Other Compen-sation ($)(2)**
Mr. Kenneth Yamamoto President and Chief Executive Officer (7)	2006	143,617	--	708	74,088	100,000	1,094
	2005	75,104	--	--	--	--	--
	2004	--	--	--	--	--	--
Mr. Leo Fang Executive Vice President(6)	2006	143,643	--	242	62,562	25,000	1,094
	2005	75,104	--	--	--	--	--
	2004	--	--	--	--	--	--
Mr. David Brunton Vice President, Finance and Chief Financial Officer	2006	144,649	--	1,103	49,683	25,000	425
	2005	170,000	--	1,058	--	100,000	3,613
	2004	167,500	--	541	--	25,000	4,875
Mr. Kirk Anderson Vice President, Operations	2006	136,740	--	324	45,502	75,000	853
	2005	132,888	--	270	--	--	3,879
	2004	130,000	--	263	--	--	3,828
Mr. Nelson Abal Vice President of Sales (10)	2006	118,789	13,599	185	29,791	20,000	813
	2005	105,416	37,677	128	--	70,000	3,163
	2004	100,000	61,315	121	--	--	2,250
Mr. Daniel Grey President and Chief Executive Officer (3)	2006	77,492	--	317	13,286	--	625
	2005	200,000	--	4,052	--	250,000	2,875
	2004	200,904	--	4,052	--	25,000	6,000
Mr. Steve Nester Vice President of Business Development(11)	2006	82,132	--	521	25,072	5,000	1,062
	2005	158,583	11,500	883	--	50,000	4,413
	2004	105,849	--	269	--	--	3,532
Ms. Yee-Ling Chin Vice President, Marketing (9)	2006	67,725	--	83	9,795	10,000	750
	2005	120,000	--	125	--	25,000	3,600
	2004	120,000	--	94	--	--	3,600

Mr. William B. Heye, Jr.	2006	--	--	--	30,545	10,000	--
President and Chief	2005	--	--	--	--	75,000	208,333
Executive Officer (4)	2004	250,000	--	4,968	--	125,000	6,000
Mr. Ignacio C. Munio	2006	--	--	--	--	--	--
Vice President,	2005	168,767	--	870	195,896	28,945	5,075
Engineering (5)	2004	175,000	25,000	1,099	85,800(5)	--	5,250

(1) Includes $708, $242, $317, $1,103, $185, $521, $324 and $83 attributable in fiscal 2006 to Messrs. Yamamoto, Fang, Grey, Brunton, Abal, Nester, Anderson and Ms. Chin, respectively, $693, $1,058, $128, $883, $270, $125 and $870 attributable in fiscal 2005 to Messrs. Grey, Brunton, Abal, Nester, Anderson, Ms. Chin and Mr. Munio, respectively, $4,052, $541,$121,$269, $263, $94, $4,968 and $1,099 attributable in fiscal 2004 to Messrs. Grey, Brunton, Abal, Nester, Anderson, Ms. Chin and Messrs. Heye and Munio, respectively, for premiums paid by us for group term life insurance. Also includes $3,600 attributable in each of fiscal 2004 to Mr. Grey for an automobile allowance.

(2) The sum for each Named Executive Officer was paid by us as matching and profit sharing contributions to our Savings and Investment Plan and Trust. The sum of $208,333 was paid to Mr. Heye and we granted Mr. Heye an option to purchase 75,000 shares of common stock at an exercise price of $4.00 per share as severance in connection with his retirement as President and Chief Executive Officer effective December 31, 2004.

(3) Mr. Grey was Vice President, Sales prior to being promoted to the office of President and Chief Executive Officer effective January 1, 2005. Mr. Grey resigned as President and Chief Executive officer on March 3, 2006.

(4) Mr. Heye retired on December 31, 2004. Mr. Heye retired from the Board of Directors on October 31, 2006.

(5) Mr. Munio left the Company on October 4, 2005.

(6) Mr. Fang was promoted to Executive Vice President on May 22, 2006.

(7) Mr. Yamamoto was Vice President of Storage Software prior to being promoted to the office of President and Chief Executive Officer effective March 3, 2006.

(8) Stock granted to executive officers as part of our wide salary reductions and Stock-For-Pay program instituted in January 2006.

(9) Ms. Chin left the company on June 23, 2006.

(10) Mr. Abal was appointed to his current position in July 2005.

(11) Mr. Nester left the Company on May 31, 2006.

Stock Option Grants And Exercises

We grant options to our executive officers under its 1996 Stock Option Plan (the “1996 Plan”, 1998 Stock Option Plan (the “1998 Plan”) and 2006 Equity Inventive Plan (the “2006 Plan”). As of October 31, 2006, options to purchase a total of 1,693,672 shares were outstanding under the foregoing plans and 135,699 shares remained available for grant under the foregoing plans. Options granted under the foregoing plans during the year ended October 31, 2006 vest over a 4 year period, 25% after one year and 2% to 3% monthly thereafter. The options will fully vest upon a change of control, as defined in the plans, unless the acquiring company assumes the options or substitutes similar options. The term of options granted under the plans is generally seven years. The following tables show for the fiscal year ended October 31, 2006, certain information regarding options granted to, exercised by and held at year end by the Named Executive Officers:

Option Grants in Last Fiscal Year

Name	Individual Grants Number of Securities Underlying Options Granted (#)	% of Total Options Granted to Employees in Fiscal Year	Exercise Or Base Price ($/Sh)	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term(1) 5% ($)	10% ($)
Mr. Kenneth Yamamoto	100,000	12.2%	1.00	03/21/2013	140,710	194,871
Mr. David Brunton	25,000	3.1%	1.00	03/21/2013	35,177	48,717
Mr. Leo Fang	25,000	3.1%	1.00	03/21/2013	35,177	48,717
Mr. Kirk Anderson	75,000	9.2%	1.00	03/21/2013	105,532	146,153
Mr. Nelson Abal	20,000	2.5%	1.00	03/21/2013	28,142	38,974

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(1) The potential realizable value is based on the term of the option at the time of grant. It is calculated by assuming that the stock price on the date of grant appreciates at the indicated annual rate, compounded annually for the entire term of the option and that the option is exercised and sold on the last day of its term for the appreciated stock price. These amounts represent certain assumed rates of appreciation only, in accordance with the rules of the SEC, and do not reflect our estimate or projection of future stock price performance or take into account any taxes that may be payable in connection with the transaction. Actual gains, if any, are dependent on the actual future performance of our common stock and no gain to the optionee is possible unless the stock price increases after the date of grant, which increase, if any, would benefit all stockholders.

Aggregated Option Exercises in Last Fiscal Year and Fiscal Year-End Option Values

Name	Shares Acquired on Exercise (#)	Value Realized ($)(1)	Number of Securities Underlying Unexercised Options at Fiscal Year-End (#) Exercisable/ Unexercisable(2)(3)	Value of Unexercised In-the-Money Options at Fiscal Year-End ($) Exercisable/ Unexercisable(2)(4)
Mr. Kenneth Yamamoto	--	--	143,747/301,253	0/0
Mr. David Brunton	--	--	230,187/89,813	0/0
Mr. Leo Fang	--	--	95/831/159,169	0/0
Mr. Kirk Anderson	--	--	117,000/75,000	0/0
Mr. Nelson Abal	--	--	39,761/50,239	0/0

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(1) Value realized is based on the fair market value of our common stock on the date of exercise minus the exercise price without taking into account any taxes that may be payable in connection with the transaction.

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(2) Reflects shares vested and unvested at October 31, 2006.

(3) Includes both "in the money" and "out of the money" options. "In the money" options are options with exercise prices below the market price of our common stock at October 31, 2006 ($0.37).

(4) Fair market value of our common stock at October 31, 2006 ($0.37) minus the exercise price of the options.

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

The following table sets forth certain information regarding the ownership of our common stock as of January 10, 2007 by: (i) each director and nominee for director; (ii) each of our "named executive officers," as defined in Item 402 under Regulation S-K promulgated by the Securities and Exchange Commission; (iii) all executive officers and directors of SBE as a group; and (iv) all those known by us to be beneficial owners of more than five percent of its common stock. The address for each of the persons and entities set forth below is c/o SBE, Inc., 4000 Executive Parkway, Suite 200, San Ramon, California 94583.

	Beneficial Ownership (1)	
Beneficial Owner	**Number of Shares**	**Percent of Total(2)**
AIGH Investment Partners LLC 6006 Berkeley Avenue Baltimore, MD 21209	788,120	7.1%
Mr. Andre Hedrick 4419 Sugarland Court Concord, CA 94521	1,436,943	12.9%
Mr. Kenneth G. Yamamoto (3)(6)	853,031	7.7%
Mr. John Reardon (3)	75,545	0.07%
Mr. Ronald J. Ritchie (3)	95,817	0.09%
Mr. Marion M. (Mel) Stuckey (3)	75,545	0.07%
Mr. John D'Errico (3)	70,863	0.06%
Mr. David Brunton (3)	453,982	4.1%
Mr. Kirk Anderson (3)	244,392	2.2%
Mr. Nelson Abal (3)	132,271	1.2%
Mr. Leo Fang (3)	354,251	3.2%
All executive officers and directors as a group (10 persons) (3)	2,355,697	21.2%

(1) This table is based upon information supplied by officers, directors and principal stockholders and Schedules 13D and 13G, if any, filed with the SEC. Unless otherwise indicated in the footnotes to this table and subject to community property laws where applicable, we believe that each of the stockholders named in this table has sole voting and investment power with respect to the shares indicated as beneficially owned.

(2) Applicable percentages are based on 11,101,554 shares outstanding on January 10, 2007, adjusted as required by rules promulgated by the SEC.

(3) Includes, 445,000, 45,000, 35,000, 45,000, 50,000, 320,000, 202,000, 110,000 and 255,000 shares that Messrs. Yamamoto, Reardon, Ritchie, Stuckey, D'Errico, Brunton, Anderson, Abal and Fang, respectively, have the right to acquire within 60 days after the date of this table under outstanding stock options.

(4) Includes 60,000 shares held by UTMA as Custodian for Melanie Yamamoto and 60,000 shares held by UTMA as Custodian for Nicholas Yamamoto, the children of Mr. Yamamoto.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Certain Transactions

In January 2006, we approved and announced a company-wide reduction in employee base cash salaries effective January 16, 2006 and a corresponding increase in stock grants to all employees, including officers, pursuant to our 1996 Plan. The number of shares of stock issued to employees and Board member in-lieu of their cash compensation is calculated at a 15% reduction from the market price on the date of issuance. Through October 31, 2006, a total of 1,016,335 shares of our common stock have been issued pursuant to such stock grants of which 310,452 were issued to executive officers. The cash salary reductions will remain in effect until such time as the Board determines to increase them.

On August 21, 2006, the Board suspended the stock-for-pay program for all members of the Board and officers. The suspension is effective as of August 1, 2006 for all members of the Board and August 16, 2006 for our officers. Despite suspension of the stock-for-pay program, the previously-announced salary reductions for all officers and cessation of cash compensation for the Board will remain in effect until such time as the Board shall determine. The Board adopted a bonus plan for the affected individuals that will pay a prescribed amount of cash or stock upon our completion of one of a number of specified milestones set forth in the plan, provided that the affected individual remains employed by us or a member of the Board at the time such milestone is achieved. All non-officer employees remain on the stock-for-pay plan until such time as the Board shall determine.

We compensate our directors as described under “Compensation of Directors” above. We compensated our named executive officers in fiscal 2006 as described under “Compensation of Executive Officers” above. Prior to the salary reduction, our executive officers received annual salaries at the following rates:

	Prior to Reduction		After Reduction	
Kenneth Yamamoto	$	225,000	$	140,000
David Brunton	$	180,000	$	142,000
Leo Fang	$	200,000	$	140,000
Kirk Anderson	$	165,000	$	132,000
Nelson Abal	$	140,000	$	126,000

In addition to salary, each of our directors and executive officers is eligible to receive a bonus pursuant to our Director and Officer Bonus Plan adopted September 21, 2006 and stock option and other grants as may be made in the sole discretion of the Compensation Committee. We entered into severance and change in control arrangements with our executive officers that provide for six months salary and accelerated vesting of all unvested stock options upon certain events triggered by a change in control.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The Audit Committee of the Board has selected BDO Seidman, LLP as our independent auditors for the fiscal year ending October 31, 2006. BDO Seidman, LLP has audited our financial statements since 2003.

Independent Auditors' Fees

The following table represents aggregate fees billed to us for fiscal years ended October 31, 2006 and 2005, by BDO Seidman, LLP, our principal accountant.

	Fiscal Year Ended (in thousands)	
	2006	**2005**
Audit Fees	$ 137	$ 116
Audit-related Fees (1)	0	36
Tax Fees (2)	12	12
All Other Fees	0	0
Total Fees	$ 149	$ 164

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(1) Fees paid in relation to our acquisition of PyX Technologies, Inc.
(2) Fees paid for preparation and filing of our federal and state income tax returns.

All fees described above were approved by the Audit Committee. The Audit Committee has determined that the rendering of the foregoing services separate from the audit services by BDO Seidman, LLP is compatible with maintaining the principal accountant's independence.

Pre-Approval of Audit and Non-Audit Services

The Audit Committee has not approved any formal policy concerning pre-approval of the auditors to perform both audit and non-audit services (services other than audit, review and attest services). Instead, on a case by case basis, any audit or non-audit services proposed to be performed are considered by and, if deemed appropriate, approved by the Audit Committee in advance of the performance of such services. All of the fees earned by BDO Seidman, LLP described above were attributable to services pre-approved by the Audit Committee.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENTS SCHEDULES

The following documents are filed as part of this Report:

(a)(1) Financial Statements

	Page
Report of Independent Registered Public Accounting Firm	56
Balance Sheets at October 31, 2006 and 2005	57
Statements of Operations for fiscal years 2006, 2005 and 2004	58
Statements of Stockholders' Equity for fiscal years 2006, 2005 and 2004	59
Statements of Cash Flows for fiscal years 2006, 2005 and 2004	60
Notes to Financial Statements	61
(a)(2) Financial Statement Schedule	
Schedule II — Valuation and Qualifying Accounts	87

All other schedules are omitted as the required information is not applicable or has been included in the financial statements or the notes thereto.

(a)(3) List of Exhibits

Exhibit Number	Description
3.1(1)	Certificate of Incorporation, as amended through December 15, 1997.
3.2(2)	Bylaws, as amended through December 8, 1998.
3.3	Certificate of Amendment of Certificate of Incorporation, dated March 26, 2004.
10.1(3)*	1996 Stock Option Plan, as amended.

10.2(3)* 2001 Non-Employee Directors' Stock Option Plan, as amended.

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10.3(3)	1992 Employee Stock Purchase Plan, as amended.
10.4(3)	1998 Non-Officer Stock Option Plan as amended.
10.5(4)	2005 PyX Technologies Stock Option Plan.
10.6(5)	2006 Equity Incentive Plan.
10.6(6)	Lease for 4000 Executive Parkway, Suite 200 dated July 27, 2005 between the Company and Alexander Properties Company.
10.8+	Letter Agreement, dated October 30, 2001, amending (i) Amendment No. S/M018-4 dated April 3, 2001, and (ii) Purchase Agreement dated May 6, 1991, each between SBE, Inc. and Compaq Computer Corporation.
10.10(7)	Form of warrant issued to associates of Puglisi & Co. ($1.50 exercise price).
10.11(7)	Form of warrant issued to associates of Puglisi & Co. ($1.75 and $2.00 exercise price).
10.12(8)	Unit Subscription Agreement, dated May 4, 2005, by and between SBE, Inc. and the other parties thereto.
10.13(8)	Agreement and Plan of Merger and Reorganization, dated March 28, 2005, by and among SBE, Inc., PyX Acquisition Sub, LLC, PyX Technologies, Inc. and the parties identified on Exhibit A thereto.
10.14(8)	Investor Rights Agreement, dated July 26, 2005, between SBE, Inc. and the investors listed on Exhibit A thereto.
10.15(8)	Form of warrant issued on July 26, 2005.
10.16(9)	Executive Severance Benefits Agreement between the Company and Leo Fang, dated May 24, 2006.
10.17	Executive Severance Benefits Agreement between the Company and Kenneth G. Yamamoto, dated March 15, 2006.
10.18(10)	Executive Severance Benefits Agreement between the Company and David W. Brunton, dated April 12, 2004.
10.19(10)	Executive Severance Benefits Agreement between the Company and Kirk Anderson, dated April 12, 2004.
11	Executive Severance Benefits Agreement between the Company and Nelson Abal, dated August 4, 2006.
12	Director and Officer Bonus Plan, dated September 21, 2006

13	Asset purchase agreement with One Stop Systems, Inc., dated January 11, 2007.
14	Agreement and Plan of Merger and Reorganization, with Neonode Inc., dated January 19, 2007

23.1	Consent of BDO Seidman LLP Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer
31.2	Certification of Chief Financial Officer
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Indicates management contract or compensation plans or arrangements filed pursuant to Item 601(b)(10) of Regulation SK.

\+ Certain confidential information has been deleted from this exhibit pursuant to a confidential treatment order that has been granted.

(1) Filed as an exhibit to Annual Report on Form 10-K for the year ended October 31, 1997 and incorporated herein by reference.

(2) Filed as an exhibit to Annual Report on Form 10-K for the year ended October 31, 1998 and incorporated herein by reference.

(3) Filed as an exhibit to Annual Report on Form 10-K for the year ended October 31, 2002 and incorporated herein by reference.

(4) Filed as an exhibit to Registration Statement on Form S-8 dated September 20, 2005 and incorporated herein by reference.

(5) Filed as an exhibit to Registration Statement on Form S-8 dated March 24, 2006 and incorporated herein by reference.

(6) Filed as an exhibit to Annual Report on Form 10-K for the year ended October 31, 2005 and incorporated herein by reference.

(7) Filed as an exhibit to Registration Statement on Form S-3 dated July 11, 2003 and incorporated herein by reference.

(8) Filed as an exhibit to Proxy Statement on Form 14A dated June 24, 2005 and incorporated herein by reference.

(9) Filed as an exhibit to Current Report on Form 8-K dated May 26, 2006 and incorporated herein by reference.

(10) Filed as an exhibit to Quarterly Report on Form 10-Q for the quarter ended January 31, 2005.

(11) Filed as an exhibit to Current Report on Form 8-K dated August 7, 2006 and incorporated herein by reference.

(12) Filed as an exhibit to Current Report on Form 8-K dated September 21, 2006 and incorporated herein by reference

(13) Filed as an exhibit to Current Report on Form 8-K dated January 12, 2007 and incorporated herein by reference.

(14) Filed as an exhibit to Current Report on Form 8-K dated January 19, 2007 and incorporated herein by reference.

(b) **Exhibits Required by Item 601**

Please refer to Part IV, Item 15(a)(3).

(c) **Financial Statements**

Please refer to Part IV, Item 15(a)(2).

SIGNATURES

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

	SBE, Inc.	
Date: January 26, 2007	By:	/s/ Kenneth G. Yamamoto Kenneth G. Yamamoto Chief Executive Officer and President *(Principal Executive Officer)*
Date: January 26, 2007	By:	/s/ David W. Brunton David W. Brunton Chief Financial Officer, Vice President, Finance and Secretary *(Principal Financial and Accounting Officer)*

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each of the undersigned officers and directors of the registrant constitutes and appoints, jointly and severally, Kenneth G. Yamamoto and David W. Brunton, and each of them, as lawful attorneys-in-fact and agents for the undersigned and for each of them, each with full power of substitution and resubstitution, for and in the name, place and stead of each of the undersigned officers and directors, in any and all capacities, to sign any and all amendments to this report, and to file the same, with all exhibits thereto and all other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing necessary or appropriate to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that each of said attorneys-in-fact or any of them, or any of their substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements for the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities indicated, as of January 26, 2007.

Signature	Title
/s/ Kenneth G. Yamamoto Kenneth G. Yamamoto	Chief Executive Officer and President *(Principal Executive Officer)*
/s/ David W. Brunton David W. Brunton	Chief Financial Officer, Vice President, Finance and Secretary *(Principal Financial and Accounting Officer)*
/s/ Ronald J. Ritchie Ronald J. Ritchie	Director, Chairman of the Board
/s/ John Reardon John Reardon	Director
/s/ Marion M. Stuckey Marion M. Stuckey	Director
/s/ John D'Errico John D'Errico	Director

Report of Independent Registered Public Accounting Firm

Board of Directors
SBE, Inc.
San Ramon, California

We have audited the accompanying balance sheets of SBE, Inc. as of October 31, 2006 and 2005 and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period October 31, 2006. We have also audited Schedule II - Valuation and Qualifying Accounts (the Schedule). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the Schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SBE, Inc. at October 31, 2006 and 2005, and the results of its operations and its cash flows for each of the years in the period ended October 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the Schedule presents fairly, in all material effects, the information set forth therein.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company has suffered recurring losses and negative cash flows from operations that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ BDO Seidman, LLP

December 21, 2006, except for Note 1.a. and 17 to the financial statements which is as of January 24, 2007.

San Francisco, California

SBE, INC.
BALANCE SHEETS
(in thousands, except share and per share amounts)

October 31		2006		2005
ASSETS				
Current assets:				
Cash and cash equivalents	$	1,147	$	3,632
Trade accounts receivable, net of allowance for				
doubtful accounts of $26 and $54		930		1,555
Inventories		739		1,283
Other		177		293
Total current assets		2,993		6,763
Property and equipment, net		508		563
Capitalized software costs, net		1,314		11,424
Other		53		82
Total assets	$	4,868	$	18,832
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current liabilities:				
Trade accounts payable	$	557	$	743
Accrued payroll and employee benefits		105		155
Capital lease obligations - current portion		54		29
Deferred software revenue		432		138
Other		144		178
Total current liabilities		1,292		1,243
Capital lease obligations		158		111
Deferred rent		97		130
Total long-term liabilities		255		241
Total liabilities		1,547		1,484
Commitments (Notes 9, 10 and 13)				
Stockholders' equity:				
Convertible preferred stock:				
$0.001 par value; authorized 2,000,000 shares; none				
outstanding		---		---
Common stock and additional paid-in capital:				
$0.001 par value; authorized 25,000,000 shares;				
issued and outstanding 10,951,348 and 9,892,347		35,186		35,431
Deferred compensation		---		(2,401)
Accumulated deficit		(31,865)		(15,682)

Total stockholders' equity		3,321		17,348
Total liabilities and stockholders' equity	$	4,868	$	18,832

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

SBE, INC.
STATEMENTS OF OPERATIONS
(in thousands, except for per share amounts)

For the years ended October 31,	2006	2005	2004
Net sales	$ 6,127	$ 8,056	$ 11,066
Operating expenses:			
Amortization and impairment of acquired software and intellectual property	9,894	1,048	1,213
Cost of hardware and other revenue	4,046	4,356	5,433
Product research and development	3,979	2,694	2,411
Sales and marketing	2,180	2,293	2,177
General and administrative	2,246	1,906	1,755
Loan loss recovery	---	---	(239)
Total operating expenses	22,345	12,297	12,750
Operating loss	(16,218)	(4,241)	(1,684)
Interest income	42	22	5
Other expense	---	(6)	---
Loss before income taxes	(16,176)	(4,225)	(1,679)
Income tax benefit (provision)	7	(5)	---
Net loss	$ (16,183)	$ (4,230)	$ (1,679)
Basic and diluted loss per common share	$ (1.57)	$ (0.66)	$ (0.33)
Basic and diluted - Shares used in per share computations	10,304	6,439	5,022

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

SBE, INC.
STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands, except shares)

	Common Stock and Additional Paid-in Capital		Note Receivable from Stockholder	Deferred Compensation	Retained Earnings (Accumulated deficit)	Total
	Shares	Amount				
Balance, October 31, 2003	4,808,650	15,302	(142)	-	(9,773)	5,387
Stock issued in connection with stock purchase plan	9,903	18	-	-	-	18
Stock issued in connection with Stock Option Plans	164,136	233	-	-	-	233
Stock issued in connection with warrant exercise	81,429	116	-	-	-	116
Stock issued in connection with the acquisition of Antares	30,000	86	-	-	-	86
Reversal of valuation allowance on note receivable from officer	-	-	(239)	-	-	(239)
Collection of note receivable from officer	-	-	381	-		381
Net loss	-	-	-	-	(1,679)	(1,679)
Balance, October 31, 2004	5,094,118	15,755	-	-	(11,452)	4,303
Stock issued in connection with Stock Option Plans	108,234	130	-	-	-	130
Stock issued in connection with the acquisition of Antares	68,945	197	-	-	-	197
Stock issued in connection with the acquisition of PyX	2,561,050	11,714	-	-	-	11,714
Stock issued in connection with private placement financing, net of financing costs of $175	2,060,000	4,975	-	-	-	4,975
Deferred compensation related to Stock Option Plans	-	2,660	-	(2,660)	-	-
Stock-based compensation	-	-	-	259	-	259
Net loss	-	-	-	-	(4,230)	(4,230)
Balance, October 31, 2005	9,892,347	35,431	-	(2,401)	(15,682)	17,348
Reclassification of deferred compensation		(2,401)		2,401		-
Stock issued in connection with Stock Option Plans	42,666	37	-	-	-	37
Stock issued in connection with the Stock for Pay	1,016,335	763	-	-	-	763

program						
Compensation related to restricted stock issued to employees	-	89	-	-	-	89
Stock-based compensation	-	1,267	-	-	-	1,267
Net loss	-	-	-	-	(16,183)	(16,183)
Balance, October 31, 2006	10,951,348	$ 35,186	$ -	$ -	$ (31,865)	$ 3,321

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

SBE, INC.
STATEMENTS OF CASH FLOWS
(in thousands)

For the years ended October 31	2006	2005	2004
Cash flows from operating activities:			
Net loss	$ (16,183)	$ (4,230)	$ (1,679)
Adjustments to reconcile loss to net cash used in operating activities:			
Depreciation and amortization	3,880	1,241	829
Impairment of intellectual property and software	6,500	---	713
Stock-based compensation expense	2,119	259	--
Non-cash valuation allowance (recovery) on loan from officer	---	---	(240)
Loss on sale of assets	---	6	---
Changes in operating assets and liabilities:			
Trade accounts receivable	625	113	150
Inventories	544	643	(46)
Other assets	146	(121)	13
Trade accounts payable	(186)	(113)	160
Other current liabilities	235	(319)	(40)
Non-current liabilities	14	102	---
Net cash used in operating activities	(2,306)	(2,419)	(140)
Cash flows from investing activities:			
Purchases of property and equipment	(176)	(337)	(87)
Cash payments related to purchase of PyX, net of cash received	---	(359)	---
Purchased software	(40)	(207)	(136)
Net cash used in investing activities	(216)	(903)	(223)
Cash flows from financing activities:			
Proceeds from stock plans	37	130	251
Proceeds from issuance of common stock and warrants, net	---	4,975	202
Proceeds from repayment of shareholder note	---	---	382
Net cash provided by financing activities	37	5,105	834
Net increase (decrease) in cash and cash equivalents	(2,485)	1,783	471
Cash and cash equivalents at beginning of year	3,632	1,849	1,378
Cash and cash equivalents at end of year	$ 1,147	$ 3,632	$ 1,849

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION						
Cash paid during the year for:						
Income taxes	$	7	$	5	$	1
SUPPLEMENTAL SCHEDULE OF NON CASH INVESTING AND FINANCING ACTIVITIES						
Assets acquired under capital leases	$	---	$	---	$	164
Non-cash stock portion of PyX purchase price	$	---	$	11,714	$	---
Non-cash stock portion of Antares purchase price	$	---	$	197	$	86

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

NOTES TO FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Liquidity:

$
—

$
400,989

$
81,450

$
(34,392
)

$
457,100

See accompanying notes to consolidated financial statements.

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TEAM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Twelve Months Ended December 31,		
	2018	2017	2016
Cash flows from operating activities:			
Net loss	$(63,146)	$(84,455)	$(12,676)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	64,862	52,143	48,673
Write-off of deferred loan costs	—	1,244	—
Amortization of deferred loan costs and debt discount	7,022	3,085	541
Provision for doubtful accounts	11,662	7,097	6,336
Foreign currency loss (gain)	1,712	499	(93)
Deferred income taxes	(31,734)	(66,246)	(4,236)
(Gain) loss on revaluation of contingent consideration	(202)	(1,174)	2,184
(Gain) loss on asset disposal	(552)	553	1,540
Loss (gain) on convertible debt embedded derivative	24,783	(818)	—
Goodwill impairment loss	—	75,241	—
Non-cash compensation cost	12,256	7,876	7,313
Other, net	(3,762)	(3,789)	(1,182)
(Increase) decrease (net of the effects of acquisitions):			
Receivables	15,386	(39,820)	16,518
Inventory	(21)	614	2,119
Prepaid expenses and other current assets	6,933	6,642	(163)
Increase (decrease) (net of the effects of acquisitions):			
Accounts payable	(8,994)	6,424	8,361
Other accrued liabilities	9,168	14,896	(2,346)
Income taxes	(3,514)	6,260	6,675
Net cash provided by (used) in operating activities	41,859	(13,728)	79,564
Cash flows from investing activities:			
Capital expenditures	(27,164)	(36,798)	(45,812)
Net proceeds from sale of discontinued operations	—	—	13,295
Business acquisitions, net of cash acquired	—	—	(48,382)
Proceeds from disposal of assets	2,580	3,259	4,232
Other	(443)	(457)	827
Net cash used in investing activities	(25,027)	(33,996)	(75,840)
Cash flows from financing activities:			
Net (payments) borrowings under revolving credit agreement	(19,690)	(23,006)	15,996
Payments under term loan	—	(170,000)	(20,000)
Issuance of convertible debt, net of issuance costs	—	222,311	—
Deferred consideration payments	—	—	(694)
Contingent consideration payments	(1,106)	(1,278)	(1,816)
Purchase of treasury stock	—	—	(7,593)
Debt issuance costs on Credit Facility	(855)	(1,938)	(801)
Corporate tax effect from share-based payment arrangements	—	—	(535)
Exercise of stock options	—	450	5,903
Issuance of common stock, net of issuance costs	—	—	5,243

Payments related to withholding tax for share-based payment arrangements	(1,390)	(947)	(1,709)
Net cash (used in) provided by financing activities	(23,041)	25,592	(6,006)
Effect of exchange rate changes on cash	(2,055)	2,468	(1,327)
Net decrease in cash and cash equivalents	(8,264)	(19,664)	(3,609)
Cash and cash equivalents at beginning of period	26,552	46,216	49,825
Cash and cash equivalents at end of period	$18,288	$26,552	$46,216
Supplemental disclosure of cash flow information:			
Cash paid (refunded) during the year for:			
Interest	$24,924	$13,176	$12,207
Income taxes	$2,720	$5,719	$(2,741)

See accompanying notes to consolidated financial statements.

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TEAM, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND PRACTICES

Description of Business. Unless otherwise indicated, the terms “Team, Inc.,” “Team,” “the Company,” “we,” “our” and “us” ar used in this report to refer to Team, Inc., to one or more of our consolidated subsidiaries or to all of them taken as a whole. We are a leading provider of standard to specialty industrial services, including inspection, engineering assessment and mechanical repair and remediation required in maintaining high temperature and high pressure piping systems and vessels that are utilized extensively in the refining, petrochemical, power, pipeline and other heavy industries. We conduct operations in three segments: Inspection and Heat Treating Group (“IHT”) (formerly TeamQualspec), Mechanical Services Group (“MS”) (formerly TeamFurmanite) and Quest Integrity Group (“Quest Integrity”). Through the capabilities and resources in these three segments, we believe that Team is uniquely qualified to provide integrated solutions involving in their most basic form, inspection to assess condition, engineering assessment to determine fitness for purpose in the context of industry standards and regulatory codes and mechanical services to repair, rerate or replace based upon the client’s election. In addition, our Company is capable of escalating with the client’s needs—as dictated by the severity of the damage found and the related operating conditions—from standard services to some of the most advanced services and integrated integrity management and asset reliability solutions available in the industry. We also believe that Team is unique in its ability to provide services in three distinct client demand profiles: (i) turnaround or project services, (ii) call-out services and (iii) nested or run-and-maintain services.

IHT provides standard and advanced non-destructive testing (“NDT”) services for the process, pipeline and power sectors, pipeline integrity management services, field heat treating services, as well as associated engineering and assessment services. These services can be offered while facilities are running (on-stream), during facility turnarounds or during new construction or expansion activities.

MS provides primarily call-out and turnaround services under both on-stream and off-line/shut down circumstances. Turnaround services are project-related and demand is a function of the number and scope of scheduled and unscheduled facility turnarounds as well as new industrial facility construction or expansion activities. The turnaround and call-out services MS provides include field machining, technical bolting, field valve repair and isolation test plugging services. On-stream services offered by MS represent the services offered while plants are operating and under pressure. These services include leak repair, fugitive emissions control and hot tapping.

Quest Integrity provides integrity and reliability management solutions for the process, pipeline and power sectors. These solutions encompass three broadly-defined disciplines: (1) highly specialized in-line inspection services for unpiggable process piping and pipelines using proprietary in-line inspection tools and analytical software; and (2) advanced engineering and condition assessment services through a multi-disciplined engineering team and (3) advanced digital imaging including remote digital video imaging, laser scanning and laser profilometry-enabled reformer care services.

We offer these services globally through over 200 locations in 20 countries throughout the world with approximately 7,200 employees. We market our services to companies in a diverse array of heavy industries which include the petrochemical, refining, power, pipeline, steel, pulp and paper industries, as well as municipalities, shipbuilding, OEMs, distributors, and some of the world’s largest engineering and construction firms.

Our stock is traded on the New York Stock Exchange (“NYSE”) under the symbol “TISI”.

Consolidation. The consolidated financial statements include the accounts of Team, Inc. and our majority-owned subsidiaries where we have control over operating and financial policies. Investments in affiliates in which we have the ability to exert significant influence over operating and financial policies, but where we do not control the operating and financial policies, are accounted for using the equity method. All material intercompany accounts and transactions have been eliminated in consolidation.

Use of estimates. Our accounting policies conform to Generally Accepted Accounting Principles in the United States (“GAAP”). The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and judgments that affect our reported financial position and results of operations. We review significant estimates and judgments affecting our consolidated financial statements on a recurring basis and record the

effect of any necessary adjustments prior to their publication. Estimates and judgments are based on information available at the time such estimates and judgments are made. Adjustments made with respect to the use of these estimates and judgments often relate to information not previously available. Uncertainties with respect to such estimates and judgments are inherent in the preparation of financial statements. Estimates and judgments are used in, among other things, (1) aspects of revenue recognition, (2) valuation of acquisition related tangible and intangible assets and assessments of all long-lived assets for possible impairment, (3) estimating various factors used to accrue liabilities for workers' compensation, auto, medical and general liability, (4) establishing an allowance for uncollectible accounts receivable, (5) estimating the useful lives of our assets, (6) assessing future tax exposure and the realization of tax assets, (7) the

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valuation of the embedded derivative liability in our convertible debt and (8) selecting assumptions used in the measurement of costs and liabilities associated with defined benefit pension plans. Our most significant accounting policies are described below.

Fair value of financial instruments. Our financial instruments consist primarily of cash, cash equivalents, accounts receivable, accounts payable and debt obligations. The carrying amount of cash, cash equivalents, trade accounts receivable and trade accounts payable are representative of their respective fair values due to the short-term maturity of these instruments. The fair value of our banking facility is representative of the carrying value based upon the variable terms and management's opinion that the current rates available to us with the same maturity and security structure are equivalent to that of the banking facility. The fair value of our convertible senior notes as of December 31, 2018 and 2017 was $231.5 million and $231.6 million, respectively, (inclusive of the fair value of the conversion option) and are a "Level 2" (as defined in Note 11) measurements, determined based on the observed trading price of these instruments.

Cash and cash equivalents. Cash and cash equivalents consist of all demand deposits and funds invested in highly liquid short-term investments with original maturities of three months or less.

Inventory. Except for certain inventories that are valued based on weighted-average cost, we use the first-in, first-out method to value our inventory. Inventory includes material, labor and certain fixed overhead costs. Inventory is stated at the lower of cost and net realizable value. Inventory quantities on hand are reviewed periodically and carrying cost is reduced to net realizable value for inventories for which their cost exceeds their utility. The cost of inventories consumed or products sold are included in operating expenses.

Property, plant and equipment. Property, plant and equipment are stated at cost less accumulated depreciation and amortization. Leasehold improvements are amortized over the shorter of their respective useful life or the lease term. Depreciation and amortization of assets are computed by the straight-line method over the following estimated useful lives of the assets:

Classification	Useful Life
Buildings	20-40 years
Enterprise Resource Planning ("ERP") System	15 years
Leasehold improvements	2-15 years
Machinery and equipment	2-12 years
Furniture and fixtures	2-10 years
Computers and computer software	2-5 years
Automobiles	2-5 years

Goodwill and intangible assets. We allocate the purchase price of acquired businesses to their identifiable tangible assets and liabilities, such as accounts receivable, inventory, property, plant and equipment, accounts payable and accrued liabilities. We also allocate a portion of the purchase price to identifiable intangible assets, such as non-compete agreements, trademarks, trade names, patents, technology and customer relationships. Allocations are based on estimated fair values of assets and liabilities. We use all available information to estimate fair values including quoted market prices, the carrying value of acquired assets, and widely accepted valuation techniques such as discounted cash flows. Certain estimates and judgments are required in the application of the fair value techniques, including estimates of future cash flows, selling prices, replacement costs, economic lives and the selection of a discount rate, as well as the use of "Level 3" measurements as defined in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 820 Fair Value Measurements and Disclosure ("ASC 820"). Deferred taxes are recorded for any differences between the assigned values and tax bases of assets and liabilities. Estimated deferred taxes are based on available information concerning the tax bases of assets acquired and liabilities assumed and loss carryforwards at the acquisition date, although such estimates may change in the future as additional information becomes known. Any remaining excess of cost over allocated fair values is recorded as goodwill. We typically engage third-party valuation experts to assist in determining the fair values for both the identifiable tangible and intangible assets. The judgments made in determining the estimated fair value assigned to each class of assets acquired and liabilities assumed, as well as asset lives, could materially impact our results of operations.

Goodwill and intangible assets acquired in a business combination and determined to have an indefinite useful life are not amortized, but are instead tested for impairment at least annually in accordance with the provisions of the ASC 350 Intangibles—Goodwill and Other (“ASC 350”). Intangible assets with estimated useful lives are amortized over their respective estimated useful lives to their estimated residual values and reviewed for impairment in accordance with ASC 350. We assess goodwill for

impairment at the reporting unit level, which we have determined to be the same as our operating segments. Each reporting unit has goodwill relating to past acquisitions.

Prior to January 1, 2017, the test for impairment was a two-step process that involved comparing the estimated fair value of each reporting unit to the reporting unit's carrying value, including goodwill. If the fair value of a reporting unit exceeded its carrying amount, the goodwill of the reporting unit was not considered impaired; therefore, the second step of the impairment test would not be deemed necessary. If the carrying amount of the reporting unit exceeded its fair value, we would then perform the second step to the goodwill impairment test, which involved the determination of the fair value of a reporting unit's assets and liabilities as if those assets and liabilities had been acquired/assumed in a business combination at the impairment testing date, to measure the amount of goodwill impairment loss to be recorded. However, effective January 1, 2017 we prospectively adopted a new accounting principle that eliminated the second step of the goodwill impairment test. Therefore, for goodwill impairment tests occurring after January 1, 2017, if the carrying value of a reporting unit exceeds its fair value, we measure any goodwill impairment losses as the amount by which the carrying amount of a reporting unit exceeds its fair value, not to exceed the total amount of goodwill allocated to that reporting unit. Our goodwill annual test date is December 1 of each year.

In the third quarter of the year ended December 31, 2017, we determined that there were sufficient indicators to trigger an interim goodwill impairment analysis, primarily due to a 43% decrease in the Company's stock price during the quarter, market softness and our financial results. This interim goodwill impairment test was prepared as of July 31, 2017. The fair values of the reporting units were determined using a combination of income and market approaches. The income approach was based on discounted cash flow models with estimated cash flows based on internal forecasts of revenue and expenses over a five-year period plus a terminal value period. The income approach estimated fair value by discounting each reporting unit's estimated future cash flows using a discount rate that approximated our weighted-average cost of capital. Major assumptions applied in an income approach include forecasted growth rates as well as forecasted profitability by reporting unit. Additionally, we considered two market approaches that used multiples, based on observable market data, of a combination of historical and projected financial metrics of our reporting units, to arrive at fair value. We applied weightings to each of the income and the two market approaches. The fair value derived from these approaches, in the aggregate, approximated our market capitalization.

The July 31, 2017 interim goodwill impairment test indicated impairment as the carrying values of the MS and IHT reporting units exceeded their fair values. The carrying value of the MS reporting unit exceeded its fair value by $54.1 million and the carrying value of the IHT reporting unit exceeded its fair value by $21.1 million, resulting in a total impairment loss of $75.2 million. The fair values of the reporting units are "Level 3" measurements as defined in Note 11. The fair value of the Quest Integrity reporting unit significantly exceeded its carrying value.

For our annual goodwill impairment tests as of December 1, 2017 and December 1, 2018, we elected to perform qualitative assessments to determine if it was more likely than not (that is, a likelihood of more than 50 percent) that the fair values of our reporting units were less than their respective carrying values as of the test dates. Our qualitative assessment for the December 1, 2017 test considered relevant events and circumstances occurring since the July 31, 2017 quantitative impairment test date that could affect the fair value or carrying amount of the reporting units, while our qualitative assessment for the December 1, 2018 test considered relevant events and circumstances occurring since the December 1, 2017 qualitative impairment test date. Specifically, we considered changes in the Company's stock price, industry and market conditions, our internal forecasts of future revenue and expenses, any significant events affecting the Company and actual changes in the carrying value of our net assets. After considering all positive and negative evidence for the assessments as of both of these dates, we concluded that it was not more likely than not that our carrying values exceeded fair values and, as such, no additional impairment was indicated.

There was $281.7 million and $284.8 million of goodwill at December 31, 2018 and 2017, respectively. A summary of goodwill is as follows (in thousands):

Twelve Months Ended
December 31, 2018

	IHT	MS	Quest Integrity	Total
Balance at beginning of period	$194,211	$56,600	$ 33,993	$284,804
Foreign currency adjustments	(1,603)	(712)	(578)	(2,893)
Disposal	—	(261)	—	(261)
Balance at end of period	$192,608	$55,627	$ 33,415	$281,650

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	Twelve Months Ended December 31, 2017			
	IHT	MS	Quest Integrity	Total
Balance at beginning of year	$213,475	$109,059	$ 33,252	$355,786
Foreign currency adjustments	1,876	1,642	741	4,259
Impairment loss	(21,140)	(54,101)	—	(75,241)
Balance at end of year	$194,211	$56,600	$ 33,993	$284,804

There was $75.2 million of accumulated impairment losses at December 31, 2018 and 2017, comprised of the impairment losses recognized in the third quarter of 2017 described above.

Income taxes. We follow the guidance of ASC 740 Income Taxes (“ASC 740”), which requires that we use the asset and liability method of accounting for deferred income taxes and provide deferred income taxes for all significant temporary differences. As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax payable and related tax expense together with assessing temporary differences resulting from differing treatment of certain items, such as depreciation, for tax and accounting purposes. These differences can result in deferred tax assets and liabilities, which are included within our consolidated balance sheets.

In accordance with ASC 740, we are required to assess the likelihood that our deferred tax assets will be realized and, to the extent we believe that it is more likely than not (a likelihood of more than 50%) that some portion or all of the deferred tax assets will not be realized, we must establish a valuation allowance. We consider all available evidence to determine whether, based on the weight of the evidence, a valuation allowance is needed. Evidence used includes the reversal of existing taxable temporary differences, taxable income in prior carryback years if carryback is permitted by tax law, information about our current financial position and our results of operations for the current and preceding years, as well as all currently available information about future years, including our anticipated future performance and tax planning strategies.

We regularly assess whether it is more likely than not that we will realize the deferred tax assets in the jurisdictions we operate in. Management believes future sources of taxable income, reversing temporary differences and other tax planning strategies will be sufficient to realize the deferred tax assets for which no valuation allowance has been established. Our valuation allowances primarily relate to net operating loss carry forwards. While we have considered these factors in assessing the need for additional valuation allowances, there is no assurance that additional valuation allowances would not need to be established in the future if information about future years change. Any changes in valuation allowances would impact our income tax provision and net income (loss) in the period in which such a determination is made. As of December 31, 2018, our deferred tax assets were $73.7 million, less a valuation allowance of $10.5 million. As of December 31, 2018, our deferred tax liabilities were $61.6 million.

Significant judgment is required in assessing the timing and amounts of deductible and taxable items for tax purposes. In accordance with ASC 740-10, we establish reserves for uncertain tax positions when, despite our belief that our tax return positions are supportable, we believe that it is not more likely than not that the position will be sustained upon challenge. When facts and circumstances change, we adjust these reserves through our provision for income taxes. To the extent interest and penalties may be assessed by taxing authorities on any related underpayment of income tax, such amounts have been accrued and are classified as a component of income tax provision (benefit) in our consolidated statements of operations. As of December 31, 2018, our unrecognized tax benefits related to uncertain tax positions were $2.2 million.

The 2017 Tax Cuts and Jobs Act (the “2017 Tax Act”) was enacted on December 22, 2017 and represented a significant change to the U.S. corporate income tax system including: a federal corporate rate reduction from 35% to 21%; limitations on the deductibility of interest expense and executive compensation; creation of new minimum taxes such as the base erosion anti-abuse tax (“BEAT”) and Global Intangible Low Taxed Income (“GILTI”) tax; and the transition of U.S. international taxation from a worldwide tax system to a modified territorial tax system, which has resulted in a one-time U.S. tax liability on those earnings that have not previously been repatriated to the U.S.

Due to the complexities involved in accounting for the 2017 Tax Act, the U.S. Securities and Exchange Commission issued Staff Accounting Bulletin No. 118 (“SAB 118”), which required companies include in their financial statements estimates of the impacts of the 2017 Tax Act to the extent such estimates have been determined. Under SAB 118, companies were allowed a measurement period of up to one year after the enactment date of the 2017 Tax Act to finalize the recording of the related tax impacts. Accordingly, the Company previously recorded certain estimates of the tax impact in its consolidated statement of operations for the fourth quarter of 2017. During the year ended December 31, 2018, the Company finalized the recording of the

impacts of the 2017 Tax Act and recorded an income tax benefit of $1.8 million, reflecting an adjustment to the provisional estimate of the deemed repatriation transition tax. As a result of the final calculation of the transition tax liability, the Company also recorded an adjustment to the deferred tax liability associated with investments in foreign subsidiaries.

Workers' compensation, auto, medical and general liability accruals. In accordance with ASC 450 Contingencies ("ASC 450"), we record a loss contingency when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We review our loss contingencies on an ongoing basis to ensure that we have appropriate reserves recorded on our balance sheet. These reserves are based on historical experience with claims incurred but not received, estimates and judgments made by management, applicable insurance coverage for litigation matters, and are adjusted as circumstances warrant. For workers' compensation, our self-insured retention is $1.0 million and our automobile liability self-insured retention is currently $500,000 per occurrence. For general liability claims, we have an effective self-insured retention of $3.0 million per occurrence. For medical claims, our self-insured retention is $350,000 per individual claimant determined on an annual basis. For environmental liability claims, our self-insured retention is $1.0 million per occurrence. We maintain insurance for claims that exceed such self-retention limits. The insurance is subject to terms, conditions, limitations and exclusions that may not fully compensate us for all losses. Our estimates and judgments could change based on new information, changes in laws or regulations, changes in management's plans or intentions, or the outcome of legal proceedings, settlements or other factors. If different estimates and judgments were applied with respect to these matters, it is likely that reserves would be recorded for different amounts.

Allowance for doubtful accounts. In the ordinary course of business, a portion of our accounts receivable are not collected due to billing disputes, customer bankruptcies, dissatisfaction with the services we performed and other various reasons. We establish an allowance to account for those accounts receivable that we estimate will eventually be deemed uncollectible. The allowance for doubtful accounts is based on a combination of our historical experience and management's review of long outstanding accounts receivable.

Concentration of credit risk. No single customer accounts for more than 10% of consolidated revenues.

Earnings (loss) per share. Basic earnings (loss) per share is computed by dividing income (loss) from continuing operations, income (loss) from discontinued operations or net income (loss) by the weighted-average number of shares of common stock outstanding during the year. Diluted earnings (loss) per share is computed by dividing income (loss) from continuing operations, income (loss) from discontinued operations or net income (loss) by the sum of (1) the weighted-average number of shares of common stock outstanding during the period, (2) the dilutive effect of the assumed exercise of share-based compensation using the treasury stock method and (3) the dilutive effect of the assumed conversion of our convertible senior notes under the treasury stock method. The Company's intent is to settle the principal amount of the convertible senior notes in cash upon conversion. If the conversion value exceeds the principal amount, the Company may elect to deliver shares of its common stock with respect to the remainder of its conversion obligation in excess of the aggregate principal amount (the "conversion spread"). Accordingly, the conversion spread is included in the denominator for the computation of diluted earnings per common share using the treasury stock method and the numerator is adjusted for any recorded gain or loss, net of tax, on the embedded derivative associated with the conversion feature.

Amounts used in basic and diluted loss per share, for all periods presented, are as follows (in thousands):

	Twelve Months Ended December 31,		
	2018	2017	2016
Weighted-average number of basic shares outstanding	30,031	29,849	28,095
Stock options, stock units and performance awards	—	—	—
Convertible senior notes	—	—	—
Total shares and dilutive securities	30,031	29,849	28,095

For the years ended December 31, 2018, 2017 and 2016, all outstanding share-based compensation awards were excluded from the calculation of diluted loss per share because their inclusion would be antidilutive due to the loss from continuing operations in those periods. Also, for the years ended December 31, 2017 and 2018, the effect of our

convertible senior notes was excluded from the calculation of diluted earnings (loss) per share since the conversion price exceeded the average price of our common stock during the applicable periods. For information on our convertible senior notes and our share-based compensation awards, refer to Note 10 and Note 12, respectively.

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Non-cash investing and financing activities. Non-cash investing and financing activities are excluded from the consolidated statements of cash flows and are as follows (in thousands):

	Twelve Months Ended December 31,		
	2018	2017	2016
Property acquired under capital lease	$5,302	$ —	$—
Note received as consideration in disposal of discontinued operations	$—	$ —	$1,511
Issuance of common stock - Furmanite acquisition	$—	$ —	$209,529

Also, we had $1.4 million, $2.6 million, and $2.3 million of accrued capital expenditures as of December 31, 2018, 2017 and 2016, respectively, which are excluded from the consolidated statements of cash flows until paid.

Foreign currency. For subsidiaries whose functional currency is not the U.S. Dollar, assets and liabilities are translated at period ending rates of exchange and revenues and expenses are translated at period average exchange rates. Translation adjustments for the asset and liability accounts are included as a separate component of accumulated other comprehensive loss in stockholders' equity. Foreign currency transaction gains and losses are included in our statements of operations.

We utilize monthly foreign currency swap contracts to reduce exposures to changes in foreign currency exchange rates including, but not limited to, the Australian Dollar, Canadian Dollar, Brazilian Real, British Pound, Euro, Malaysian Ringgit and Mexican Peso. The impact from these swap contracts was not material as of December 31, 2018 or 2017 or for the years ended December 31, 2018, 2017 and 2016.

Defined benefit pension plans. Pension benefit costs and liabilities are dependent on assumptions used in calculating such amounts. The primary assumptions include factors such as discount rates, expected investment return on plan assets, mortality rates and retirement rates. These rates are reviewed annually and adjusted to reflect current conditions. These rates are determined based on reference to yields. The expected return on plan assets is derived from detailed periodic studies, which include a review of asset allocation strategies, anticipated future long-term performance of individual asset classes, risks (standard deviations) and correlations of returns among the asset classes that comprise the plans' asset mix. While the studies give appropriate consideration to recent plan performance and historical returns, the assumptions are primarily long-term, prospective rates of return. Mortality and retirement rates are based on actual and anticipated plan experience. In accordance with GAAP, actual results that differ from the assumptions are accumulated and are subject to amortization over future periods and, therefore, generally affect recognized expense in future periods. While we believe that the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect the pension obligation and future expense.

Revision to prior period consolidated financial statements. In connection with the preparation of the Company's 2018 consolidated financial statements, the Company identified errors in its previously issued 2017 consolidated financial statements. These prior period errors are related to the measurement of valuation allowances on deferred tax assets. The prior period consolidated financial statements and other affected prior period financial information have been revised to correct these errors. The effect of correcting the errors increased our income tax benefit and favorably impacted our net loss by $19.7 million in the twelve months ended December 31, 2017. The correction also resulted in an increase of $19.7 million to previously reported stockholders' equity as of December 31, 2017. Based on an analysis of quantitative and qualitative factors, the Company determined the related impacts were not material to its previously filed annual or interim consolidated financial statements, and therefore, amendments of previously filed reports are not required.

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The table below provides a summary of the financial statement line items which were impacted by these error corrections (in thousands, except per share data):

	December 31, 2017		
	As Previously Reported	Adjustments	As Revised
Effect on consolidated balance sheet			
Liabilities and Equity			
Deferred income taxes	$38,100	$ (19,706)	$18,394
Total Liabilities	$598,367	$ (19,706)	$578,661
Retained earnings	$115,780	$ 19,706	$135,486
Total equity	$457,468	$ 19,706	$477,174

	Twelve Months Ended December 31, 2017		
	As Previously Reported	Adjustments	As Revised
Effect on consolidated statement of operations			
Benefit for income taxes	$(33,372)	$ (19,706)	$(53,078)
Loss from continuing operations	$(104,161)	$ 19,706	$(84,455)
Net loss	$(104,161)	$ 19,706	$(84,455)
Basic loss per common share:			
Continuing operations	$(3.49)	0.66	$(2.83)
Net loss	$(3.49)	0.66	$(2.83)
Diluted loss per common share:			
Continuing operations	$(3.49)	0.66	$(2.83)
Net loss	$(3.49)	0.66	$(2.83)

Newly Adopted Accounting Principles

ASU No. 2014-09. In May 2014, the FASB issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”), which requires the Company to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 establishes ASC Topic 606, Revenue from Contracts with Customers. (“ASC 606”). We adopted ASC 606 effective January 1, 2018. ASC 606 replaces most of the previous revenue recognition guidance under GAAP. Most of our contracts with customers are short-term in nature and billed on a time and materials basis, while certain other contracts are at a fixed price. For these fixed price contracts, ASC 606 generally results in the recognition of revenue as the services are provided compared to recognition of revenue at the time of completion of those contracts, under previous guidance. The adoption of ASC 606 has not resulted in significant changes to the overall pattern or timing of our revenue recognition.

To account for the cumulative effect of initially applying ASC 606 as of January 1, 2018, we recognized a pre-tax increase to the opening balance of retained earnings of $8.8 million, pursuant to the modified retrospective transition method, for certain fixed-price contracts that were not yet completed as of the date of adoption. The cumulative effect of adoption resulted in a net increase to prepaid expenses and other current assets of $8.5 million, a reduction to inventory of $0.4 million and a reduction to other accrued liabilities of $0.7 million. Also, we recorded the related tax impacts as of January 1, 2018, which resulted in a net reduction to the opening balance of retained earnings of $2.0 million and a corresponding increase to deferred tax liabilities. Because we have applied the modified retrospective transition method of adoption, comparative periods prior to January 1, 2018 were not retrospectively adjusted to

reflect adoption of ASU 2014-09 and are presented in accordance with our historical accounting.

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The effect of ASC 606 on our consolidated balance sheet as of December 31, 2018 and our consolidated statements of operations for the twelve months ended December 31, 2018 were as follows (in thousands):

	December 31, 2018		
	Without adoption of ASC 606	Adjustments to apply ASC 606	As reported
Effect on consolidated balance sheet			
Assets			
Prepaid expenses and other current assets	$16,321	$ 3,124	$19,445
Liabilities and Equity			
Deferred income taxes	$5,494	$ 612	$6,106
Retained earnings	$78,938	$ 2,512	$81,450

	Twelve Months Ended December 31, 2018		
	Without adoption of ASC 606	Adjustments to apply ASC 606	As reported
Effect on consolidated statement of operations			
Revenues	$1,251,694	$ (4,765)	$1,246,929
Operating expenses	$917,768	$ 905	$918,673
Benefit for income taxes	$(29,660)	$ (1,403)	$(31,063)
Net loss	$(58,879)	$ (4,267)	$(63,146)

Refer to Note 2 for additional disclosures required by ASC 606.

ASU No. 2016-15. In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”), which clarifies the classification in the statement of cash flows of certain items, including debt prepayment or extinguishment costs, settlement of contingent consideration arising from a business combination, insurance settlement proceeds and cash receipts and payments having aspects of more than one class of cash flows. The adoption of this ASU on January 1, 2018 had no impact on our consolidated statements of cash flows.

ASU No. 2016-16. In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory (“ASU 2016-16”), which requires an entity to recognize the income tax consequences of an intra-entity transfer of an asset, other than inventory, when the transfer occurs. Adoption of ASU 2016-16 on January 1, 2018 did not have a material impact on our consolidated financial statements.

ASU No. 2016-18. In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force) (“ASU 2016-18”), which states that inflows and outflows of restricted cash and cash equivalents must be included in the statement of cash flows as cash inflows and outflows and must be included in cash and cash equivalents. We adopted of ASU 2016-18 on January 1, 2018 on a retrospective basis. As a result of adoption, the consolidated statement of cash flows for the twelve months ended December 31, 2016 was retrospectively adjusted to reflect restricted cash as part of cash and cash equivalents. The adjustment resulted in a $5.0 million increase to beginning cash and cash equivalents at January 1, 2016 and a $5.0 million decrease to cash flows from investing activities for the twelve months ended December 31, 2016, compared to amounts originally reported. The adoption of ASU 2016-18 had no impact to the consolidated statements of cash flows for the twelve months ended December 31, 2018 and 2017.

ASU No. 2017-07. In March 2017, the FASB issued ASU No. 2017-07, Compensation—Retirement Benefits: Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost (“ASU 2017-07”), which prescribes where in the statement of operations the components of net periodic pension cost and net

periodic postretirement benefit cost should be reported. Under ASU 2017-07, the service cost component is required to be reported in the same line or line items that other compensation costs of the associated employees are reported, while the other components are reported outside of operating income (loss), in the "Other expense, net" line item of our consolidated statements of operations. Adoption of ASU 2017-07 on January 1, 2018 did not have a material impact on our consolidated statements of operations.

ASU No. 2017-09. In May 2017, the FASB issued ASU No. 2017-09, Compensation–Stock Compensation: Scope of Modification Accounting ("ASU 2017-09"), which provides guidance about which changes to the terms or conditions of a share-based payment award require an entity apply modification accounting in Topic 718. Under ASU 2017-09, modification accounting

is required unless the effect of the modification does not impact the award's fair value, vesting conditions and its classification as an equity instrument or liability instrument. Our adoption of ASU 2017-09 on January 1, 2018 on a prospective basis did not have any impact on our share-based compensation expense.

ASU No. 2017-12. In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedge Activities ("ASU 2017-12"). This update makes certain targeted improvements to the accounting and presentation of certain hedging relationships. For net investment hedges, ASU 2017-12 requires that the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness be recorded in the currency translation adjustment section of other comprehensive income (loss). In the third quarter of 2018, we elected to early adopt ASU 2017-12, with application as of January 1, 2018. Adoption of ASU 2017-12 did not have any impact on our consolidated financial statements.

ASU No. 2018-02. In February 2018, the FASB issued ASU 2018-02, Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("ASU 2018-02"). ASU 2018-02 introduces the option to reclassify from accumulated other comprehensive income (loss) to retained earnings the "stranded" tax effects resulting from the 2017 Tax Act. Under GAAP, certain deferred tax assets or liabilities may originate through income tax activity recognized in other comprehensive income (loss). However, because the adjustment of deferred tax assets and liabilities due to the reduction of the historical corporate income tax rate to the newly enacted corporate income tax rate is required to be included in income (loss) from continuing operations, the tax effects of items within accumulated other comprehensive income (loss) are not adjusted to reflect the new tax rate, resulting in "stranded" tax effects. ASU 2018-02 provides an option to reclassify such tax effects from accumulated other comprehensive income (loss) to retained earnings. We early adopted ASU 2018-02 in the fourth quarter of 2018. The effect of adoption resulted in an increase to retained earnings of $2.3 million and an offsetting adjustment to accumulated other comprehensive loss.

ASU No. 2018-13. In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement, which removes, modifies and adds certain disclosure requirements for fair value measurements. Our early adoption of ASU 2018-13 in the third quarter of 2018 did not have any impact on our consolidated financial statements. Refer to Note 11 for our fair value disclosures.

ASU No. 2018-14. In August 2018, the FASB issued ASU No. 2018-14, Compensation — Retirement Benefits — Defined Benefit Plans — General (Subtopic 715-20): Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans ("ASU 2018-14"), which modifies the disclosure requirements for employers that sponsor defined benefit plans or other postretirement plans. Our early adoption of ASU 2018-14 on December 31, 2018 did not have a material impact on our disclosures. Refer to Note 13 for our employee benefit plans disclosures.

Accounting Principles Not Yet Adopted

Topic 842 - Leases. In February 2016, the FASB issued ASU No. 2016-02, Leases ("ASU 2016-02"), which establishes ASC Topic 842, Leases ("ASC 842"), replaced previous lease accounting guidance along with subsequent ASUs issued in 2018 to clarify certain provisions of ASU 2016-02. ASC 842 changes the accounting for leases, including a requirement to record leases with terms of greater than twelve months on the balance sheet as assets and liabilities. ASC 842 will also require us to expand our financial statement disclosures on leasing activities.

We will adopt Topic 842 effective January 1, 2019 and intend to elect the modified retrospective transition method, which specified the comparative financial information will not be restated and will continue to be reported under the lease standard in effect during those periods. We expect to elect the "package of practical expedients," which permits us not to reassess under the new standard our prior conclusions on lease identification, lease classification and initial direct costs. We also intend to elect the short-term lease recognition practical expedient in which leases with a term of 12 months or less will not be recognized on the balance sheet and the practical expedient to not separate lease and non-lease components for the majority of our leases. Based on our current assessment and estimates, we expect the adoption of ASC 842, as of January 1, 2019, to result in the recognition of operating lease right-of-use assets and additional net liabilities in the range of approximately $62 million to $72 million. The cumulative effect adjustment to retained earnings due to the adoption of ASC 842 is not expected to be material. We do not anticipate that the adoption of ASC 842 will result in any material impacts to our statements of operations or statements of cash flows.

ASU No. 2016-13. In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments–Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (“ASU 2016-13”), which amends GAAP by introducing a new impairment model for financial instruments that is based on expected credit losses rather than incurred credit losses. The new impairment model applies to most financial assets, including trade accounts receivable. ASU 2016-13 is effective for interim and annual

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reporting periods beginning after December 15, 2019 and requires a modified retrospective transition approach. We are currently evaluating the impact this ASU will have on our ongoing financial reporting.

2. REVENUE

As discussed in "Newly Adopted Accounting Principles—ASU No. 2014-09" in Note 1, on January 1, 2018, we adopted ASC 606 using the modified retrospective method, which was applied to those contracts that were not completed as of January 1, 2018.

In accordance with ASC 606, we follow a five-step process to recognize revenue: 1) identify the contract with the customer, 2) identify the performance obligations, 3) determine the transaction price, 4) allocate the transaction price to the performance obligations and 5) recognize revenue when the performance obligations are satisfied.

Most of our contracts with customers are short-term in nature and billed on a time and materials basis, while certain other contracts are at a fixed price. Certain contracts may contain a combination of fixed and variable elements. We act as a principal and have performance obligations to provide the service itself or oversee the services provided by any subcontractors. Revenue is measured based on consideration specified in a contract with a customer and excludes amounts collected on behalf of third parties, such as taxes assessed by governmental authorities. Generally, in contracts where the amount of consideration is variable, the amount is determinable each period based on our right to invoice (as discussed further below) the customer for services performed to date. As most of our contracts contain only one performance obligation, the allocation of a contracts transaction price to multiple performance obligations is generally not applicable. Customers are generally billed as we satisfy our performance obligations and payment terms typically range from 30 to 90 days from the invoice date. Billings under certain fixed-price contracts may be based upon the achievement of specified milestones, while some arrangements may require advance customer payment. Our contracts do not include significant financing components since the contracts typically span less than one year.

Contracts generally include an assurance type warranty clause to guarantee that the services comply with agreed specifications. The warranty period typically is 12 months or less from the date of service. Warranty expenses were not material for the twelve months ended December 31, 2018, 2017 and 2016.

Revenue is recognized as (or when) the performance obligations are satisfied by transferring control over a service or product to the customer. Revenue recognition guidance prescribes two recognition methods (over time or point in time). Most of our performance obligations qualify for recognition over time because we typically perform our services on customer facilities or assets and customers receive the benefits of our services as we perform. Where a performance obligation is satisfied over time, the related revenue is also recognized over time using the method deemed most appropriate to reflect the measure of progress and transfer of control. For our time and materials contracts, we are generally able to elect the right-to-invoice practical expedient, which permits us to recognize revenue in the amount to which we have a right to invoice the customer if that amount corresponds directly with the value to the customer of our performance completed to date. For our fixed price contracts, we typically recognize revenue using the cost-to-cost method, which measures the extent of progress towards completion based on the ratio of costs incurred to date to the total estimated costs at completion of the performance obligation. Under this method, revenue is recognized proportionately as costs are incurred. For contracts where control is transferred at a point in time, revenue is recognized at the time control of the asset is transferred to the customer, which is typically upon delivery and acceptance by the customer.

Disaggregation of revenue. Essentially all of our revenues are associated with contracts with customers. A disaggregation of our revenue from contracts with customers by geographic region, by reportable operating segment and by service type is presented below (in thousands):

	Twelve Months Ended December 31, 2018		
	United States and Canada	Other Countries	Total
Revenue:			
IHT	$602,615	$14,763	$617,378
MS	383,405	148,960	532,365

Quest Integrity	62,262	34,924	97,186
Total	$1,048,282	$198,647	$1,246,929

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	Twelve Months Ended December 31, 2018					
	Asset Integrity Management	Repair and Maintenance Services	Heat Treating	Non-Destructive Evaluation	Other	Total
Revenue:						
IHT	$46,726	$ 27,420	$80,840	$ 447,080	$15,312	$617,378
MS	402	523,701	2,753	—	5,509	532,365
Quest Integrity	97,186	—	—	—	—	97,186
Total	$144,314	$ 551,121	$83,593	$ 447,080	$20,821	$1,246,929

For additional information on our reportable operating segments and geographic information, refer to Note 15.
Contract balances. The timing of revenue recognition, billings and cash collections results in trade accounts receivable, contract assets and contract liabilities on the consolidated balance sheets. Trade accounts receivable include billed and unbilled amounts currently due from customers and represent unconditional rights to receive consideration. The amounts due are stated at their net estimated realizable value. Refer to Notes 1 and 4 for additional information on our trade receivables and the allowance for doubtful accounts. Contract assets include unbilled amounts typically resulting from sales under fixed-price contracts when the cost-to-cost method of revenue recognition is utilized, the revenue recognized exceeds the amount billed to the customer and the right to payment is conditional on something other than the passage of time. Amounts may not exceed their net realizable value. If we receive advances or deposits from our customers, a contract liability is recorded. Additionally, a contract liability arises if items of variable consideration result in less revenue being recorded than what is billed. Contract assets and contract liabilities are generally classified as current.
The following table provides information about trade accounts receivable, contract assets and contract liabilities as of December 31, 2018 and January 1, 2018, the date of adoption of ASC 606, (in thousands):

	December 31, 2018	January 1, 2018
Trade accounts receivable, net[1]	$ 268,352	$301,963
Contract assets[2]	$ 5,745	$9,823
Contract liabilities[3]	$ 1,784	$5,415

1 Includes billed and unbilled amounts, net of allowance for doubtful accounts. See Note 4 for details.
2 Included in the "Prepaid expenses and other current assets" line on the consolidated balance sheet.
3 Included in the "Other accrued liabilities" line of the consolidated balance sheet.

The $4.1 million decrease in our contract assets from January 1, 2018 to December 31, 2018 is due to fewer fixed price contracts in progress at December 31, 2018 as compared to January 1, 2018, consistent with lower activity levels in the fourth quarter of 2018 compared to the same quarter in 2017. The $3.6 million decrease in contract liabilities is due to our completion of performance obligations during the year ended December 31, 2018 associated with contracts under which customers had paid for all or a portion of the consideration in advance of the work being performed. Due to the short-term nature of our contracts, contract liability balances as of the end of any period are generally recognized as revenue in the following quarter. Accordingly, essentially all of the contract liability balance at January 1, 2018 was recognized as revenue during the year ended December 31, 2018.
Contract costs. The Company recognizes the incremental costs of obtaining contracts as selling, general and administrative expenses when incurred if the amortization period of the asset that otherwise would have been recognized is one year or less. Assets recognized for costs to obtain a contract were not material as of December 31, 2018 or January 1, 2018. Costs to fulfill a contract are recorded as assets if they relate directly to a contract or a specific anticipated contract, the costs generate or enhance resources that will be used in satisfying performance obligations in the future and the costs are expected to be recovered. Costs to fulfill recognized as assets primarily consist of labor and materials costs and generally relate to engineering and set-up costs incurred prior to the

satisfaction of performance obligations begins. Assets recognized for costs to fulfill a contract are included in the "Prepaid expenses and other current assets" line of the consolidated balance sheets and were not material as of December 31, 2018 and January 1, 2018. Such assets are recognized as expenses as we transfer the related goods or services to the customer. All other costs to fulfill a contract are expensed as incurred.

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Remaining performance obligations. As of December 31, 2018 and January 1, 2018, there were no material amounts of remaining performance obligations that are required to be disclosed. As permitted by ASC 606, we have elected not to disclose information about remaining performance obligations where i) the performance obligation is part of a contract that has an original expected duration of one year or less or ii) when we recognize revenue from the satisfaction of the performance obligation in accordance with the right-to-invoice practical expedient.

3. ACQUISITION

In November 2015, Team and Furmanite Corporation (now Furmanite LLC, "Furmanite") entered into an Agreement and Plan of Merger (the "Merger Agreement") pursuant to which we acquired all the outstanding shares of Furmanite in a stock transaction whereby Furmanite shareholders received 0.215 shares of Team common stock for each share of Furmanite common stock they owned. The merger was completed on February 29, 2016. Outstanding Furmanite share-based payment awards were generally converted into comparable share-based awards of Team, with certain awards vesting upon the closing of the merger, pursuant to the Merger Agreement. The combination doubled the size of Team's mechanical services capabilities and established a deeper, broader talent and resource pool that better supports customers across standard and specialty mechanical services worldwide.

The acquisition-date fair value of the consideration transferred totaled $282.3 million, which consisted of the following (in thousands, except shares):

	February 29, 2016
Common stock (8,208,006 shares)	$209,529
Converted share-based payment awards	2,001
Cash	70,811
Total consideration	$282,341

The fair value of the 8,208,006 common shares issued was determined based on the closing market price of our common shares on the acquisition date of February 29, 2016. The fair value of the converted share-based payment awards reflects an apportionment of the fair value of the awards, based on the closing market price of our common stock and other assumptions as of the acquisition date, that is attributable to employee service completed prior to the acquisition date. The fair value of the awards attributable to service after the acquisition date is recognized as share-based compensation expense over the applicable vesting periods. The cash consideration represents amounts Team paid, immediately prior to the closing of the acquisition, to settle Furmanite's outstanding debt and certain related liabilities, which were not assumed by Team. The cash portion of the consideration was financed through additional borrowings under our banking credit facility.

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The following table presents the purchase price allocation for Furmanite (in thousands):

	February 29, 2016
Cash and cash equivalents	$37,734
Accounts receivable	65,925
Inventory	25,847
Current deferred tax assets	19,857
Prepaid expenses and other current assets	23,044
Current assets of discontinued operations	18,623
Property, plant and equipment	63,259
Intangible assets	88,958
Goodwill	89,646
Other non-current assets	687
Non-current deferred tax assets	2,542
Total assets acquired	436,122
Accounts payable	12,359
Other accrued liabilities	33,127
Income taxes payable	229
Current liabilities of discontinued operations	1,434
Non-current deferred tax liabilities	91,431
Defined benefit pension liability	13,509
Other long-term liabilities	1,692
Total liabilities assumed	153,781
Net assets acquired	$282,341

The purchase price allocation shown above is based upon the fair values at the acquisition date. The fair values recorded are "Level 3" measurements as defined in Note 11.

Of the $89.0 million of acquired intangible assets, $69.8 million was assigned to customer relationships with an estimated useful life of 12 years, $16.9 million was assigned to trade names with a weighted-average estimated useful life of 12 years and $2.3 million was assigned to developed technology with an estimated useful life of 10 years.

The $89.6 million of goodwill was assigned to the MS segment. The goodwill recognized is attributable primarily to expected synergies and the assembled workforce of Furmanite. None of the goodwill recognized is expected to be deductible for income tax purposes.

The fair value of accounts receivable acquired was $65.9 million, considering we expect $7.9 million to be uncollectible. Additionally, we acquired accounts receivable with a fair value of $13.6 million associated with discontinued operations, which is included in the current assets of discontinued operations line above. The gross contractual amount of receivables acquired was $88.0 million

Current assets of discontinued operations as of the acquisition date also includes $3.3 million of goodwill and $1.6 million of intangible assets that were allocated to a business that we sold in December 2016, as discussed in Note 16. The amount of current assets of discontinued operations acquired shown above is net of costs to sell of $1.1 million.

For the year ended December 31, 2016 we recognized a total of $6.7 million of acquisition costs related to the Furmanite acquisition, which were included in selling, general and administrative expenses in the consolidated statements of operations.

Our consolidated statement of operations for the year ended December 31, 2016 includes the activity of Furmanite beginning on the acquisition date of February 29, 2016. Subsequent to the acquisition date, we commenced integration activities relative to Furmanite. As a result, certain business operations have been consolidated and/or transferred from legacy Furmanite operations to legacy Team operations to facilitate the new operating structure. Revenues of $216 million and a net loss of $6.4 million are included in the year ended December 31, 2016 and only include operating results that are directly attributable to legacy Furmanite

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operations. These amounts do not reflect any attempt to adjust for the effects of integration activities, which are not practicable to determine.

Certain transactions related to the Furmanite acquisition were recognized separately from the acquisition of assets and assumption of liabilities in accordance with GAAP. These transactions, which were attributable to certain compensation (both cash and share-based) that was paid or became payable in conjunction with the closing of the acquisition, totaled $4.7 million and were recognized as selling, general and administrative expenses during the year ended December 31, 2016.

Our unaudited pro forma consolidated results of operations are shown below as if the acquisition of Furmanite had occurred on June 1, 2015. These results are not necessarily indicative of the results that would actually have occurred if the acquisition had taken place at June 1, 2015, nor are they necessarily indicative of future results (in thousands, except per share data).

	Pro forma data Year Ended December 31, 2016 (unaudited)
Revenues	$1,240,466
Income (loss) from continuing operations attributable to Team shareholders	$(7,497)
Earnings (loss) per share from continuing operations:	
Basic	$(0.25)
Diluted	$(0.25)

These amounts have been calculated after applying Team's accounting policies and adjusting the results of Furmanite to reflect the additional depreciation and amortization that would have been charged assuming the fair value adjustments to property, plant and equipment and intangible assets had been applied on June 1, 2015, together with the related tax effects. Additionally, these pro forma results exclude discontinued operations as well as the impact of transaction and integration-related costs associated with the Furmanite acquisition included in the historical results.

4. RECEIVABLES

A summary of accounts receivable as of December 31, 2018 and 2017 is as follows (in thousands):

	December 31,	
	2018	2017
Trade accounts receivable	$207,266	$244,133
Unbilled revenues	76,268	69,138
Allowance for doubtful accounts	(15,182)	(11,308)
Total	$268,352	$301,963

The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is remote. The following summarizes the activity in the allowance for doubtful accounts (in thousands):

	Twelve Months Ended December 31,		
	2018	2017	2016
Balance at beginning of period	$11,308	$7,835	$3,548
Provision for doubtful accounts	11,662	7,097	6,336
Write-off of bad debts	(7,788)	(3,624)	(2,049)
Balance at end of period	$15,182	$11,308	$7,835

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5. INVENTORY

A summary of inventory as of December 31, 2018 and 2017 is as follows (in thousands):

	December 31,	
	2018	2017
Raw materials	$8,448	$8,707
Work in progress	3,900	2,836
Finished goods	36,192	38,160
Total	$48,540	$49,703

6. PROPERTY, PLANT AND EQUIPMENT

A summary of property, plant and equipment as of December 31, 2018 and 2017 is as follows (in thousands):

	December 31,	
	2018	2017
Land	$6,376	$6,698
Buildings and leasehold improvements	57,006	47,924
Machinery and equipment	269,084	261,343
Furniture and fixtures	10,253	9,405
Capitalized ERP system development costs	46,637	46,637
Computers and computer software	15,826	13,052
Automobiles	4,879	5,070
Construction in progress	6,550	12,613
Total	416,611	402,742
Accumulated depreciation and amortization	(221,817)	(199,523)
Property, plant, and equipment, net	$194,794	$203,219

Included in the table above is a building under capital lease of $5.3 million and accumulated amortization of $0.1 million as of December 31, 2018. Depreciation expense for the years ended December 31, 2018, 2017 and 2016 was $36.2 million, $35.7 million and $33.5 million, respectively.

7. INTANGIBLE ASSETS

A summary of intangible assets as of December 31, 2018 and 2017 is as follows (in thousands):

	December 31, 2018		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	$174,894	$ (51,160)	$123,734
Non-compete agreements	5,433	(4,882)	551
Trade names	24,753	(20,594)	4,159
Technology	7,847	(5,187)	2,660
Licenses	851	(583)	268
Total	$213,778	$ (82,406)	$131,372

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	December 31, 2017		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	$175,226	$ (38,712)	$136,514
Non-compete agreements	5,563	(4,509)	1,054
Trade names	24,830	(6,211)	18,619
Technology	7,867	(4,292)	3,575
Licenses	859	(460)	399
Total	$214,345	$ (54,184)	$160,161

Amortization expense for the years ended December 31, 2018, 2017 and 2016 was $28.7 million, $16.5 million and $16.1 million, respectively. Amortization expense for current intangible assets is forecast to be approximately $14 million per year in 2019 and 2020 and approximately $13 million per year in 2021, 2022 and 2023. The higher amortization expense in 2018 is primarily due to a change in the estimated useful life of intangible asset associated with the Furmanite trade name. Management determined that, as a result of initiatives to consolidate the Company's branding, the useful life of this intangible asset was not expected to extend beyond December 31, 2018. In accordance with ASC 350, we accounted for the change in useful life prospectively effective January 1, 2018 and amortized the remaining balance over 2018, which resulted in incremental amortization expense in 2018 of $12 million. The weighted-average amortization period for intangible assets subject to amortization was 13.5 years as of December 31, 2018. The weighted-average amortization period as of December 31, 2018 is 13.6 years for customer relationships, 4.7 years for non-compete agreements, 14.3 years for trade names, 9.9 years for technology and 10.6 years for licenses.

8. OTHER ACCRUED LIABILITIES

A summary of other accrued liabilities as of December 31, 2018 and 2017 is as follows (in thousands):

	December 31,	
	2018	2017
Payroll and other compensation expenses	$47,988	$40,988
Insurance accruals	16,001	15,799
Property, sales and other non-income related taxes	7,271	6,483
Lease commitments	1,145	1,616
Contract liabilities	1,784	6,102
Accrued commission	2,290	1,473
Accrued interest	5,261	5,950
Volume discount	4,322	1,545
Contingent consideration	429	1,246
Professional fees	1,219	1,098
Other	7,598	10,172
Total	$95,308	$92,472

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9. INCOME TAXES

For the years ended December 31, 2018, 2017 and 2016, our income tax benefit on the loss from continuing operations reflected an effective tax rate benefit of 33%, 39% and 20%, respectively. Our income tax benefit on continuing operations for the years ended December 31, 2018, 2017 and 2016 was $31.1 million, $53.1 million and $3.1 million, respectively, and includes federal, state and foreign taxes. The components of our tax benefit on continuing operations were as follows (in thousands):

	Current	Deferred	Total
Twelve months ended December 31, 2018:			
U.S. Federal	$(3,295)	$(27,670)	$(30,965)
State & local	509	(2,360)	(1,851)
Foreign jurisdictions	3,457	(1,704)	1,753
	$671	$(31,734)	$(31,063)
Twelve months ended December 31, 2017:			
U.S. Federal	$6,177	$(62,222)	$(56,045)
State & local	170	(4,819)	(4,649)
Foreign jurisdictions	6,821	795	7,616
	$13,168	$(66,246)	$(53,078)
Twelve months ended December 31, 2016:			
U.S. Federal	$(2,048)	$(5,262)	$(7,310)
State & local	(1,338)	206	(1,132)
Foreign jurisdictions	4,529	820	5,349
	$1,143	$(4,236)	$(3,093)

The components of pre-tax income (loss) from continuing operations for the years ended December 31, 2018, 2017 and 2016 were as follows (in thousands):

	Twelve Months Ended December 31,		
	2018	2017	2016
Domestic	$(90,822)	$(149,045)	$(25,488)
Foreign	(3,387)	11,512	9,830
	$(94,209)	$(137,533)	$(15,658)

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The income tax benefit attributable to the loss from continuing operations differed from the amounts computed by applying the U.S. Federal income tax rate (21% in 2018, 35% in 2017 and 2016) to pre-tax loss from continuing operations as a result of the following (in thousands):

	Twelve Months Ended December 31,		
	2018	2017	2016
Pre-tax loss from continuing operations	$(94,209)	$(137,533)	$(15,658)
Computed income taxes at statutory rate	(19,784)	(48,136)	(5,481)
State income taxes, net of federal benefit	(2,360)	(4,709)	(713)
Foreign tax rate differential	(52)	(642)	(707)
Deferred taxes on investment in foreign subsidiaries	(7,284)	(17,079)	1,777
Non-deductible expenses	686	1,030	871
Foreign tax credits	—	(17,445)	(2,302)
Other tax credits	(1,995)	(631)	(1,033)
Deemed repatriation tax	(1,751)	24,374	—
Goodwill impairment	—	19,442	—
Dividend from foreign subsidiaries	—	—	2,021
Valuation allowance	2,923	1,249	1,986
Rate change	81	(17,360)	—
Other	(1,527)	6,829	488
Total benefit for income tax on continuing operations	$(31,063)	$(53,078)	$(3,093)

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The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below (in thousands):

	December 31,	
	2018	2017
Deferred tax assets:		
Accrued compensation and benefits	$10,463	$9,810
Receivables	3,096	2,381
Inventory	422	873
Stock options	1,101	738
Foreign currency translation and other equity adjustments	—	2,945
Other accrued liabilities	2,058	3,066
Tax credit carry forward	1,920	2,588
Net operating loss carry forwards	48,732	35,185
Other	5,925	2,066
Deferred tax assets	73,717	59,652
Less: Valuation allowance	(10,549)	(6,479)
Deferred tax assets, net	63,168	53,173
Deferred tax liabilities:		
Property, plant and equipment	(22,429)	(20,918)
Goodwill and intangible costs	(23,210)	(27,762)
Unremitted earnings of foreign subsidiaries	(5,375)	(13,795)
Convertible debt	(7,055)	(3,622)
Other	(3,553)	(677)
Deferred tax liabilities	(61,622)	(66,774)
Net deferred tax asset (liability)	$1,546	$(13,601)

As of December 31, 2018, we had a valuation allowance of $10.5 million to reduce our deferred tax assets to an amount more likely than not to be recovered. This valuation allowance relates primarily to deferred tax assets on foreign and state net operating loss carry forwards. In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible.

At December 31, 2018, we had net operating loss carry forwards for U.S. federal income tax purposes of $132.3 million. Of this amount, $94.7 million expires in 2036 and 2037 and $37.6 million has an indefinite carry forward period. These carry forwards are available, subject to certain limitations, to offset future taxable income. Additionally, total federal net operating losses of $13.6 million will be carried back to prior years. Further, we have state net operating loss carry forwards of $92.0 million with $77.1 million expiring various dates through 2038 and $14.9 million with an indefinite carry forward period.

In addition, as of December 31, 2018, we have an alternative minimum tax credit carry forwards of approximately $2.4 million which, under the 2017 Tax Act, can be used to offset regular income tax in future periods, or is refundable for any tax year beginning after 2017 and before 2022 in an amount equal to 50% (100% for tax years beginning in 2021). Also, at December 31, 2018, there are research and development credit carry forwards of $1.2 million.

As of December 31, 2018, we had foreign net operating loss carry forwards totaling $41.1 million that were expected to be realized in the future periods. A total of $24.9 million has an unlimited carry forward period and will therefore not expire.

At December 31, 2018, none of our undistributed earnings of foreign operations were considered to be permanently reinvested overseas. As of December 31, 2018, the deferred tax liability related to undistributed earnings of foreign subsidiaries was $5.4 million.

At December 31, 2018, we have established liabilities for uncertain tax positions of $2.2 million, inclusive of interest and penalties. To the extent these uncertainties are ultimately resolved favorably, the resulting reduction of recorded liabilities would

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have an effect on our effective tax rate. In accordance with ASC 740-10, our policy is to recognize interest and penalties related to unrecognized tax benefits through the tax provision.

We file income tax returns in the U.S. with federal and state jurisdictions as well as various foreign jurisdictions. With few exceptions, we are no longer subject to U.S. Federal, state and local or non-U.S. income tax examinations by tax authorities for years prior to 2015. The IRS audits for the tax years ended May 31, 2015 and December 31, 2015 have been completed as of December 31, 2018, and the final audit adjustment recorded was not material. The income tax laws and regulations are voluminous and are often ambiguous. As such, we are required to make certain subjective assumptions and judgments regarding our tax positions that may have a material effect on our results of operations, financial position or cash flows. We believe, however, that there is appropriate support for the income tax positions taken, and to be taken, on our returns, and that our accruals for tax liabilities are adequate for all open tax years based on an assessment of many factors including past experience and interpretations of tax law applied to the facts of each matter.

Set forth below is a reconciliation of the changes in our unrecognized tax benefits associated with uncertain tax positions (in thousands):

	Twelve Months Ended December 31,		
	2018	2017	2016
Balance at beginning of year	$1,159	$858	$539
Acquisition of Furmanite uncertain tax positions	—	—	660
Additions based on current year tax positions	—	—	464
Additions based on tax positions related to prior years	1,478	301	96
Reductions based on tax positions related to prior years	(416)	—	(564)
Settlements	—	—	(337)
Balance at end of year	$2,221	$1,159	$858

The estimated amount of liabilities recorded for uncertain tax positions that we believe will be effectively settled within the next twelve months is immaterial.

The 2017 Tax Act and SAB 118 Provisional Estimates

On December 22, 2017, the U.S. government enacted the 2017 Tax Act, which significantly revised U.S. corporate income tax law by lowering the U.S. federal corporate income tax rate from 35% to 21%, implementing a territorial tax system, imposing a one-time tax on foreign unremitted earnings and setting limitations on deductibility of certain costs (e.g., interest expense), among other changes.

Due to the complexities involved in accounting for the 2017 Tax Act, the SEC issued SAB 118, which requires that companies include in their financial statements estimates of the impact of the 2017 Tax Act to the extent such estimates have been determined. Accordingly, the Company recorded the following estimates of the tax impact of the new law in its statement of operations for the year ended December 31, 2017:

a) The Company accrued an estimate of $8.4 million of tax benefit (net of applicable foreign tax credits) for the 2017 Tax Act's one-time transition tax on the foreign subsidiaries' accumulated, unremitted earnings going back to 1986. The Company has elected to pay the transition tax in installments over the period of eight years, pursuant to the guidance of the new Internal Revenue Code Section 965, however in 2019 the Company will utilize available tax credits to fully offset remaining balance of the one-time transition tax liability.

b) The Company accrued $17.4 million of provisional tax benefit related to the net change in deferred tax balances stemming from the 2017 Tax Act's reduction of the U.S. federal income tax rate,

c) The Company recorded an estimate of the state tax impact of the 2017 Tax Act, based on the current law in the states in the U.S. in which it operates, and

d) The Company calculated an estimate of the effect on certain deferred tax assets and liabilities of the Company related to the 2017 Tax Act's revised rules regarding certain incentive-based compensation tax deductions under Internal Revenue Code Section 162(m).

Pursuant to the SAB 118, the company was allowed a measurement period of up to one year after the enactment date of the 2017 Tax Act to finalize the recording of the related tax impacts. During the year ended December 31, 2018, the Company finalized the recording of the impacts of the 2017 Tax Act and recorded an income tax benefit of $1.8 million, reflecting an adjustment to

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the provisional estimate of the deemed repatriation transition tax. In 2019, we will amend the one-time transition tax to include tax credits to offset the remainder of the tax liability on the transition tax. As a result of the final calculation of the transition tax liability, the Company also recorded an adjustment to the deferred tax liability associated with investments in foreign subsidiaries.
Effective January 1, 2018, the Company is subject to GILTI for earnings and profits of its foreign subsidiaries as well as BEAT for certain tax payments between a U.S. corporation and its subsidiaries. As of December 31, 2018, the Company had no tax liabilities relating to GILTI or BEAT tax.

10. LONG-TERM DEBT, LEASES, DERIVATIVES AND LETTERS OF CREDIT

As of December 31, 2018 and 2017, our long-term debt and capital lease obligations are summarized as follows (in thousands):

	December 31, 2018		2017	
Credit Facility	$	156,843	$	177,857
Convertible debt[1]	195,184		209,892	
Capital lease obligations	5,356		—	
Total long-term debt and capital lease obligations	357,383		387,749	
Less: current portion of long-term debt and capital lease obligations	569		—	
Total long-term debt and capital lease obligations, less current portion	$	356,814	$	387,749

1 Comprised of principal amount outstanding plus embedded derivative liability (if any), less unamortized discount and issuance costs. See Convertible Debt section below for additional information.

Future maturities of long-term debt, excluding capital leases, are as follows (in thousands):

December 31	
2019	$—
2020	156,843
2021	—
2022	—
2023	230,000
Thereafter	—
Total	$386,843

For information on our capital lease obligations, see the Lease Obligations section below.

Credit Facility

In July 2015, we renewed our banking credit facility (the "Credit Facility"). In accordance with the second amendment to the Credit Facility, which was signed in February 2016, the Credit Facility had a borrowing capacity of up to

$600.0 million and consisted of a $400.0 million, five-year revolving loan facility and a $200.0 million five-year term loan facility. The swing line facility is $35.0 million. On July 31, 2017, we completed the issuance of $230.0 million of 5.00% convertible senior notes in a private offering (the “Offering,” which is described further below) and used the proceeds from the Offering to repay in full the then-outstanding term-loan portion of our Credit Facility and a portion of the outstanding revolving borrowings. Concurrent with the completion of the Offering and the repayment of outstanding borrowings discussed above, we entered into the sixth amendment to the Credit Facility, effective as of June 30, 2017, which reduced the capacity of the Credit Facility to a $300.0 million revolving loan facility, subject to a borrowing availability test (based on eligible accounts, inventory and fixed assets). The Credit Facility matures on July 7, 2020, bears interest based on a variable Eurodollar rate option (LIBOR plus 3.00% margin at December 31, 2018) and has commitment fees on unused borrowing capacity (0.50% at December 31, 2018). The Credit Facility limits our ability to pay cash dividends. The Company’s obligations under the Credit Facility are guaranteed by its material direct and indirect domestic subsidiaries and are secured by a lien on substantially all of the Company’s and the guarantors’ tangible and intangible property (subject to certain specified exclusions) and by a pledge of all of the equity interests in the Company’s material direct and indirect domestic subsidiaries and 65% of the equity interests in the Company’s material first-tier foreign subsidiaries.

The Credit Facility contains financial covenants, which were amended in March 2018 pursuant to the seventh amendment (the “Seventh Amendment”) to the Credit Facility. The Seventh Amendment eliminated the ratio of consolidated funded debt to consolidated EBITDA (the “Total Leverage Ratio,” as defined in the Credit Facility agreement) covenant through the remainder of the term of the Credit Facility and also modified both the ratio of senior secured debt to consolidated EBITDA (the “Senior Secured Leverage Ratio,” as defined in the Credit Facility agreement) and the ratio of consolidated EBITDA to consolidated interest charges (the “Interest Coverage Ratio,” as defined in the Credit Facility agreement) as follows. The Company is required to maintain a maximum Senior Secured Leverage Ratio of not more than 3.50 to 1.00 as of December 31, 2018 and each quarter thereafter through June 30, 2019 and not more than 2.75 to 1.00 as of September 30, 2019 and each quarter thereafter. With respect to the Interest Coverage Ratio, the Company is required to maintain a ratio of not less than 2.25 to 1.00 as of December 31, 2018 and not less than 2.50 to 1.00 as of March 31, 2019 and each quarter thereafter. As of December 31, 2018, we are in compliance with these covenants. The Senior Secured Leverage Ratio and the Interest Coverage Ratio stood at 2.56 to 1.00 and 2.90 to 1.00, respectively, as of December 31, 2018. At December 31, 2018, we had $18.3 million of cash on hand and approximately $66 million of available borrowing capacity through our Credit Facility. In connection with the repayment in full of the outstanding term-loan portion of our Credit Facility of $160.0 million on July 31, 2017 and the reduction in capacity of the revolving portion of the Credit Facility, we recorded a loss of $1.2 million during the third quarter of 2017 associated with the write-off of a portion of the debt issuance costs associated with the Credit Facility. As of December 31, 2018, we had $1.8 million of unamortized debt issuance costs that are being amortized over the life of the Credit Facility.

Our ability to maintain compliance with the financial covenants is dependent upon our future operating performance and future financial condition, both of which are subject to various risks and uncertainties. Accordingly, there can be no assurance that we will be able to maintain compliance with the Credit Facility covenants as of any future date. In the event we are unable to maintain compliance with our financial covenants, we would seek to enter into an amendment to the Credit Facility with our bank group in order to modify and/or to provide relief from the financial covenants for an additional period of time. Although we have entered into amendments in the past, there can be no assurance that any future amendments would be available on terms acceptable to us, if at all.

In order to secure our casualty insurance programs we are required to post letters of credit generally issued by a bank as collateral. A letter of credit commits the issuer to remit specified amounts to the holder, if the holder demonstrates that we failed to meet our obligations under the letter of credit. If this were to occur, we would be obligated to reimburse the issuer for any payments the issuer was required to remit to the holder of the letter of credit. We were contingently liable for outstanding stand-by letters of credit totaling $22.8 million at December 31, 2018 and $22.5 million at December 31, 2017. Outstanding letters of credit reduce amounts available under our Credit Facility and are considered as having been funded for purposes of calculating our financial covenants under the Credit Facility.

Convertible Debt

Description of the Notes

On July 31, 2017, we issued $230.0 million principal amount of 5.00% Convertible Senior Notes due 2023 (the “Notes”) in a private offering to qualified institutional buyers (as defined in the Securities Act of 1933) pursuant to Rule 144A under the Securities Act (the “Offering”). The Notes are senior unsecured obligations of the Company. The Notes bear interest at rate of 5.0% per year, payable semiannually in arrears on February 1 and August 1 of each year, beginning on February 1, 2018. The Notes mature on August 1, 2023 unless repurchased, redeemed or converted in accordance with their terms prior to such date. The Notes are convertible at an initial conversion rate of 46.0829 shares of our common stock per $1,000 principal amount of the Notes, which is equivalent to an initial conversion price of approximately $21.70 per share, which represents a conversion premium of 40% to the last reported sale price of $15.50 per share on the NYSE on July 25, 2017, the date the pricing of the Notes was completed. The conversion rate, and thus the conversion price, may be adjusted under certain circumstances as described in the indenture governing the Notes.

Holders may convert their Notes at their option prior to the close of business on the business day immediately preceding May 1, 2023, but only under the following circumstances:

- during any calendar quarter commencing after the calendar quarter ending on December 31, 2017 (and only during such calendar quarter), if the last reported sale price of our common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day;

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- during the five business day period after any five consecutive trading day period (the "measurement period") in which the trading price per $1,000 principal amount of Notes for each trading day of such measurement period was less than 98% of the product of the last reported sale price of our common stock and the conversion rate on such trading day;

- if we call any or all of the Notes for redemption, at any time prior to the close of business on the business day immediately preceding the redemption date; or;

- upon the occurrence of specified corporate events described in the indenture governing the Notes.

On or after May 1, 2023 until the close of business on the business day immediately preceding the maturity date, holders may, at their option, convert their Notes at any time, regardless of the foregoing circumstances.

The Notes are initially convertible into 10,599,067 shares of common stock. Previously, because the Notes could be convertible in full into more than 19.99 percent of our outstanding common stock, we were required by the listing rules of the NYSE to obtain the approval of the holders of our outstanding shares of common stock before the Notes could converted into more than 5,964,858 shares of common stock. At our annual shareholders' meeting, held on May 17, 2018, our shareholders approved the issuance of shares of common stock upon conversion of the Notes. The Notes will be convertible into, subject to various conditions, cash or shares of the Company's common stock or a combination of cash and shares of the Company's common stock, in each case, at the Company's election.

If holders elect to convert the Notes in connection with certain fundamental change transactions described in the indenture governing the Notes, we will, under certain circumstances described in the indenture governing the Notes, increase the conversion rate for the Notes so surrendered for conversion.
We may not redeem the Notes prior to August 5, 2021. We will have the option to redeem all or any portion of the Notes on or after August 5, 2021, if certain conditions (including that our common stock is trading at or above 130% of the conversion price then in effect for at least 20 trading days (whether or not consecutive)), including the trading day immediately preceding the date on which the Company provides notice of redemption, during any 30 consecutive trading day period ending on, and including, the trading day immediately preceding the date on which the Company provides notice of redemption at a redemption price equal to 100% of the principal amount of the Notes to be redeemed, plus accrued and unpaid interest to, but excluding, the redemption date.

Net proceeds received from the Offering were approximately $222.3 million after deducting discounts, commissions and expenses. We used $160.0 million of the net proceeds to repay all outstanding borrowings under the term-loan portion of our Credit Facility and $62.3 million of the net proceeds to repay a portion of the outstanding borrowings under the revolving portion of our Credit Facility, which may be subsequently reborrowed for general corporate purposes.

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Accounting Treatment of the Notes

As of December 31, 2018 and 2017, the Notes were recorded in our consolidated balance sheet as follows (in thousands):

	December 31, 2018	December 31, 2017
Liability component:		
Principal	$230,000	$230,000
Unamortized issuance costs	(5,834)	(6,820)
Unamortized discount	(28,982)	(33,882)
Net carrying amount of the liability component	195,184	189,298
Embedded derivative liability[1]	—	20,594
Total[2]	$195,184	$209,892
Equity component:		
Carrying amount of the equity component, net of issuance costs[3]	$13,912	$13,912

1 The embedded derivative liability was reclassified to stockholders' equity as of May 17, 2018 and is no longer marked to fair value each period, as discussed further below. It is excluded from the table above as of December 31, 2018.

2 Included in the Long-term debt line of the consolidated balance sheets.

3 Relates to the portion of the Notes accounted for under ASC 470-20 (defined below) and is included in the "Additional paid-in capital" line of the consolidated balance sheets.

Under ASC 470-20, Debt with Conversion and Other Options, ("ASC 470-20"), an entity must separately account for the liability and equity components of convertible debt instruments that may be settled entirely or partially in cash upon conversion (such as the Notes) in a manner that reflects the issuer's economic interest cost. However, entities must first consider the guidance in ASC 815-15, Embedded Derivatives ("ASC 815-15"), to determine if an instrument contains an embedded feature that should be separately accounted for as a derivative. Unless an exception under ASC 815-15 applies, such accounting requires that an embedded feature that is not "clearly and closely related" to the host contract be accounted for separately as a derivative and marked to fair value in the statement of operations each period. The Company concluded that the conversion feature is not "clearly and closely related" to the debt host contract. However, ASC 815-15 provides an exception for embedded features that are considered both indexed to our common stock and classified in stockholders' equity. Because the Notes permit the Company to settle the conversion feature in cash, stock or any combination thereof at its election, ordinarily the conversion feature would be considered both indexed to our common stock and classified in stockholders' equity and therefore exempt from the requirements of ASC 815-15. However, because the Notes could be convertible into more than 19.99 percent of our outstanding common stock and shareholder approval in accordance with the NYSE rules (as described above) to issue more than 19.99 percent of our outstanding common stock had not yet been obtained at the time the Notes were issued, the Company could have been required to settle the conversion feature for a portion of the Notes in cash instead of shares. Therefore, the conversion feature for a portion of the Notes could not be classified in stockholders' equity and therefore the exception under ASC 815-15 did not apply. As such, the Company concluded that for a portion of the Notes, it must recognize as an embedded derivative under ASC 815-15 while the remainder of the Notes are subject to ASC 470-20.

The Company determined the portions of the Notes subject to ASC 815-15 and ASC 470-20 as follows. First, while the Notes are initially convertible into 10,599,067 shares of common stock, the occurrence of certain corporate events could increase the conversion rate, which could result in the Notes becoming convertible into a maximum of 14,838,703 shares. As noted above, we were required to obtain stockholder approval to issue more than 5,964,858 shares of stock to settle the Notes upon conversion. Therefore, approximately 40% of the maximum number of shares

were authorized for issuance without shareholder approval, while 8,873,845 shares, or approximately 60% would be required to be settled in cash. The Company thus concluded that embedded derivative accounting under ASC 815-15 was applicable to approximately 60% of the Notes, while the remaining 40% of the Notes are subject to ASC 470-20. As a result of obtaining shareholder approval for the issuance of shares of common stock upon conversion of the Notes, the embedded derivative meets the criteria to be classified in stockholders' equity, effective on the date of shareholder approval. Accordingly, we recorded the change in fair value of the embedded derivative liability in our results of operations through the shareholder approval date of May 17, 2018 and then reclassified the embedded derivative liability to stockholders' equity at its May 17, 2018 fair value of $45.4 million during the second quarter of 2018. The related income tax effects of the reclassification charged directly to stockholders' equity were $7.8 million. As a result of the reclassification to stockholders' equity, the embedded derivative will no longer be marked to fair value each period. Losses on the embedded derivative liability recognized in the consolidated statements of operations were $24.8 million for the twelve months ended December 31, 2018 (incurred in the first

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and second quarters of 2018). Gains on the embedded derivative liability recognized in the consolidated statements of operations were $0.8 million for the twelve months ended December 31, 2017.

We estimated the fair value of similar notes without the conversion feature to be $194.2 million, with the resulting conversion feature having an estimated fair value of $35.8 million at the issuance date. For the portion of the Notes subject to ASC 815-15, we recorded an embedded derivative liability at fair value of $21.4 million and for the portion of the Notes subject to ASC 470-20, we recorded $14.4 million as additional paid-in capital in stockholders' equity. The fair values recorded are "Level 2" measurements as defined in Note 11. The difference between the principal amount of the Notes and the amounts allocated to the embedded derivative liability and additional paid-in capital resulted in a debt discount of $35.8 million that is amortized as interest expense over 72 months (the six-year period from issuance to maturity of the Notes).

The Company incurred approximately $7.7 million in issuance costs associated with the Notes. Issuance costs of $7.2 million were allocated as a reduction of the carrying amount of the debt while the remaining $0.5 million were allocated as a reduction to additional paid-in capital in stockholders' equity. The portion allocated to the debt component is being amortized over the life of the debt. As of December 31, 2018, the remaining amortization period is 55 months.

The following table sets forth interest expense information related to the Notes (dollars in thousands):

	Twelve Months Ended December 31,	
	2018	2017
Coupon interest	$11,500	$4,823
Amortization of debt discount and issuance costs	5,886	2,310
Total interest expense on convertible senior notes	$17,386	$7,133
Effective interest rate	9.12 %	9.12 %

Derivatives and Hedging

ASC 815, Derivatives and Hedging ("ASC 815"), requires that derivative instruments be recorded at fair value and included in the balance sheet as assets or liabilities. The accounting for changes in the fair value of a derivative instrument depends on the intended use of the derivative and the resulting designation, which is established at the inception date of a derivative. Special accounting for derivatives qualifying as fair value hedges allows derivatives' gains and losses to offset related results on the hedged item in the statement of operations. For derivative instruments designated as cash flow hedges, changes in fair value, to the extent the hedge is effective, are recognized in other comprehensive income (loss) until the hedged item is recognized in earnings. Hedge effectiveness is measured at least quarterly based on the relative cumulative changes in fair value between the derivative contract and the hedged item over time. Credit risks related to derivatives include the possibility that the counter-party will not fulfill the terms of the contract. We consider counterparty credit risk to our derivative contracts when valuing our derivative instruments.

Our borrowing of €12.3 million under the Credit Facility serves as an economic hedge of our net investment in our European operations as fluctuations in the fair value of the borrowing attributable to the U.S. Dollar/Euro spot rate will offset translation gains or losses attributable to our investment in our European operations. At December 31, 2018 the €12.3 million borrowing had a U.S. Dollar value of $14.1 million.

As discussed above, we previously recorded an embedded derivative liability for a portion of the Notes. In accordance with ASC 815-15, the embedded derivative instrument was recorded at fair value each period with changes in fair value reflected in our results of operations. No hedge accounting was applied. As a result of obtaining shareholder approval for the issuance of shares upon conversion of the Notes, we recorded the change in fair value of the embedded derivative liability in our results of operations through the shareholder approval date of May 17, 2018 and then reclassified the embedded derivative liability to stockholders' equity at its May 17, 2018 fair value of $45.4 million during the second quarter of 2018. As a result of the reclassification to stockholders' equity, the embedded

derivative is no longer marked to fair value each period. See Note 11 for more information on the fair value measurement of the embedded derivative liability.

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The amounts recognized in other comprehensive income (loss), reclassified into income (loss) and the amounts recognized in income (loss) for the years ended December 31, 2018, 2017 and 2016 are as follows (in thousands):

	Gain (Loss) Recognized in Other Comprehensive Income (Loss)			Gain (Loss) Reclassified from Other Comprehensive Income (Loss) to Earnings		
	Twelve Months Ended December 31,			Twelve Months Ended December 31,		
	2018	2017	2016	2018	2017	2016
Derivatives Classified as Hedging Instruments						
Net investment hedge	$658	$(1,802)	481	$ —	$ —	$ —

	Gain (Loss) Recognized in Income (Loss)[1]		
	Twelve Months Ended December 31,		
	2018	2017	2016
Derivatives Not Classified as Hedging Instruments			
Embedded derivative in convertible debt	$(24,783)	$818	$ —

1 Reflected as "Loss (gain) on convertible debt embedded derivative" in the consolidated statements of operations.

The following table presents the fair value totals and balance sheet classification for derivatives designated as hedges and derivatives not designated as hedges under ASC 815 (in thousands):

	December 31, 2018			December 31, 2017		
	Classification	Balance Sheet Location	Fair Value	Classification	Balance Sheet Location	Fair Value
Derivatives Classified as Hedging Instruments						
Net investment hedge	Liability	Long-term debt	$(3,904)	Liability	Long-term debt	$(3,246)
Derivatives Not Classified as Hedging Instruments						
Embedded derivative in convertible debt	Liability	Long-term debt	$—	Liability	Long-term debt	$20,594

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Lease Obligations

We enter into operating and capital leases to rent facilities and obtain vehicles and equipment for our field operations. Our obligations under non-cancellable operating and capital leases at December 31, 2018, primarily consisting of facility and auto leases, are as follows (in thousands):

Twelve Months Ended December 31,		
	Operating	Capital
2019	$ 23,315	$ 583
2020	16,858	500
2021	12,577	504
2022	9,873	524
2023	7,846	525
Thereafter	23,224	5,631
Total minimum lease payments	$ 93,693	$ 8,267
Less amounts representing interest		(2,911)
Present value of future minimum lease payments		$ 5,356

Total rent expense resulting from operating leases for the years ended December 31, 2018, 2017 and 2016 were $44.9 million, $47.7 million and $40.0 million, respectively.

11. FAIR VALUE MEASUREMENTS

We apply the provisions of ASC 820, which among other things, requires enhanced disclosures about assets and liabilities carried at fair value.

As defined in ASC 820, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We utilize market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable. We primarily apply the market approach for recurring fair value measurements and endeavor to utilize the best information available. Accordingly, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The use of unobservable inputs is intended to allow for fair value determinations in situations in which there is little, if any, market activity for the asset or liability at the measurement date. We are able to classify fair value balances based on the observability of those inputs. ASC 820 establishes a fair value hierarchy such that “Level 1” measurements include unadjusted quoted market prices for identical assets or liabilities in an active market, “Level 2” measurements include quoted market prices for identical assets or liabilities in an active market which have been adjusted for items such as effects of restrictions for transferability and those that are not quoted but are observable through corroboration with observable market data, including quoted market prices for similar assets, and “Level 3” measurements include those that are unobservable and of a highly subjective measure.

The following table sets forth, by level within the fair value hierarchy, our financial assets and liabilities that are accounted for at fair value on a recurring basis as of December 31, 2018 and 2017. As required by ASC 820, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement (in thousands):

	December 31, 2018			
	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Liabilities:				

Contingent consideration[1]	$ —	$ —	$ 429	$ 429
Net investment hedge	$ —	$ (3,904)	$ —	$ (3,904)
Embedded derivative in convertible debt[2]	$ —	$ —	$ —	$ —

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	December 31, 2017			
	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Liabilities:				
Contingent consideration[1]	$ —	$ —	$ 1,712	$ 1,712
Net investment hedge	$ —	$ (3,246)	$ —	$ (3,246)
Embedded derivative in convertible debt[2]	$ —	$ 20,594	$ —	$ 20,594

1 Inclusive of both current and noncurrent portions.

2 The embedded derivative liability was reclassified to stockholders' equity as of May 17, 2018 and is no longer marked to fair value each period, as discussed in Note 10.

There were no transfers in and out of Level 3 during the years ended December 31, 2018 and 2017.

The fair value of the convertible debt embedded derivative liability was estimated using a lattice model with inputs including our stock price, our stock price volatility and interest rates. As the assumptions used in the valuation are primarily derived from observable market data, the fair value measurement is classified as Level 2 in the fair value hierarchy. See Note 10 for more information on the embedded derivative liability.

The fair value of contingent consideration liabilities classified in the table above were estimated using a discounted cash flow technique with significant inputs that are not observable in the market and thus represents a Level 3 fair value measurement as defined in ASC 820. The significant inputs in the Level 3 measurement not supported by market activity include a combination of actual cash flows and probability-weighted assessments of expected future cash flows related to the acquired businesses, appropriately discounted considering the uncertainties associated with the obligation, and as calculated in accordance with the terms of the acquisition agreements.

The following table represents the changes in the fair value of Level 3 contingent consideration (in thousands):

	Twelve Months Ended December 31,	
	2018	2017
Beginning balance	$ 1,712	$ 3,739
Accretion of liability	39	222
Foreign currency effects	(14)	203
Payment	(1,106)	(1,278)
Revaluation	(202)	(1,174)
Ending balance	$ 429	$ 1,712

12. SHARE-BASED COMPENSATION

We have adopted stock incentive plans and other arrangements pursuant to which our Board of Directors (the "Board") may grant stock options, restricted stock, stock units, stock appreciation rights, common stock or performance awards to officers, directors and key employees. At December 31, 2018, there were approximately 1.5 million restricted stock units, performance awards and stock options outstanding to officers, directors and key employees. The exercise price, terms and other conditions applicable to each form of share-based compensation under our plans are generally determined by the Compensation Committee of our Board at the time of grant and may vary.

Our share-based payments consist primarily of stock units, performance awards, common stock and stock options. In May 2016, our shareholders approved the 2016 Team, Inc. Equity Incentive Plan (the "2016 Plan"), which replaced all of our previous equity compensation plans. The 2016 Plan authorized the issuance of share-based awards representing

up to 2,000,000 shares of common stock. In May 2018, our shareholders approved the 2018 Team, Inc. Equity Incentive Plan (the “2018 Plan”), which replaced the 2016 Plan. The 2018 Plan authorizes the issuance of share-based awards representing up to 450,000 shares of common stock, plus the number of shares remaining available for issuance under the 2016 Plan, plus the number of shares subject to outstanding awards under specified prior plans that may become available for reissuance in certain circumstances. Shares issued in connection with our share-based compensation are issued out of authorized but unissued common stock.

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Shares issued in connection with our share-based compensation are issued out of authorized but unissued common stock.
In connection with the acquisition of Furmanite in February 2016, we assumed the share plan related to Furmanite employee grants. As provided for in the Merger Agreement, each option to purchase Furmanite common stock outstanding immediately prior to the closing of the acquisition was converted into an option to purchase Team common stock, adjusted by the 0.215 exchange ratio. Similarly, each previously existing Furmanite restricted share, restricted stock unit or performance stock unit outstanding immediately prior to the acquisition were converted into Team restricted stock units, also at the 0.215 exchange ratio. The converted awards generally have the same terms and conditions as the replaced awards, except the vesting of certain awards was accelerated to the acquisition date and any performance conditions associated with the Furmanite awards no longer apply. The fair value of the options was determined using a Black-Scholes model, while the fair value of the restricted stock units was determined based on the market price on the acquisition date. The fair value of the converted Furmanite awards was allocated between consideration transferred in the acquisition and future share-based compensation expense, based on past service completed and future service required.
Compensation expense related to share-based compensation totaled $12.3 million, $7.9 million and $7.3 million for the years ended December 31, 2018, 2017 and 2016, respectively. Share-based compensation expense reflects an estimate of expected forfeitures. At December 31, 2018, $18.2 million of unrecognized compensation expense related to share-based compensation is expected to be recognized over a remaining weighted-average period of 2.4 years. The recognized income tax benefit totaled $2.5 million, $0.9 million and $2.5 million for the years ended December 31, 2018, 2017 and 2016, respectively.
Stock units are settled with common stock upon vesting unless it is not legally feasible to issue shares, in which case the value of the award is settled in cash. We determine the fair value of each stock unit based on the market price on the date of grant. Stock units generally vest in annual installments over four years and the expense associated with the units is recognized over the same vesting period. We also grant common stock to our directors which typically vests immediately. Compensation expense related to stock units and director stock grants totaled $7.9 million, $7.1 million, $7.2 million for the years ended December 31, 2018, 2017 and 2016, respectively.
Transactions involving our stock units and director stock grants for the twelve months ended December 31, 2018 are summarized below:

	Twelve Months Ended December 31, 2018	
	No. of Stock Units	Weighted Average Fair Value
	(in thousands)	
Stock and stock units, beginning of year	854	$ 21.42
Changes during the year:		
Granted	370	$ 18.09
Vested and settled	(291)	$ 24.76
Cancelled	(77)	$ 21.37
Stock and stock units, end of year	856	$ 18.79

The weighted-average grant date fair value related to stock units and director stock grants during the years ended December 31, 2017 and 2016 were $13.64 and $34.23, respectively. The intrinsic value of stock units and director stock grants vested during the years ended December 31, 2018, 2017 and 2016 were $4.8 million, $3.0 million and $4.9 million, respectively.
We have a performance stock unit award program whereby we grant Long-Term Performance Stock Unit (“LTPSU”) awards to our executive officers. Under this program, the Company communicates “target awards” to the executive

officers at the beginning of a performance period. LTPSU awards cliff vest with the achievement of the performance goals and completion of the required service period. Settlement occurs with common stock as soon as practicable following the vesting date. LTPSU awards granted in 2017 (the “2017 Awards”) and in 2018 (the “2018 Awards”) are subject to a two-year performance period and a concurrent two-year service period. For the 2017 Awards, the performance goal is separated into three independent performance factors based on (i) relative total shareholder return (“RTSR”) as measured against a designated peer group, (ii) RTSR as measured against a designated index and (iii) results of operations over the two-year performance period, with possible payouts ranging from 0% to 200% of the “target awards” for the first two performance factors and ranging from 0% to 300% of the “target awards” for the third performance factor. For the 2018 Awards, the performance goal is separated into two independent performance factors based on (i) RTSR as measured against a designated peer group and (ii) results of operations over the two-year performance period, with possible payouts ranging from 0% to 200% of the target awards for each of the two performance factors.

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On January 24, 2018, we granted 350,000 performance units to our Chief Executive Officer that vest in 20% increments upon the achievement of five specified Company stock price milestones, subject to a minimum vesting period of one year and the provision of service through each of the vesting dates. Settlement occurs with common stock within 30 days of the respective vesting dates. Any outstanding unvested performance units are forfeited on the fifth anniversary of the grant date.

The RTSR and the stock price milestone factors are considered to be market conditions under GAAP. For performance units subject to market conditions, we determine the fair value of the performance units based on the results of a Monte Carlo simulation, which uses market-based inputs as of the date of grant to simulate future stock returns. Compensation expense for awards with market conditions is recognized on a straight-line basis over the longer of (i) the minimum required service period and (ii) the service period derived from the Monte Carlo simulation, separately for each vesting tranche. For performance units subject to market conditions, because the expected outcome is incorporated into the grant date fair value through the Monte Carlo simulation, compensation expense is not subsequently adjusted for changes in the expected or actual performance outcome. For performance units not subject to market conditions, we determine the fair value of each performance unit based on the market price of our common stock on the date of grant. For these awards, we recognize compensation expense over the vesting term on a straight-line basis based upon the performance target that is probable of being met, subject to adjustment for changes in the expected or actual performance outcome. Compensation expense (credit) related to performance awards totaled $4.3 million, $0.8 million and $(0.4) million for the years ended December 31, 2018, 2017 and 2016, respectively.

Transactions involving our performance awards during the twelve months ended December 31, 2018 are summarized below:

	Twelve Months Ended December 31, 2018			
	Performance Units Subject to Market Conditions		Performance Units Not Subject to Market Conditions	
	No. of Stock Units[1]	Weighted Average Fair Value	No. of Stock Units[1]	Weighted Average Fair Value
	(in thousands)		(in thousands)	
Performance stock units, beginning of period	45	$ 17.66	84	$ 25.76
Changes during the period:				
Granted	465	$ 14.24	115	$ 15.00
Vested and settled	—	$ —	(15)	$ 13.45
Cancelled	(15)	$ 16.78	(39)	$ 27.95
Performance stock units, end of period	495	$ 14.47	145	$ 17.88

1 Performance units with variable payouts are shown at target level of performance.

The weighted-average grant date fair value related to performance stock units during the year ended December 31, 2017 was $19.68. No performance stock units were granted during the year ended December 31, 2016. The intrinsic value of performance stock unit awards vested during the years ended December 31, 2018, 2017 and 2016 were $0.3 million, zero and $0.4 million, respectively.

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We determine the fair value of each stock option at the grant date using a Black-Scholes model and recognize the resulting expense of our stock option awards over the period during which an employee is required to provide services in exchange for the awards, usually the vesting period. There was no compensation expense related to stock options for the year ended December 31, 2018, less than $0.1 million of expense for the year ended December 31, 2017, and $0.2 million for the year ended December 31, 2016. Our options typically vest in equal annual installments over a four-year service period. Expense related to an option grant is recognized on a straight-line basis over the specified vesting period for those options. Stock options generally have a ten-year term.

Transactions involving our stock options for the twelve months ended December 31, 2018 are summarized below:

	Twelve Months Ended December 31, 2018	
	No. of Options (in thousands)	Weighted Average Exercise Price
Shares under option, beginning of year	79	$ 31.94
Changes during the year:		
Granted	—	$ —
Exercised	—	$ —
Cancelled	—	$ —
Expired	(27)	$ 30.75
Shares under option, end of year	52	$ 32.56
Exercisable at end of year	52	$ 32.56

No stock options were granted during the years ended December 31, 2018, 2017 and 2016. Options exercisable at December 31, 2018 had a weighted-average remaining contractual life of 3.5 years, and exercise prices ranging from $21.12 to $50.47. The intrinsic value of stock option awards exercised was insignificant for the years ended December 31, 2018 and 2017, but was $1.6 million for the year ended December 31, 2016.

13. EMPLOYEE BENEFIT PLANS

Defined contribution plan. Under the Team, Inc. Salary Deferral Plan (the “Plan”), contributions are made to the Plan by qualified employees at their election and our matching contributions to the Plan are made at specified rates. Our contributions to the Plan in the years ended December 31, 2018, 2017, and 2016 were approximately $11.0 million, $10.4 million, $7.1 million, respectively.

Defined benefit plans. In connection with our acquisition of Furmanite, we assumed liabilities associated with the defined benefit pension plans of two foreign subsidiaries, one plan covering certain United Kingdom employees (the “U.K. Plan”) and the other covering certain of its Norwegian employees (the “Norwegian Plan”). As the Norwegian Plan represented approximately one percent of both the Company’s total pension plan liabilities and total pension plan assets, only the schedules of net periodic pension cost (credit) and changes in benefit obligation and plan assets include combined amounts from the two plans, while assumption and narrative information relates solely to the U.K. Plan. In connection with the sale of the Company’s Norwegian operations in 2018, all assets and liabilities associated with the Norwegian Plan were transferred to the buyer.

Benefits for the U.K. Plan are based on the average of the employee’s salary for the last three years of employment. The U.K. Plan has had no new participants added since the plan was frozen in 1994 and accruals for future benefits ceased in connection with a plan curtailment in 2013. Plan assets are primarily invested in unitized pension funds managed by U.K. registered fund managers. The most recent valuation of the U.K. Plan was performed as of December 31, 2018. Estimated defined benefit pension plan contributions for 2019 are expected to be approximately $2.3 million.

Pension benefit costs and liabilities are dependent on assumptions used in calculating such amounts. The primary assumptions include factors such as discount rates, expected investment return on plan assets, mortality rates and retirement rates. The discount rate assumption used to determine end of year benefit obligations was 2.8% as of December 31, 2018. These rates are reviewed

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annually and adjusted to reflect current conditions. These rates are determined appropriate based on reference to yields. The expected return on plan assets of 3.3% for 2019 is derived from detailed periodic studies, which include a review of asset allocation strategies, anticipated future long-term performance of individual asset classes, risks (standard deviations) and correlations of returns among the asset classes that comprise the plans' asset mix. While the studies give appropriate consideration to recent plan performance and historical returns, the assumptions are primarily long-term, prospective rates of return. Mortality and retirement rates are based on actual and anticipated plan experience. In accordance with GAAP, actual results that differ from the assumptions are accumulated and are subject to amortization over future periods and, therefore, generally affect recognized expense in future periods. While management believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect the pension obligation and future expense.

Net pension cost (credit) included the following components (in thousands):

	Twelve Months Ended December 31,		
	2018	2017	2016[1]
Service cost	$77	$90	79
Interest cost	2,303	2,438	2,504
Expected return on plan assets	(3,720)	(3,110)	(2,577)
Amortization of net actuarial (gain) loss	(78)	71	—
Net periodic pension cost (credit)	$(1,418)	$(511)	6

1 Reflects net pension cost from the date of the Furmanite acquisition.

The weighted-average assumptions used to determine benefit obligations at December 31, 2018 and 2017 are as follows:

	December 31,	
	2018	2017
Discount rate	2.8%	2.5%
Rate of compensation increase[1]	Not applicable	Not applicable
Inflation	3.2%	3.1%

1 Not applicable due to plan curtailment.

The weighted-average assumptions used to determine net periodic benefit cost (credit) for the years ended December 31, 2018 and 2017 are as follows:

	Twelve Months Ended December 31,	
	2018	2017
Discount rate	2.5%	2.7%
Expected long-term return on plan assets	4.7%	4.5%
Rate of compensation increase[1]	Not applicable	Not applicable
Inflation	3.1%	3.3%

1 Not applicable due to plan curtailment.

The plan actuary determines the expected return on plan assets based on a combination of expected yields on equity securities and corporate bonds and considering historical returns.

The expected long-term rate of return on invested assets for 2019 is determined based on the weighted average of expected returns on asset investment categories as follows: 3.3% overall, 5.8% for equities and 2.7% for debt securities.

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The following table sets forth the changes in the benefit obligation and plan assets for the years ended December 31, 2018 and 2017 (in thousands):

	Twelve Months Ended December 31,	
	2018	2017
Projected benefit obligation:		
Beginning of year	$96,875	$89,206
Service cost	77	90
Interest cost	2,303	2,438
Actuarial (gain) loss	(4,347)	890
Benefits paid	(4,539)	(4,187)
Prior service cost	669	—
Disposal of Norwegian Plan	(1,075)	—
Foreign currency translation adjustment and other	(5,404)	8,438
End of year	84,559	96,875
Fair value of plan assets:		
Beginning of year	81,899	67,967
Actual gain (loss) on plan assets	(462)	7,383
Employer contributions	2,404	4,350
Benefits paid	(4,539)	(4,187)
Disposal of Norwegian Plan	(983)	—
Foreign currency translation adjustment and other	(4,700)	6,386
End of year	73,619	81,899
Excess projected obligation under (over) fair value of plan assets at end of year	$(10,940)	$(14,976)
Amounts recognized in accumulated other comprehensive loss:		
Net actuarial loss	$(7,190)	$(7,221)
Prior service cost	(669)	—
Total	$(7,859)	$(7,221)

Significant changes affecting pension benefit obligations in 2018 compared to 2017 primarily includes actuarial gains in 2018 versus actuarial losses in 2017 due to changes in market conditions that affect the financial assumptions used to value liabilities as well as foreign currency translation adjustments due to the strengthening of the U.S. Dollar versus the British Pound in 2018. The accumulated benefit obligation for the U.K. Plan was $84.6 million and $95.6 million at December 31, 2018 and 2017, respectively.

At December 31, 2018, expected future benefit payments are as follows for the years ended December 31, (in thousands):

2019	$3,403
2020	3,536
2021	3,752
2022	3,926
2023	3,811
2024-2028	22,475
Total	$40,903

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The following tables summarize the plan assets of the U.K. Plan measured at fair value on a recurring basis (at least annually) as of December 31, 2018 and 2017 (in thousands):

December 31, 2018

Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2) (a)	Significant Unobservable Inputs (Level 3) (a)
Cash	$1,119	$ 1,119	$ —	$ —
Equity securities:				
Diversified growth fund (h)	12,330	—	12,330	—
Global equity fund (o)	1,835	—	1,835	—
Fixed income securities:				
U.K. government fixed income securities (k)	18,048	—	18,048	—
U.K. government index-linked securities (l)	14,245	—	14,245	—
Global absolute return bond fund (m)	18,570	—	18,570	—
Corporate bonds (n)	7,472	—	7,472	—
Total	$73,619	$ 1,119	$ 72,500	$ —

December 31, 2017

Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2) (a)	Significant Unobservable Inputs (Level 3) (a)
Cash	$651	$ 651	$ —	$ —
Equity securities:				
U.K. equity (b)	17,809	—	17,809	—
U.S. equity index (c)	4,370	—	4,370	—
European equity index (d)	4,378	—	4,378	—
Pacific rim equity index (e)	3,506	—	3,506	—
Japanese equity index (f)	2,733	—	2,733	—
Emerging markets equity index (g)	2,785	—	2,785	—
Diversified growth fund (h)	17,296	—	17,296	—
Global absolute return fund (i)	6,534	—	6,534	—
Fixed income securities:				
Cash fund (j)	5,315	—	5,315	—
U.K. government fixed income securities (k)	6,494	—	6,494	—
U.K. government index-linked securities (l)	8,934	—	8,934	—
Total	$80,805	$ 651	$ 80,154	$ —

a) The net asset value of the commingled equity and fixed income funds are determined by prices of the underlying securities, less the funds' liabilities, and then divided by the number of shares outstanding. As the funds are not traded in active markets, the commingled funds are classified as Level 2 or Level 3 assets. The net asset value is corroborated by observable market data (e.g., purchase or sale activities) for Level 2 assets.

b) This category includes investments in U.K. companies and aims to achieve a return that is consistent with the return of the FTSE All-Share Index.

c) This category includes investments in a variety of large and small U.S. companies and aims to achieve a return that is consistent with the return of the FTSE All-World USA Index.

d)

This category includes investments in a variety of large and small European companies and aims to achieve a return that is consistent with the return of the FTSE All-World Developed Europe ex-U.K. Index.

e) This category includes investments in a variety of large and small companies across the Australian, Hong Kong, New Zealand and Singapore markets and aims to achieve a return that is consistent with the return of the FTSE-All-World Developed Asia Pacific ex-Japan Index.

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f) This category includes investments in a variety of large and small Japanese companies and aims to achieve a return that is consistent with the return of the FTSE All-World Japan Index.

g) This category includes investments in companies in the Emerging Markets to achieve a return that is consistent with the return of the IFC Investable Index ex-Malaysia.

h) This category includes investments in a diversified portfolio of equity, bonds, alternatives and cash markets and aims to achieve a return that is consistent with the return of the Libor GBP 3 month +3% Index.

i) This category includes investments in a diversified portfolio of equity and bonds combined with investment strategies based on advanced derivative techniques and aims to achieve a return over rolling three-year periods equivalent to cash plus 5% per year, gross of fees.

j) This category includes investments in British pound sterling-denominated money market instruments and fixed-income securities issued by governments, corporations or other issuers which may be listed or traded on a recognized market.

k) This category includes investments in funds with the objective to provide a leveraged return to U.K. government fixed income securities (gilts) that have maturity periods ranging from 2030 to 2060.

l) This category includes investments in funds with the objective to provide a leveraged return to various U.K. government indexed-linked securities (gilts), with maturity periods ranging from 2022 to 2062. The funds invest in U.K. government bonds and derivatives.

m) This category includes investments in funds predominantly in a wide range of fixed and floating rate investment grade and below investment grade debt instruments traded on regulated markets worldwide with the objective to achieve a return of 3% above 1 month LIBOR over a 3-year basis.

n) This category includes investments in a diversified pool of debt and debt like assets to generate capital and income returns.

o) This category includes investments in a diversified portfolio of equity, bonds, money markets, alternatives and credit markets to achieve a return with downside protection through monthly put options.

Investment objectives for the U.K. Plan, as of December 31, 2018, are to:

- optimize the long-term return on plan assets at an acceptable level of risk
- maintain a broad diversification across asset classes
- maintain careful control of the risk level within each asset class

The trustees of the U.K. Plan have established a long-term investment strategy comprising global investment weightings targeted at 27.5% (range of 25% to 30%) for equity securities/diversified growth funds and 72.5% (range of 70% to 75%) for debt securities. During 2018, the U.K. Plan changed its asset allocation and target asset allocations to reduce investment strategy risk from equity to debt securities. Diversified growth funds are actively managed absolute return funds that hold a combination of debt and equity securities. Selection of the targeted asset allocation was based upon a review of the expected return and risk characteristics of each asset class, as well as the correlation of returns among asset classes. Actual allocations to each asset class vary from target allocations due to periodic investment strategy changes, market value fluctuations and the timing of benefit payments and contributions.

The following table sets forth the weighted-average asset allocation and target asset allocations as of December 31, 2018 and 2017 by asset category:

	Asset Allocations		Target Asset Allocations	
	2018	2017	2018	2017
Equity securities and diversified growth funds[1]	19.2%	73.5%	27.5%	65.0%
Debt securities[2]	79.2%	25.7%	72.5%	35.0%
Other	1.5 %	0.8 %	— %	— %
Total	100 %	100 %	100 %	100 %

1 Diversified growth funds refer to actively managed absolute return funds that hold a combination of equity and debt securities.

2

Includes investments in funds with the objective to provide leveraged returns to U.K. government fixed income securities, U.K. government indexed-linked securities, global bonds, and corporate bonds.

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14. COMMITMENTS AND CONTINGENCIES

Con Ed Matter. We have, from time to time, provided temporary leak repair services to the steam system of Consolidated Edison Company of New York ("Con Ed") located in New York City. In July 2007, a Con Ed steam main located in midtown Manhattan ruptured resulting in one death and other injuries and property damage. As of December 31, 2018, eighty-three lawsuits are currently pending against Con Ed, the City of New York and Team in the Supreme Court of New York, alleging that our temporary leak repair services may have contributed to the cause of the rupture, allegations which we dispute. The lawsuits seek generally unspecified compensatory damages for personal injury, property damage and business interruption. Additionally, Con Ed is alleging that our contract with Con Ed requires us to fully indemnify and defend Con Ed for all claims asserted against Con Ed including those amounts that Con Ed has paid to settle with certain plaintiffs for undisclosed sums as well as Con Ed's own alleged damages to its infrastructure. Con Ed filed an action to join Team and the City of New York as defendants in all lawsuits filed against Con Ed that did not include Team and the City of New York as direct defendants. We are unable to estimate the amount of liability to us, if any, associated with these lawsuits. We maintain insurance coverage, subject to a deductible limit of $250,000, which we believe should cover these claims. We have not accrued any liability in excess of the deductible limit for the lawsuits. We do not believe the ultimate outcome of these matters will have a material adverse effect on our financial position, results of operations, or cash flows.

Patent Infringement Matters. In December 2014, our subsidiary, Quest Integrity Group, LLC, filed three patent infringement lawsuits against three different defendants, two in the U.S. District of Delaware (the "Delaware Cases") and one in the U.S. District of Western Washington (the "Washington Case"). Quest Integrity alleges that the three defendants infringed Quest Integrity's patent, entitled "2D and 3D Display System and Method for Furnace Tube Inspection". This Quest Integrity patent generally teaches a system and method for displaying inspection data collected during the inspection of furnace tubes in petroleum and petro-chemical refineries. The subject patent litigation is specific to the visual display of the collected data and does not relate to Quest Integrity's underlying advanced inspection technology. In these lawsuits Quest Integrity is seeking temporary and permanent injunctive relief, as well as monetary damages. Defendants have denied they infringe any valid claim of Quest Integrity's patent, and have asserted declaratory judgment counterclaims that the patent at issue is invalid and/or unenforceable, and not infringed. In June 2015, the U.S. District of Delaware denied our motions for preliminary injunctive relief in the Delaware Cases (that is, our request that the defendants stop using our patented systems and methods during the pendency of the actions). In March 2017, the judge in the Delaware Cases granted summary judgment against Quest Integrity, finding certain patent claims of the asserted patent invalid. In late 2018 and early 2019, Quest Integrity settled with two of the three defendants and has appealed the ruling in the Delaware Case with the remaining defendant.

We are involved in various other lawsuits and are subject to various claims and proceedings encountered in the normal conduct of business. In our opinion, any uninsured losses that might arise from these lawsuits and proceedings will not have a materially adverse effect on our consolidated financial statements.

We establish a liability for loss contingencies, when information available to us indicates that it is probable that a liability has been incurred and the amount of loss can be reasonably estimated.

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15. SEGMENT AND GEOGRAPHIC DISCLOSURES

ASC 280, Segment Reporting, requires we disclose certain information about our operating segments where operating segments are defined as "components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance." We conduct operations in three segments: IHT, MS Group and Quest Integrity Group. Furmanite, which we acquired in the first quarter of 2016 (see Note 3), is included in the MS segment, except that Furmanite's corporate-related activities are included within corporate and shared support services in the tables below. Discontinued operations are not allocated to the segments.

In July 2018, we announced an organizational restructuring and certain new leadership appointments. The organizational changes include a Product and Service Line organization and an Operations organization. The Product and Service Lines organization is responsible for value positioning and pricing, standardization of best practices, technical training and program development, and technology innovation across Team's global enterprise. The Operations organization, comprised of cross-segment divisions aligned by major geographic regions, will be responsible for executing product and service delivery in accordance with established Team service line standards, safety and quality protocols. Overall company management and decision-making by our chief operating decision maker continues to be performed according to the structure of the three operating segments (IHT, MS and Quest Integrity). Accordingly, these changes had no effect on our reportable segments.

Segment data for our three operating segments are as follows (in thousands):

	Twelve Months Ended December 31,		
	2018	2017	2016
Revenues:			
IHT	$617,378	$588,441	$589,478
MS	532,365	529,973	539,627
Quest Integrity	97,186	81,797	67,591
Total	$1,246,929	$1,200,211	$1,196,696

	Twelve Months Ended December 31,		
	2018	2017	2016
Operating income (loss):			
IHT[1]	$37,329	$11,128	$43,367
MS[1]	6,323	(33,993)	27,283
Quest Integrity	20,138	12,337	4,780
Corporate and shared support services	(102,751)	(104,582)	(78,548)
Total	$(38,961)	$(115,110)	$(3,118)

1 Includes goodwill impairment loss of $21.1 million and $54.1 million for IHT and MS, respectively, for the year ended December 31, 2017.

	Twelve Months Ended December 31,		
	2018	2017	2016
Capital expenditures[1]:			
IHT	$7,643	$10,505	$8,803
MS	11,141	17,791	15,077
Quest Integrity	3,526	3,316	2,007
Corporate and shared support services	3,621	5,186	19,956
Total	$25,931	$36,798	$45,843

1

Excludes capital leases. Totals may vary from amounts presented in the consolidated statements of cash flows due to the timing of cash payments.

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	Twelve Months Ended December 31,		
	2018	2017	2016
Depreciation and amortization:			
IHT	$18,810	$19,279	$19,853
MS	36,177	23,412	21,387
Quest Integrity	4,285	4,423	5,323
Corporate and shared support services	5,590	5,029	2,110
Total	$64,862	$52,143	$48,673

Separate measures of Team's assets by operating segment are not produced or utilized by management to evaluate segment performance.

A geographic breakdown of our revenues for the years ended December 31, 2018, 2017 and 2016 and our total long-lived assets as of December 31, 2018, 2017 and 2016 are as follows (in thousands):

	Total Revenues[1]	Total Long-lived Assets[2]
Twelve months ended December 31, 2018		
United States	$908,382	$298,567
Canada	139,900	4,165
Europe	126,142	20,224
Other foreign countries	72,505	3,210
Total	$1,246,929	$326,166
Twelve months ended December 31, 2017		
United States	$871,367	$330,909
Canada	134,256	5,377
Europe	119,603	22,480
Other foreign countries	74,985	4,614
Total	$1,200,211	$363,380
Twelve months ended December 31, 2016		
United States	$889,967	$348,123
Canada	128,122	5,901
Europe	108,720	20,249
Other foreign countries	69,887	4,962
Total	$1,196,696	$379,235

1 Revenues attributable to individual countries/geographic areas are based on the country of domicile of the legal entity that performs the work.

2 Excludes goodwill, intangible assets not being amortized that are to be held and used, financial instruments and deferred tax assets.

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16. DISCONTINUED OPERATIONS

As part of our acquisition of Furmanite, we acquired a pipeline inspection business that primarily performed process management inspection services to contractors and operators participating primarily in the midstream oil and gas market in the U.S. We previously concluded that this business was not a strategic fit for Team and we completed the sale of business in December 2016. Proceeds from the sale were $13.3 million cash (net of costs to sell) and a $1.5 million principal amount of a note from the buyer that bears interest at a 5% stated rate per annum, payable quarterly in arrears, with the principal amount due in full at maturity in January 2020.

We concluded that this business qualified as a discontinued operation upon its acquisition under GAAP. Therefore, we classified the operating results as discontinued operations in our consolidated statements of operations. Discontinued operations does not include any allocation of corporate overhead expense or interest expense. For information about the assets and liabilities of discontinued operations acquired in the Furmanite acquisition, see Note 3.

Loss from discontinued operations, net of income tax, from the date of the Furmanite acquisition, consists of the following (in thousands):

	Twelve Months Ended December 31, 2016
Revenues	$46,771
Operating expenses	43,081
Gross margin	3,690
Selling, general and administrative expenses	1,939
Gain on disposal	7
Income from discontinued operations, before income tax	1,758
Less: Provision for income taxes	1,869
Loss from discontinued operations, net of income tax	$(111)

The provision for income taxes on discontinued operations includes the effect of a permanent difference associated with non-deductible goodwill that was derecognized as part of the disposal transaction.

Cash flows attributable to our discontinued operations are included in our statements of consolidated cash flows. For the year ended December 31, 2016, there were no material amounts of depreciation, amortization, capital expenditures or significant operating non-cash items related to discontinued operations.

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17. RESTRUCTURING AND OTHER RELATED CHARGES

Our restructuring and other related charges, net for the years ended December 31, 2018, 2017 and 2016 are summarized by segment as follows (in thousands):

	Twelve Months Ended December 31,		
	2018	2017	2016
OneTEAM Program			
Severance and related costs			
IHT	$2,995	$—	$—
MS	2,514	—	—
Quest Integrity	418	—	—
Corporate and shared support services	800	—	—
Subtotal	6,727	—	—
2017 Cost Savings Initiative			
Severance and related costs			
IHT	—	966	—
MS	—	1,622	—
Quest Integrity	—	428	—
Corporate and shared support services	—	864	—
Subtotal	—	3,880	—
Furmanite Belgium and Netherlands Exit			
Severance and related costs (credits)			
MS	—	(173)	4,862
Disposal (gain)/impairment loss			
MS	—	(1,056)	651
Subtotal	—	(1,229)	5,513
Grand total	$6,727	$2,651	$5,513

OneTEAM Program. In the fourth quarter of 2017, we engaged outside consultants to assess all aspects of our business for improvement and cost saving opportunities. In the first quarter of 2018, we completed the design phase of the project, known as OneTEAM, and entered in the deployment phase starting in the second quarter of 2018. As part of the OneTEAM Program, we have decided to eliminate certain employee positions. For the twelve months ended December 31, 2018, we have incurred severance charges of $6.7 million, which is also the amount we have incurred cumulatively to date. As the OneTEAM Program continues, we expect some additional employee positions may be identified and impacted, resulting in additional severance costs. We expect that the OneTEAM Program will be largely completed in the first half of 2019.

A rollforward of our accrued severance liability associated with this program is presented below (in thousands):

	Twelve Months Ended December 31, 2018
Balance, beginning of period	$ —
Charges	6,727
Payments	(4,444)

Balance, end of period	$ 2,283

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2017 Cost Savings Initiative. On July 24, 2017, we announced our commitment to a cost savings initiative to take direct actions to reduce our overall cost structure due to a continuation of weak market conditions. This initiative was completed in the latter part of 2017. No costs or expenses were recognized in the consolidated statements of operations for this initiative during the twelve months ended December 31, 2018. The resulting severance and related charges of this initiative, which were generally recorded in the third and fourth quarters of 2017, amounted to $3.9 million during the year ended December 31, 2017. This is also the amount we have incurred cumulatively to date. Most of these expenses were paid in cash in 2017.

Furmanite Belgium and Netherlands Exit. Due to continued economic softness and unfavorable costs structures, we committed to a plan to exit the acquired Furmanite operations in Belgium and the Netherlands in the fourth quarter of 2016 and communicated the plan to the affected employees. The closures are now complete. During the year ended December 31, 2017, we recorded a reduction to severance costs of $0.2 million and a disposal gain of $1.1 million. The disposal gain resulted from an asset sale of the Furmanite operations in Belgium, which was completed during the first quarter of 2017, whereby we conveyed the business operations, $0.3 million of cash and approximately $0.2 million of other assets to the purchaser in exchange for the assumption by the purchaser of certain liabilities, primarily severance-related liabilities of $1.6 million associated with the employees who transferred to the purchaser in connection with the transaction.

A rollforward of our accrued severance liability associated with the Belgium and Netherlands exit is presented below (in thousands):

	Twelve Months Ended December 31, 2017
Balance, beginning of period	$ 4,846
Charges (credits), net	(173)
Payments	(3,144)
Disposal	(1,601)
Foreign currency adjustments	72
Balance, end of period	$ —

With respect to these exit activities, to date we have incurred cumulatively $4.7 million of severance-related costs and an impairment loss on property, plant and equipment of $0.7 million, partially offset by a disposal gain of $1.1 million.

18. ACCUMULATED OTHER COMPREHENSIVE LOSS

A summary of changes in accumulated other comprehensive loss included within shareholders' equity is as follows (in thousands):

	Twelve Months Ended December 31, 2018					Twelve Months Ended December 31, 2017				
	Foreign Currency Translation Adjustments	Foreign Currency Hedge	Defined benefit pension plans	Tax Provision	Total	Foreign Currency Translation Adjustments	Foreign Currency Hedge	Defined benefit pension plans	Tax Provision	Total
Balance at beginning of year	$(21,366)	$3,246	$(7,221)	$5,545	$(19,796)	$(31,973)	$5,048	$(10,518)	$8,443	$(29,000)
	(9,241)	658	(638)	(3,045)	(12,266)	10,607	(1,802)	3,297	(2,898)	9,204

Other comprehensive income (loss)										
Adoption of new accounting principle	—	—	—	(2,330)	(2,330)	—	—	—	—	—
Balance at end of year	$(30,607)	$3,904	$(7,859)	$170	$(34,392)	$(21,366)	$3,246	$(7,221)	$5,545	$(19,796)

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The following table represents the related tax effects allocated to each component of other comprehensive income (loss) (in thousands):

	Twelve Months Ended December 31,								
	2018			2017			2016		
	Gross Amount	Tax Effect	Net Amount	Gross Amount	Tax Effect	Net Amount	Gross Amount	Tax Effect	Net Amount
Foreign currency translation adjustments	$(9,241)	$(2,923)	$(12,164)	$10,607	$(2,919)	$7,688	$(3,849)	$1,351	$(2,498)
Foreign currency hedge	658	(162)	496	(1,802)	688	(1,114)	481	(181)	300
Defined benefit pension plans	(638)	40	(598)	3,297	(667)	2,630	(10,518)	2,090	(8,428)
Total	$(9,221)	$(3,045)	$(12,266)	$12,102	$(2,898)	$9,204	$(13,886)	$3,260	$(10,626)

19. ISSUANCE AND REPURCHASE OF COMMON STOCK

At-the-Market Equity Issuance Program. On November 28, 2016, we filed with the SEC a prospectus supplement, to our October 2016 shelf registration statement on Form S-3 (the “Shelf Registration Statement”), under which we could have sold up to $150.0 million of our common stock through an “at-the-market” equity offering program (the “ATM Program”). Through December 31, 2016, we sold 167,931 shares of common stock under the ATM Program. The net proceeds from such sales were $6.0 million after deducting the aggregate commissions paid of approximately $0.1 million and were used to reduce outstanding indebtedness. No shares of common stock were sold under the ATM Program during 2017.

On July 31, 2017, we delivered written notice to Merrill Lynch, Pierce, Fenner & Smith Incorporated, Raymond James & Associates, Inc. and SunTrust Robinson Humphrey, Inc. (collectively, the “Agents”) of our termination of the ATM Equity Offering[SM] Sales Agreement, dated November 28, 2016 (the “Sales Agreement”), pursuant to Section 9(a) thereof. The Sales Agreement was terminable by us or the Agents for any reason at any time without penalty upon three days’ written notice to the other party.

In connection with the filing of the Shelf Registration Statement and the commencement of the ATM Program, we capitalized costs totaling $0.7 million, substantially all of which was written off to selling, general and administrative expense in 2017 after the cancellation of the ATM Program.

Common Stock Repurchase Plan. On June 23, 2014, our Board authorized an increase in the stock repurchase plan limit to $50.0 million (less $13.3 million repurchased previously). During year ended May 31, 2015, we repurchased 546,977 shares for a total cost of $21.1 million. During the year ended December 31, 2016, we repurchased 274,110 shares for a total cost of $7.6 million. In the fourth quarter of 2016, these 821,087 shares were retired and are not included in common stock issued and outstanding as of December 31, 2016. The retirement of the shares resulted in a reduction in common stock of $0.2 million, a reduction of $9.1 million to additional paid-in capital, and a $19.4 million reduction to retained earnings. No shares were repurchased during the years ended December 31, 2018 and 2017. At December 31, 2018, $7.9 million remained available to repurchase shares under the stock repurchase plan.

Under the Credit Facility, the Company is limited in its ability to make stock repurchases unless the Total Leverage Ratio is below 2.50 to 1.00. Notwithstanding such provision, in the event that after giving pro forma effect to such repurchase, if Liquidity (as defined in the Credit Agreement) is at least $15.0 million and the Total Leverage Ratio is less than or equal to 4.00 to 1.00, the Credit Facility generally permits the Company to make stock repurchases provided that such repurchases, plus any payments of cash dividends, do not exceed $50.0 million in the aggregate.

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20. QUARTERLY FINANCIAL DATA (Unaudited)

The following is a summary of selected unaudited quarterly financial data for the years ended December 31, 2018 and 2017 (in thousands, except per share data):

	Year Ended December 31, 2018				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Year
Revenues	$302,385	$343,889	$290,856	$309,799	$1,246,929
Gross margin	$75,534	$97,182	$70,139	$85,401	$328,256
Operating income (loss)	$(14,125)	$1,799	$(19,694)	$(6,941)	$(38,961)
Income (loss) from continuing operations[1]	$(12,264)	$(31,341)	$(23,526)	$3,985	$(63,146)
Net income (loss)[1]	$(12,264)	$(31,341)	$(23,526)	$3,985	$(63,146)
Basic earnings (loss) per share:					
Continuing operations[1]	$(0.41)	$(1.04)	$(0.78)	$0.13	$(2.10)
Net income (loss)[1]	$(0.41)	$(1.04)	$(0.78)	$0.13	$(2.10)
Diluted earnings (loss) per share:					
Continuing operations[1]	$(0.41)	$(1.04)	$(0.78)	$0.13	$(2.10)
Net income (loss)[1]	$(0.41)	$(1.04)	$(0.78)	$0.13	$(2.10)

	Year Ended December 31, 2017				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Year
Revenues	$286,554	$312,256	$285,067	$316,334	$1,200,211
Gross margin	$74,804	$84,643	$68,941	$81,611	$309,999
Operating loss[2]	$(12,088)	$(6,693)	$(94,116)	$(2,213)	$(115,110)
Income (loss) from continuing operations[1]	$(9,508)	$(11,086)	$(83,528)	$19,667	$(84,455)
Net income (loss)[1]	$(9,508)	$(11,086)	$(83,528)	$19,667	$(84,455)
Basic earnings (loss) per share:					
Continuing operations[1]	$(0.32)	$(0.37)	$(2.80)	$0.66	$(2.83)
Net income (loss)[1]	$(0.32)	$(0.37)	$(2.80)	$0.66	$(2.83)
Diluted earnings (loss) per share:					
Continuing operations[1]	$(0.32)	$(0.37)	$(2.80)	$0.66	$(2.83)
Net income (loss)[1]	$(0.32)	$(0.37)	$(2.80)	$0.66	$(2.83)

1 Income (loss) from continuing operations, net income (loss) and the related earnings (loss) per share amounts for each of the quarters in 2018 and the fourth quarter of 2017 are revised from those originally reported to correct errors in income tax expense (benefit) associated with the measurement of valuation allowances on deferred tax assets. Based on an analysis of quantitative and qualitative factors, the Company determined the related impacts were not material to its previously filed annual or interim consolidated financial statements, and therefore, amendments of previously filed reports are not required.

2 Includes a goodwill impairment loss of $75.2 million in the third quarter of 2017.

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FIVE YEAR COMPARISON

In November 2015, we announced we would change our fiscal year end to December 31 of each calendar year from May 31. In connection with this change, we previously filed a Transition Report on Form 10-K to report the results of the seven-month transition period from June 1, 2015 to December 31, 2015.

The following table presents our selected financial data. This information has been derived from our audited consolidated financial statements. This historical data should be read in conjunction with the Consolidated Financial Statements and the related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations." (in thousands, except per share data).

	Years Ended December 31,			Seven Months Ended December 31,	Years Ended May 31,	
	2018	2017 [(1)]	2016 [(2)]	2015 [(3)]	2015	2014
Statements of operations data:						
Revenues	$1,246,929	$1,200,211	$1,196,696	$571,718	$842,047	$749,527
Operating income (loss)	$(38,961)	$(115,110)	$(3,118)	$19,162	$68,465	$53,421
Income (loss) from continuing operations	$(63,146)	$(84,455)	$(12,565)	$8,878	$40,497	$30,149
Net income (loss) attributable to Team shareholders	$(63,146)	$(84,455)	$(12,676)	$8,878	$40,070	$29,855
Basic earnings (loss) per share:						
Continuing operations	$(2.10)	$(2.83)	$(0.45)	$0.43	$1.95	$1.46
Net income (loss)	$(2.10)	$(2.83)	$(0.45)	$0.43	$1.95	$1.46
Diluted earnings (loss) per share:						
Continuing operations	$(2.10)	$(2.83)	$(0.45)	$0.41	$1.85	$1.40
Net income (loss)	$(2.10)	$(2.83)	$(0.45)	$0.41	$1.85	$1.40
Weighted-average shares outstanding						
Basic	30,031	29,849	28,095	20,852	20,500	20,439
Diluted	30,031	29,849	28,095	21,425	21,651	21,285
Balance sheet data:						
Total assets	$977,821	$1,055,835	$1,147,418	$798,991	$523,833	$484,941
Long-term debt and other long-term liabilities	$380,770	$430,877	$464,060	$368,685	$97,234	$92,753
Stockholders' equity	$457,100	$477,174	$535,637	$338,146	$335,375	$317,045
Working capital	$215,005	$249,276	$253,636	$222,399	$197,472	$173,671
Noncontrolling interest	$—	$—	$—	$—	$6,034	$5,678
Other financial data:						
Depreciation and amortization	$64,862	$52,143	$48,673	$19,426	$22,787	$21,468
Goodwill impairment loss	$—	$75,241	$—	$—	$—	$—
Share-based compensation	$12,256	$7,876	$7,313	$3,469	$4,838	$4,239
Capital expenditures[4]	$25,931	$36,798	$45,843	$25,802	$28,769	$33,016

1 As revised. See Note 1 to the consolidated financial statements for additional information.

2 Effective February 29, 2016, the Company acquired Furmanite Corporation for a purchase price of $282.3 million, consisting of $209.5 million of common stock, $2.0 million of converted share-based payment awards and $70.8 million of cash.

3 Effective July 7, 2015, the Company acquired Qualspec Group LLC for a purchase price of $255.5 million, consisting of $4.0 million cash, $265.0 million of other assets and $13.5 million in current and long-term liabilities.

4

Excludes capital leases. Totals may vary from amounts presented in the consolidated statements of cash flows due to the timing of cash payments.