



**Three University Plaza**                      **07601**  
**Hackensack, New Jersey**                  (Zip Code)  
(Address of principal executive offices)

**(201) 371-8000**

(Registrant’s telephone number, including area code)

**[None]**

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of outstanding shares of the registrant’s common stock, \$.01 par value, as of July 31, 2014 was 25,269,767.



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**INNODATA INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)****(in thousands, except share data)**

|  | June 30,<br>2014 | December<br>31,<br>2013 |
|--|------------------|-------------------------|
| <b>ASSETS</b>  |                  |                         |
| Current assets:  |                  |                         |
| Cash and cash equivalents  | \$28,103         | \$ 24,752               |
| Accounts receivable, net   | 9,372            | 11,876                  |
| Prepaid expenses and other current assets  | 2,158            | 1,907                   |
| Deferred income taxes  | 335              | 45                      |
| Total current assets   | 39,968           | 38,580                  |
| Property and equipment, net  | 6,536            | 6,083                   |
| Other assets   | 3,607            | 3,323                   |
| Deferred income taxes  | 1,291            | 1,336                   |
| Goodwill   | 675              | 675                     |
| Total assets   | \$52,077         | \$ 49,997               |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                  |                         |
| Current liabilities:   |                  |                         |
| Accounts payable   | \$1,215          | \$ 898                  |
| Accrued expenses   | 2,162            | 2,780                   |
| Accrued salaries, wages and related benefits   | 4,586            | 4,647                   |
| Income and other taxes   | 959              | 1,003                   |
| Current portion of long term obligations   | 870              | 351                     |
| Deferred income taxes  | 77               | 57                      |
| Total current liabilities  | 9,869            | 9,736                   |
| Deferred income taxes  | 190              | 190                     |
| Long term obligations  | 5,194            | 3,747                   |
| Commitments and contingencies  |                  |                         |
| Non-controlling interests  | (4,139 )         | (3,649 )                |
| <b>STOCKHOLDERS' EQUITY:</b>   |                  |                         |
| Serial preferred stock; 5,000,000 shares authorized, none outstanding  | -                | -                       |
| Common stock, \$.01 par value; 75,000,000 shares authorized; 26,792,000 shares issued and 25,248,000 outstanding at June 30, 2014 and 26,597,000 shares issued and 25,053,000 outstanding at December 31, 2013 | 267              | 266                     |
| Additional paid-in capital   | 23,496           | 22,963                  |
| Retained earnings  | 21,250           | 21,724                  |
| Accumulated other comprehensive income (loss)  | 238              | (692 )                  |
|  | 45,251           | 44,261                  |
| Less: treasury stock, 1,544,000 shares at cost   | (4,288 )         | (4,288 )                |

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|  |          |           |
|--|----------|-----------|
| Total stockholders' equity                 | 40,963   | 39,973    |
| Total liabilities and stockholders' equity | \$52,077 | \$ 49,997 |

See notes to condensed consolidated financial statements.

**INNODATA INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS****(Unaudited)****(In thousands, except per share amounts)**

|  | <b>Three Months<br/>Ended<br/>June 30,</b> |            |
|--|--|------------|
|  | 2014                                       | 2013       |
| Revenues   | \$14,314                                   | \$16,160   |
| Operating costs and expenses:  |  |            |
| Direct operating costs   | 11,319                                     | 13,419     |
| Selling and administrative expenses  | 3,862                                      | 4,357      |
| Interest income, net   | (22 )                                      | (117 )     |
| Totals   | 15,159                                     | 17,659     |
| Loss before income taxes   | (845 )                                     | (1,499 )   |
| Provision for (benefit from) income taxes  | 106  | (1,013 )   |
| Net loss   | (951 )                                     | (486 )     |
| Loss attributable to non-controlling interests   | 288  | 365        |
| Net loss attributable to Innodata Inc. and Subsidiaries  | \$(663 )                                   | \$(121 )   |
| Loss per share attributable to Innodata Inc. and Subsidiaries:   |  |            |
| Basic and Diluted  | \$(0.03 )                                  | \$(0.00 )  |
| Weighted average shares outstanding:   |  |            |
| Basic and Diluted  | 25,239                                     | 24,940     |
| Comprehensive loss:  |  |            |
| Net loss   | \$(951 )                                   | \$(486 )   |
| Pension liability adjustment, net of taxes   | 25   | 18         |
| Change in fair value of derivatives, net of taxes of \$0 and \$717 for the three months ended June 30, 2014 and 2013, respectively | 255  | (1,221 )   |
| Other Comprehensive income (loss)  | 280  | (1,203 )   |
| Total Comprehensive loss   | (671 )                                     | (1,689 )   |
| Comprehensive loss attributed to non-controlling interest  | 288  | 365        |
| Comprehensive loss attributable to Innodata Inc. and Subsidiaries  | \$(383 )                                   | \$(1,324 ) |

See notes to condensed consolidated financial statements.

## INNODATA INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME  
(LOSS)

(Unaudited)

(In thousands, except per share amounts)

|  | <b>Six Months<br/>Ended<br/>June 30,</b> |          |
|--|--|----------|
|  | 2014                                     | 2013     |
| Revenues   | \$28,380                                 | \$33,063 |
| Operating costs and expenses:  |  |          |
| Direct operating costs   | 21,610                                   | 26,210   |
| Selling and administrative expenses  | 7,651                                    | 8,980    |
| Interest income, net   | (31 )                                    | (257 )   |
| Totals   | 29,230                                   | 34,933   |
| Loss before income taxes   | (850 )                                   | (1,870 ) |
| Provision for (benefit from) income taxes  | 207                                      | (1,488 ) |
| Net loss   | (1,057 )                                 | (382 )   |
| Loss attributable to non-controlling interests   | 583                                      | 578      |
| Net income (loss) attributable to Innodata Inc. and Subsidiaries   | \$(474 )                                 | \$196    |
| Income (loss) per share attributable to Innodata Inc. and Subsidiaries:  |  |          |
| Basic and Diluted  | \$(0.02 )                                | \$0.01   |
| Weighted average shares outstanding:   |  |          |
| Basic and Diluted  | 25,146                                   | 24,938   |
| Comprehensive income (loss):   |  |          |
| Net loss   | \$(1,057 )                               | \$(382 ) |
| Pension liability adjustment, net of taxes   | 20                                       | 36       |
| Change in fair value of derivatives, net of taxes of \$0 and \$722 for the six months ended June 30, 2014 and 2013, respectively | 910                                      | (1,230 ) |
| Other Comprehensive income (loss)  | 930                                      | (1,194 ) |
| Total Comprehensive loss   | (127 )                                   | (1,576 ) |
| Comprehensive loss attributed to non-controlling interest  | 583                                      | 578      |
| Comprehensive income (loss) attributable to Innodata Inc. and Subsidiaries   | \$456                                    | \$(998 ) |

See notes to condensed consolidated financial statements.



## INNODATA INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)  
(In thousands)

|   | <b>Six Months<br/>Ended<br/>June 30,</b> |          |
|---|--|----------|
|   | 2014                                     | 2013     |
| Cash flow from operating activities:  |  |          |
| Net loss  | \$(1,057 )                               | \$(382 ) |
| Adjustments to reconcile net loss to net cash provided by operating activities: |  |          |
| Depreciation and amortization   | 1,391                                    | 1,913    |
| Stock-based compensation  | 544                                      | 489      |
| Deferred income taxes   | (226 )                                   | (2,049 ) |
| Pension cost  | 440                                      | 257      |
| Changes in operating assets and liabilities:                                    |  |          |
| Accounts receivable   | 2,504                                    | 3,419    |
| Prepaid expenses and other current assets                                       | 449                                      | 342      |
| Other assets  | 218                                      | (143 )   |
| Accounts payable and accrued expenses   | 276                                      | (389 )   |
| Accrued salaries, wages and related benefits                                    | (61 )                                    | (1,321 ) |
| Restricted shares withheld for taxes  | (14 )                                    | (31 )    |
| Payment of minimum withholding taxes on net settlement of stock options         | (23 )                                    | -        |
| Income and other taxes  | (44 )                                    | (435 )   |
| Net cash provided by operating activities                                       | 4,397                                    | 1,670    |
| Cash flow from investing activities:  |  |          |
| Capital expenditures  | (1,492 )                                 | (2,971 ) |
| Sale of investments – other   | -  | 318      |
| Net cash used in investing activities   | (1,492 )                                 | (2,653 ) |
| Cash flow from financing activities:  |  |          |
| Proceeds from equipment financing   | 859                                      | -        |
| Proceeds from exercise of stock options   | 120                                      | 131      |
| Payment of long term obligations  | (533 )                                   | (194 )   |
| Net cash provided by (used in) financing activities                             | 446                                      | (63 )    |
| Net increase (decrease) in cash and cash equivalents                            | 3,351                                    | (1,046 ) |
| Cash and cash equivalents, beginning of period                                  | 24,752                                   | 25,425   |
| Cash and cash equivalents, end of period  | \$28,103                                 | \$24,379 |
| Supplemental disclosures of cash flow information:                              |  |          |
| Cash paid for income taxes  | \$412                                    | \$663    |
| Vendor financed software licenses acquired                                      | \$1,205                                  | \$-      |

See notes to condensed consolidated financial statements.

## INNODATA INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

## SIX MONTHS ENDED JUNE 30, 2014 AND 2013

(Unaudited)

(In thousands)

|   | Common Stock |        | Additional         | Retained  | Accumulated                                | Treasury   | Total     |
|---|--------------|--------|--------------------|-----------|--|------------|-----------|
|   | Shares       | Amount | Paid-in<br>Capital | Earnings  | Other<br>Comprehensive<br>Income<br>(Loss) | Stock      |           |
| January 1, 2014   | 25,053       | \$ 266 | \$ 22,963          | \$ 21,724 | \$ (692 )                                  | \$(4,288 ) | \$ 39,973 |
| Net loss  | -            | -      | -                  | (474 )    | -  | -          | (474 )    |
| Stock-based compensation                                | -            | -      | 544                | -         | -  | -          | 544       |
| Issuance of common stock upon exercise of stock options | 200          | 1      | 96                 | -         | -  | -          | 97        |
| Restricted shares withheld for taxes                    | (5 )         | -      | (14 )              | -         | -  | -          | (14 )     |
| Acquisition of non-controlling interest                 | -            | -      | (93 )              | -         | -  | -          | (93 )     |
| Pension liability adjustments, net of taxes             | -            | -      | -                  | -         | 20   | -          | 20        |
| Change in fair value of derivatives, net of taxes       | -            | -      | -                  | -         | 910  | -          | 910       |
| June 30, 2014   | 25,248       | \$ 267 | \$ 23,496          | \$ 21,250 | \$ 238                                     | \$(4,288 ) | \$ 40,963 |
| January 1, 2013   | 24,892       | \$ 264 | \$ 22,140          | \$ 32,356 | \$ 37                                      | \$(4,288 ) | \$ 50,509 |
| Net income  | -            | -      | -                  | 196       | -  | -          | 196       |
| Stock-based compensation                                | -            | -      | 489                | -         | -  | -          | 489       |
| Issuance of common stock upon exercise of stock options | 76           | 1      | 130                | -         | -  | -          | 131       |
| Restricted shares withheld for taxes                    | (3 )         | -      | (31 )              | -         | -  | -          | (31 )     |
| Acquisition of non-controlling interest                 | -            | -      | (385 )             | -         | -  | -          | (385 )    |
| Pension liability adjustments, net of taxes             | -            | -      | -                  | -         | 36   | -          | 36        |
| Change in fair value of derivatives, net of taxes       | -            | -      | -                  | -         | (1,230 )                                   | -          | (1,230 )  |
| June 30, 2013   | 24,965       | \$ 265 | \$ 22,343          | \$ 32,552 | \$ (1,157 )                                | \$(4,288 ) | \$ 49,715 |

See notes to condensed consolidated financial statements



**INNODATA INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SIX MONTHS ENDED JUNE 30, 2014 AND 2013**

**(Unaudited)**

**1. Description of Business and Summary of Significant Accounting Policies**

**Description of Business-** Innodata Inc. and subsidiaries (the “Company”) is a global provider of business process, information technology and professional services that are focused on digital enablement. The Company’s clients comprise several of the world’s leading digital retailers that sell digital content; preeminent publishers and other providers of online business information products; and enterprises in information-intensive industries (such as aerospace, defense, financial services, healthcare, high technology, insurance, and manufacturing) that create and manage large volumes of content to support their products or operations.

The Company operates in two reporting segments: Content Services (CS) and Innodata Advanced Data Solutions (IADS).

The Company’s CS segment provides solutions to digital retailers, information services companies, publishers and enterprises that have one or more of the following broad business requirements: development of digital content (including e-books); development of new digital information products; and operational support of existing digital information products and systems.

The Company formed its IADS segment in mid-2011 to design and develop new capabilities to enable clients in the financial services, insurance, medical and healthcare sectors to improve decision-support through digital technologies. IADS operates through two subsidiaries. Synodex offers a range of services for healthcare, medical and insurance companies, and docGenix provides services to financial services institutions. As of June 30, 2014, Innodata owns 83% of Synodex and 94% of docGenix, both limited liability companies.

**Basis of Presentation-**The condensed consolidated financial statements for the interim periods included herein are unaudited; however, they contain all adjustments (consisting of only normal recurring adjustments) which, in the opinion of management, are necessary to present fairly the consolidated financial position of the Company as of June 30, 2014, and the results of its operations and comprehensive income (loss), cash flows and stockholders’ equity for the six months ended June 30, 2014 and 2013. The results of operations for the interim periods are not necessarily

indicative of results that may be expected for any other interim period or for the full year.

These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2013, included in the Company's Annual Report on Form 10-K. Unless otherwise noted, the accounting policies used in preparing these condensed consolidated financial statements are the same as those described in the December 31, 2013 consolidated financial statements.

**Principles of Consolidation**-The condensed consolidated financial statements include the accounts of Innodata Inc. and its wholly-owned subsidiaries and the Synodex and docGenix limited liability companies that are majority-owned by the Company. The non-controlling interests in the Synodex and docGenix limited liability companies are accounted for in accordance with Financial Accounting Standards Board (FASB) non-controlling interest guidance. All significant intercompany transactions and balances have been eliminated in consolidation.

**Use of Estimates**-In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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. Actual results could differ from those estimates. Significant estimates include those related to revenue recognition, allowance for doubtful accounts and billing adjustments, long-lived assets, goodwill, valuation of deferred tax assets, valuation of securities underlying stock-based compensation, litigation accruals, pension benefits, valuation of derivative instruments and estimated accruals for various tax exposures.

**INNODATA INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SIX MONTHS ENDED JUNE 30, 2014 AND 2013**

**(Unaudited)**

**Recent Accounting Pronouncements-** In July 2013, the FASB issued guidance on presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. This update clarifies that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. In situations where a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction, or the tax law of the jurisdiction does not require and the entity does not intend to use the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. This accounting guidance is effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2013. Retroactive application is permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In May 2014, the FASB issued guidance on revenue from contracts with customers. This update is a comprehensive new revenue recognition model that requires a company to recognize revenue to depict the transfer of goods or services to a customer at an amount that reflects the consideration it expects to receive in exchange for those goods or services. It also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. This accounting guidance is effective prospectively for annual reporting periods, and interim periods within that period, beginning after December 15, 2016 and early adoption is not permitted. Companies may use either a full retrospective or a modified retrospective approach to adopt the new standard when it takes effect. The Company has not yet determined the potential effects of the adoption of this standard on its consolidated financial statements.

In June 2014, the FASB issued guidance on accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. This new guidance requires that a performance target that affects vesting, and that could be achieved after the requisite service period, be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant date fair value of the award. This update further clarifies that compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. This accounting guidance is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015, with early adoption permitted. The Company does not anticipate that the adoption of this standard will have a material

impact on its consolidated financial statements.

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**INNODATA INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SIX MONTHS ENDED JUNE 30, 2014 AND 2013****(Unaudited)****2. Property and equipment**

Property and equipment are stated at costs less accumulated depreciation and amortization (in thousands), and consist of the following:

|   | June 30,<br>2014 | December<br>31,<br>2013 |
|---|------------------|-------------------------|
| Equipment                                       | \$17,639         | \$ 17,327               |
| Software  | 4,649            | 4,045                   |
| Furniture and equipment                         | 2,656            | 2,600                   |
| Leasehold improvements                          | 5,856            | 5,810                   |
| Total   | 30,800           | 29,782                  |
| Less: accumulated depreciation and amortization | (24,264)         | (23,699 )               |
|   | \$6,536          | \$ 6,083                |

Depreciation and amortization expense of property and equipment was approximately \$1.4 million and \$1.9 million for the six months ended June 30, 2014 and 2013, respectively.

**3. Income Taxes**

The Company had unrecognized tax benefits of approximately \$1.8 million at June 30, 2014 and \$2.3 million at December 31, 2013. The portion of unrecognized tax benefits relating to interest and penalties was approximately \$0.6 million and \$0.8 million at June 30, 2014 and December 31, 2013, respectively. The unrecognized tax benefits as of June 30, 2014 and December 31, 2013, if recognized, would have an impact on the Company's effective tax rate.

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The following presents a roll-forward of the Company's unrecognized tax benefits and associated interest for the six months ended June 30, 2014 (amounts in thousands):

|   | Unrecognized tax benefits |       |
|---|---------------------------|-------|
| Balance - January 1, 2014                 | \$                        | 2,245 |
| Decrease for tax position in prior years  | (722                      | )     |
| Increases for tax position in prior years | 191                       |       |
| Foreign currency revaluation              | 65                        |       |
| Balance – June 30, 2014                   | \$                        | 1,779 |

The Company is subject to Federal income tax, as well as income tax in various states and foreign jurisdictions. The Company is no longer subject to examination by Federal tax authorities for years prior to 2006 and by New Jersey tax authorities for years prior to 2012. Various foreign subsidiaries currently have open tax years from 2003 through 2013.

**INNODATA INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SIX MONTHS ENDED JUNE 30, 2014 AND 2013**

**(Unaudited)**

Pursuant to an income tax audit by the Indian Bureau of Taxation in March 2006, one of the Company's Indian subsidiaries received a tax assessment approximating \$272,000, including interest, through June 30, 2014, for the fiscal tax year ended June 30, 2003. Management disagreed with the basis of the tax assessment and filed an appeal with the Appeal Officer against the assessment. In October 2010, the matter was resolved with a judgment in the Company's favor. Under the Indian Income Tax Act, however, the income tax assessing officer has the right to appeal against the judgment passed by the Appeal Officer. In December 2010, the income tax assessing officer exercised this right, against which the Company has filed an application to defend the case, and the Company intends to contest it vigorously. The Indian Bureau of Taxation has also completed an audit of the Company's Indian subsidiary's income tax return for the fiscal tax year ended June 30, 2004. The ultimate outcome was favorable, and there was no tax assessment imposed for the fiscal tax year ended June 30, 2004. In 2008 and 2009, the Indian subsidiary received a final tax assessment for the fiscal years ended June 30, 2005 and 2006 from the Indian Bureau of Taxation. The tax assessment amounted to \$295,000 and \$308,000, including interest through June 30, 2014, for the fiscal years ended June 30, 2005 and 2006, respectively. Management disagrees with the basis of these tax assessments, has filed an appeal against the assessments and is contesting them vigorously. In January 2012, the Indian subsidiary received a final tax assessment of approximately \$1.0 million, including interest, for the fiscal year ended June 30, 2008, from the Indian Bureau of Taxation. Management disagrees with the basis of this tax assessment, and has filed an appeal against it. Due to this assessment, the Company recorded a tax provision amounting to \$484,000 including interest through June 30, 2014. Based on recent experience and the current regulatory environment, management believes that the tax provision of \$484,000 including interest is adequate. In February 2014, the Indian Bureau of Taxation has also completed an audit of the Company's Indian subsidiary's income tax return for the fiscal tax year ended June 30, 2009. The ultimate outcome was favorable, and there was no tax assessment imposed for the fiscal tax year ended June 30, 2009. The Company had previously recorded a tax provision amounting to \$149,000 including interest for the fiscal tax year ended June 30, 2009. As the ultimate outcome was favorable, the Company reversed this amount in the first quarter of 2014. The Indian Bureau of Taxation commenced an audit of this subsidiary's income tax return for the fiscal year ended June 30, 2010 and 2011. The ultimate outcome cannot be determined at this time. As the Company is continually subject to tax audits by the Indian Bureau of Taxation, the Company continuously assesses the likelihood of an unfavorable assessment for all fiscal years for which the Company has not been audited, and as of June 30, 2014, the Company recorded a tax provision amounting to \$673,000 including interest for such years.

The Company from time to time is also subject to various other tax proceedings and claims for its Philippines subsidiaries. The Company has recorded a tax provision amounting to \$272,000 including interest through June 30, 2014, for several ongoing tax proceedings in the Philippines. Although the ultimate outcome cannot be determined at this time, the Company continues to contest these claims vigorously.

#### 4. Commitments and Contingencies

**Line of Credit** - The Company's \$15.0 million uncommitted bank line expired in June 2014. The Company did not make any borrowings under this line.

**Litigation** - In 2008, the Supreme Court of the Republic of the Philippines refused to review a decision of the Court of Appeals in Manila against a Philippines subsidiary of the Company that is inactive and has no material assets, and purportedly also against Innodata Inc., that orders the reinstatement of certain former employees of the subsidiary to their former positions and also orders the payment of back wages and benefits that aggregate approximately \$8.0 million. Based on consultation with legal counsel, the Company believes that recovery against the Company is unlikely.

The Company is also subject to various legal proceedings and claims which arise in the ordinary course of business.

**INNODATA INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SIX MONTHS ENDED JUNE 30, 2014 AND 2013**

**(Unaudited)**

While management currently believes that the ultimate outcome of these proceedings will not have a material adverse effect on the Company's financial position or overall trends in results of operations, litigation is subject to inherent uncertainties. Substantial recovery against the Company in the above-referenced Philippines action could have a material adverse impact on the Company, and unfavorable rulings or recoveries in the other proceedings could have a material adverse impact on the operating results of the period in which the ruling or recovery occurs. In addition, the Company's estimate of potential impact on the Company's financial position or overall results of operations for the above legal proceedings could change in the future.

The Company's legal reserves related to legal proceedings and claims are based on a determination of whether or not a loss is probable. The Company reviews outstanding proceedings and claims with external counsel to assess probability and estimates of loss. The reserves are adjusted if necessary. While the Company intends to defend these matters vigorously, adverse outcomes that it estimates could reach approximately \$250,000 in the aggregate beyond recorded amounts are reasonably possible. If circumstances change, the Company may be required to record adjustments that could be material to its reported financial condition and results of operations.

**5. Stock Options**

The Company adopted, with stockholder approval, amendments to the Innodata Inc. 2013 Stock Plan. The maximum number of shares of common stock that may be delivered, purchased or used for reference purposes (with respect to stock appreciation rights or stock units) with respect to awards granted under the Innodata Inc. 2013 Stock Plan, as amended and restated (the "2013 Plan") is 2,138,655 shares of common stock of Innodata ("Stock"), plus (i) 41,096 shares of Stock that were available for issuance under the Innodata Isogen, Inc. 2009 Stock Plan, as amended and restated (the "Prior Plan") as of June 4, 2013, plus (ii) any shares subject to an award or portion of any award under the Prior Plan that were outstanding as of June 4, 2013 that expire or terminate unexercised, become unexercisable or are forfeited or otherwise terminated, surrendered or canceled as to any shares without the delivery of shares of stock or other consideration. Shares of stock subject to options or stock appreciation rights granted under the 2013 Plan count against the share reserve as one share for every one share subject to such option or stock appreciation right and shares subject to any other type of award granted under the 2013 Plan count against the share reserve as two shares for every one share subject to such award. If any award, or portion of an award, under the 2013 Plan or Prior Plan expires or terminates unexercised, becomes unexercisable or is forfeited or otherwise terminated, surrendered or canceled as to

any shares without the delivery of shares of Stock or other consideration, the shares subject to such award will thereafter be available for further awards under the 2013 Plan as provided in the next sentence. Shares of Stock that again become available for awards pursuant to the expiration, termination, forfeiture or cancellation of any award (other than an option or stock appreciation right) granted under the 2013 Plan, or of any award (other than an option or stock appreciation right) granted after March 31, 2011 under the Prior Plan, will be added back as two shares for every one share subject to such award or Prior Plan award. All other awards under the 2013 Plan and all other awards under the Prior Plan will be added back as one share for every one share subject to such award or Prior Plan award. The number of shares used for reference purposes in connection with these awards will be considered "delivered" for purposes of computing the maximum number of shares that may be delivered under the 2013 Plan.

## INNODATA INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## SIX MONTHS ENDED JUNE 30, 2014 AND 2013

(Unaudited)

A summary of option activity under the Company's stock option plans as of June 30, 2014, and changes during the period then ended, is presented below:

|  | Number of<br>Options | Weighted<br>-<br>Average<br>Exercise<br>Price | Weighted-Average<br>Remaining<br>Contractual Term<br>(years) | Aggregate<br>Intrinsic<br>Value |
|--|----------------------|---|--|---------------------------------|
| Outstanding at January 1, 2014               | 3,048,069            | \$ 2.99                                       |  |                                 |
| Granted                                      | 1,292,000            | 2.79  |  |                                 |
| Exercised                                    | (345,114 )           | 1.58  |  |                                 |
| Forfeited/Expired                            | (83,563 )            | 2.78  |  |                                 |
| Outstanding at June 30, 2014                 | 3,911,392            | \$ 3.05                                       | 5.20   | \$ 1,301,628                    |
| Exercisable at June 30, 2014                 | 1,520,193            | \$ 3.06                                       | 3.69   | \$ 654,338                      |
| Vested and Expected to Vest at June 30, 2014 | 3,911,392            | \$ 3.05                                       | 3.69   | \$ 1,301,628                    |

The fair value of stock options is estimated on the date of grant using the Black-Scholes option pricing model. The weighted average fair values of the options granted and weighted average assumptions are as follows:

|  | Six Months Ended<br>June 30, |         |
|--|------------------------------|---------|
|  | 2014                         | 2013    |
| Weighted average fair value of options granted | \$ 1.35                      | \$ 1.89 |
| Risk-free interest rate                        | 1.53% - 1.68%                | 0.76%   |
| Expected life (years)                          | 5                            | 5       |
| Expected volatility factor                     | 54.96                        | % 67 %  |
| Expected dividends                             | -                            | -       |

A summary of restricted shares under the Company's stock plans as of June 30, 2014, and changes during the period then ended, are presented below:

|                             | Number<br>of<br>Shares | Weighted-<br>Average<br>Grant<br>Date Fair<br>Value |
|-----------------------------|------------------------|---|
| Unvested at January 1, 2014 | 25,000                 | \$ 3.31   |
| Granted                     | -                      | -   |
| Vested                      | (17,500)               | 3.62  |
| Forfeited/Expired           | -                      | -   |
| Unvested at June 30, 2014   | 7,500                  | \$ 2.59   |

The total compensation cost related to non-vested stock awards not yet recognized as of June 30, 2014 totaled approximately \$2.7 million. The weighted-average period over which these costs will be recognized is twenty-eight months.



**INNODATA INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SIX MONTHS ENDED JUNE 30, 2014 AND 2013****(Unaudited)**

The stock-based compensation expense related to the Company's various stock awards was allocated as follows (in thousands):

|                                     | Three months ended June 30, |       | Six months ended June 30, |       |
|-------------------------------------|-----------------------------|-------|---------------------------|-------|
|                                     | 2014                        | 2013  | 2014                      | 2013  |
| Direct operating costs              | \$106                       | \$78  | \$175                     | \$129 |
| Selling and administrative expenses | 240                         | 133   | 369                       | 360   |
| Total stock-based compensation      | \$346                       | \$211 | \$544                     | \$489 |

In March 2014, the Company's Chairman and CEO (the "CEO") exercised 154,000 stock options at a total exercise price of \$0.4 million. The CEO paid the exercise price by surrendering to the Company 137,065 of the shares of common stock he would have otherwise received on the option exercise. In addition, the CEO surrendered 7,866 shares to the Company in consideration of the payment by the Company on his behalf of \$22,891 of the Company's minimum withholding tax requirement payable in respect of the option exercise. Because the payment value attributable to the surrendered shares upon settlement does not exceed the fair value of the option, no compensation cost was recognized at the date of settlement. In connection with this transaction, the Company issued a net total of 9,069 shares of common stock to the CEO.

**6. Long term obligations**

Total long-term obligations as of June 30, 2014 and December 31, 2013 consist of the following (in thousands):

| June 30, | December 31, |
|----------|--------------|
|----------|--------------|

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|  | 2014    | 2013     |
|--|---------|----------|
| Vendor obligations                             |         |          |
| Capital lease obligations <sup>(1)</sup>       | \$773   | \$ 17    |
| Deferred lease payments <sup>(2)</sup>         | 813     | 764      |
| Microsoft licenses <sup>(3)</sup>              | 797     | -        |
| Pension obligations                            |         |          |
| Accrued pension liability                      | 3,681   | 3,317    |
|  | 6,064   | 4,098    |
| Less: Current portion of long term obligations | 870     | 351      |
| Totals   | \$5,194 | \$ 3,747 |

<sup>(1)</sup> In March 2014, the Company entered into an equipment sale leaseback agreement with a financing company. The cash proceeds from the transaction were \$0.9 million. The Company leased the equipment for a period of 36 months at an effective interest rate of approximately 6% and has the option to purchase the equipment at a nominal amount at the end of the lease term. The Company has accounted for this transaction as a financing arrangement, wherein the equipment remains on the Company's books and will continue to be depreciated. As of June 30, 2014, the Company had made \$0.1 million in lease payments under the sale lease back agreement.

**INNODATA INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SIX MONTHS ENDED JUNE 30, 2014 AND 2013****(Unaudited)**

<sup>(2)</sup> Deferred lease payments represents the effect of straight-lining non-financing type lease payments over the respective lease terms.

<sup>(3)</sup> In March 2014, the Company renewed a vendor agreement to acquire certain additional software licenses and to receive support and subsequent software upgrades on these and other currently owned software licenses through February 2017. Pursuant to this agreement, the Company is obligated to pay approximately \$0.4 million annually over the term of the agreement. The total cost, net of deferred interest (in thousands), was allocated to the following asset accounts in 2014:

|   |         |
|---|---------|
| Prepaid expenses and other current assets | \$356   |
| Other assets                              | 713     |
| Property and equipment                    | 136     |
|   | \$1,205 |

**7. Comprehensive Income (Loss)**

Accumulated other comprehensive income (loss), as reflected in the condensed consolidated balance sheets, consists of pension liability adjustments, net of taxes, and changes in fair value of derivatives, net of taxes. The components of accumulated other comprehensive income (loss) as of June 30, 2014, and reclassifications out of accumulated other comprehensive income (loss) for the three and six months ended June 30, 2014 and 2013, were as follows (net of tax):

|  | Pension<br>Liability<br>Adjustment | Fair Value<br>of<br>Derivatives | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|--|------------------------------------|---------------------------------|--|
| Balance at April 1, 2014   | \$ (121 )                          | \$ 79                           | \$ (42 )   |
| Other comprehensive income (loss) before reclassifications, net of taxes       | 15                                 | 259                             | 274  |
| Total other comprehensive income (loss) before reclassifications, net of taxes | (106 )                             | 338                             | 232  |
| Net amount reclassified to earnings  | 10                                 | (4 )                            | 6  |

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Balance at June 30, 2014 \$ (96 ) \$ 334 \$ 238

|  | Pension<br>Liability<br>Adjustment | Fair Value<br>of<br>Derivatives | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|--|------------------------------------|---------------------------------|--|
| Balance at April 1, 2013   | \$ (25 )                           | \$ 71                           | \$ 46  |
| Other comprehensive income (loss) before reclassifications, net of taxes       | -                                  | (1,182 )                        | (1,182 )   |
| Total other comprehensive income (loss) before reclassifications, net of taxes | (25 )                              | (1,111 )                        | (1,136 )   |
| Net amount reclassified to earnings  | 18                                 | (39 )                           | (21 )  |
| Balance at June 30, 2013   | \$ (7 )                            | \$ (1,150 )                     | \$ (1,157 )  |

**INNODATA INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SIX MONTHS ENDED JUNE 30, 2014 AND 2013****(Unaudited)**

|  | Pension<br>Liability<br>Adjustment | Fair Value<br>of<br>Derivatives | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|--|------------------------------------|---------------------------------|--|
| Balance at January 1, 2014   | \$ (116 )                          | \$ (576 )                       | \$ (692 )  |
| Other comprehensive income (loss) before reclassifications, net of taxes       | -                                  | 529                             | 529  |
| Total other comprehensive income (loss) before reclassifications, net of taxes | (116 )                             | (47 )                           | (163 )   |
| Net amount reclassified to earnings  | 20                                 | 381                             | 401  |
| Balance at June 30, 2014   | \$ (96 )                           | \$ 334                          | \$ 238   |

|  | Pension<br>Liability<br>Adjustment | Fair Value<br>of<br>Derivatives | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|--|------------------------------------|---------------------------------|--|
| Balance at January 1, 2013   | \$ (43 )                           | \$ 80                           | \$ 37  |
| Other comprehensive income (loss) before reclassifications, net of taxes       | -                                  | (1,499 )                        | (1,499 )   |
| Total other comprehensive income (loss) before reclassifications, net of taxes | (43 )                              | (1,419 )                        | (1,462 )   |
| Net amount reclassified to earnings  | 36                                 | 269                             | 305  |
| Balance at June 30, 2013   | \$ (7 )                            | \$ (1,150 )                     | \$ (1,157 )  |

All reclassifications out of accumulated other comprehensive income (loss) had an impact on direct operating costs in the condensed consolidated statement of operations and comprehensive income (loss).

**8. Segment Reporting and Concentrations**

The Company's operations are classified into two reportable segments: Content Services (CS) and Innodata Advanced Data Solutions (IADS).

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The CS segment provides solutions to digital retailers, information services companies, publishers and enterprises that have one or more of the following broad business requirements: development of digital content (including e-books); development of new digital information products; and operational support of existing digital information products and systems.

In the second quarter of 2011, the Company launched its IADS segment to perform advanced data analysis. IADS operates through two subsidiaries: Synodex and docGenix. Synodex offers a range of data analysis services in the healthcare, medical and insurance areas. docGenix provides services to certain financial services institutions.

A significant portion of the Company's revenues are generated from its production facilities in the Philippines, India, Sri Lanka and Israel.

## INNODATA INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## SIX MONTHS ENDED JUNE 30, 2014 AND 2013

(Unaudited)

Revenues from external clients and segment operating profit (loss), and other reportable segment information are as follows (in thousands):

|   | Three Months<br>Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---|-----------------------------------|-----------|------------------------------|-----------|
|   | 2014                              | 2013      | 2014                         | 2013      |
| Revenues:   |                                   |           |                              |           |
| Content Services  | \$14,136                          | \$16,008  | \$28,130                     | \$32,276  |
| IADS  | 178                               | 152       | 250                          | 787       |
| Total Consolidated                                      | \$14,314                          | \$16,160  | \$28,380                     | \$33,063  |
| Loss before provision for income taxes <sup>(1)</sup> : |                                   |           |                              |           |
| Content Services  | \$981                             | \$1,062   | \$2,871                      | \$2,080   |
| IADS  | (1,826)                           | (2,561)   | (3,721)                      | (3,950)   |
| Total Consolidated                                      | \$(845)                           | \$(1,499) | \$(850)                      | \$(1,870) |
| Loss before provision for income taxes <sup>(2)</sup> : |                                   |           |                              |           |
| Content Services  | \$511                             | \$589     | \$1,932                      | \$1,227   |
| IADS  | (1,356)                           | (2,088)   | (2,782)                      | (3,097)   |
| Total Consolidated                                      | \$(845)                           | \$(1,499) | \$(850)                      | \$(1,870) |

|                    | June 30,<br>2014 | December<br>31, 2013 |
|--------------------|------------------|----------------------|
| Total assets:      |                  |                      |
| Content Services   | \$51,057         | \$48,981             |
| IADS               | 1,020            | 1,016                |
| Total Consolidated | \$52,077         | \$49,997             |

(1) Before elimination of any inter-segment profits

(2) After elimination of any inter-segment profits

The following table summarizes revenues by geographic region (determined based upon customer's domicile) (in thousands):

|                            | Three months ended |          | Six months ended |          |
|----------------------------|--------------------|----------|------------------|----------|
|                            | June 30, 2014      | 2013     | June 30, 2014    | 2013     |
| United States              | \$7,756            | \$10,992 | \$15,745         | \$22,903 |
| The Netherlands            | 2,645              | 2,151    | 5,276            | 4,210    |
| United Kingdom             | 2,231              | 1,813    | 4,124            | 3,662    |
| Other - principally Europe | 1,682              | 1,204    | 3,235            | 2,288    |
|                            | \$14,314           | \$16,160 | \$28,380         | \$33,063 |



**INNODATA INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SIX MONTHS ENDED JUNE 30, 2014 AND 2013****(Unaudited)**

Long-lived assets as of June 30, 2014 and December 31, 2013, respectively, by geographic region, are comprised of (in thousands):

|                    | June<br>30,<br>2014 | December<br>31,<br>2013 |
|--------------------|---------------------|-------------------------|
| United States      | \$1,215             | \$ 1,151                |
| Foreign countries: |                     |                         |
| Philippines        | 2,311               | 1,917                   |
| India              | 2,592               | 2,660                   |
| Sri Lanka          | 1,061               | 989                     |
| Israel             | 32                  | 41                      |
| Total foreign      | 5,996               | 5,607                   |
|                    | \$7,211             | \$ 6,758                |

Two clients generated approximately 32% and 25% of the Company's total revenues for the three months ended June 30, 2014 and 2013, respectively. Two other clients accounted for less than 10% of the Company's total revenues for the three months ended June 30, 2014 but accounted for 29% of the Company's total revenues for the three months ended June 30, 2013. No other client accounted for 10% or more of total revenues during these periods. Further, for the three months ended June 30, 2014 and 2013, revenues from non-U.S. clients accounted for 46% and 32%, respectively, of the Company's total revenues.

Two clients generated approximately 32% and 24% of the Company's total revenues for the six months ended June 30, 2014 and 2013, respectively. Two other clients accounted for less than 10% of the Company's total revenues for the six months ended June 30, 2014 but accounted for 29% of the Company's total revenues for the six months ended June 30, 2013. No other client accounted for 10% or more of total revenues during these periods. Further, for the six months ended June 30, 2014 and 2013, revenues from non-U.S. clients accounted for 45% and 31%, respectively, of the Company's total revenues.

As of June 30, 2014, approximately 54% of the Company's accounts receivable was from foreign (principally European) clients and 47% of accounts receivable was due from three clients. As of December 31, 2013, approximately 38% of the Company's accounts receivable was from foreign (principally European) clients and 65% of accounts receivable was due from four clients.

### 9. Income (Loss) Per Share

|  | Three months ended |          | Six months ended |        |
|--|--------------------|----------|------------------|--------|
|  | June 30, 2014      | 2013     | June 30, 2014    | 2013   |
|  | (in thousands)     |          |                  |        |
| Net income (loss) attributable to Innodata Inc. and Subsidiaries | \$(663 )           | \$(121 ) | \$(474 )         | \$196  |
| Weighted average common shares outstanding                       | 25,239             | 24,940   | 25,146           | 24,938 |
| Dilutive effect of outstanding options                           | -                  | -        | -                | -      |
| Adjusted for dilutive computation                                | 25,239             | 24,940   | 25,146           | 24,938 |

**INNODATA INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SIX MONTHS ENDED JUNE 30, 2014 AND 2013**

**(Unaudited)**

Basic income (loss) per share is computed using the weighted-average number of common shares outstanding during the period. Diluted income (loss) per share is computed by considering the impact of the potential issuance of common shares, using the treasury stock method, on the weighted average number of shares outstanding. For those securities that are not convertible into a class of common stock, the “two-class” method of computing income per share is used.

Options to purchase 1.6 million shares and 1.7 million shares of common stock for the three months ended June 30, 2014 and 2013, respectively, were outstanding but not included in the computation of diluted income (loss) per share, because the options exercise price was greater than the average market price of the common shares and, therefore, the effect would have been antidilutive. In addition, diluted net income (loss) per share for the three months ended June 30, 2014 and 2013 does not include 2.3 million and 1.7 million potential common shares, respectively, derived from the exercise of stock options because as a result of the Company’s incurring losses, their effect would have been antidilutive.

Options to purchase 1.6 million shares and 0.6 million shares of common stock for the six months ended June 30, 2014 and 2013, respectively, were outstanding but not included in the computation of diluted income (loss) per share, because the options exercise price was greater than the average market price of the common shares and, therefore, the effect would have been antidilutive. In addition, diluted net loss per share for the six months ended June 30, 2014 does not include 2.3 million potential common shares derived from the exercise of stock options because as a result of the Company’s incurring losses, their effect would have been antidilutive.

**10. Derivatives**

The Company conducts a large portion of its operations in international markets that subject it to foreign currency fluctuations. The most significant foreign currency exposures occur when revenue and associated accounts receivable are collected in one currency and expenses to generate that revenue are incurred in another currency. The Company’s primary exchange rate exposure relates to payroll, other payroll costs and operating expenses in the Philippines, India, Sri Lanka and Israel.

To manage its exposure to fluctuations in foreign currency exchange rates, the Company entered into foreign currency forward contracts, authorized under Company policies, with counterparties that were highly rated financial institutions. The Company utilized non-deliverable forward contracts expiring within twelve months to reduce its foreign currency risk.

The Company formally documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking hedge transactions. The Company does not hold or issue derivatives for trading purposes. All derivatives are recognized at their fair value and classified based on the instrument's maturity date. The total notional amount for outstanding derivatives as of June 30, 2014 and December 31, 2013 was \$17.5 million and \$15.2 million, respectively, which is comprised of cash flow hedges denominated in U.S. dollars.

## INNODATA INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## SIX MONTHS ENDED JUNE 30, 2014 AND 2013

(Unaudited)

The following table presents the fair value of derivative instruments included within the condensed consolidated balance sheets as of June 30, 2014 and December 31, 2013 (in thousands):

|  | Balance Sheet Location                    | Fair Value |       |
|--|---|------------|-------|
|  |   | 2014       | 2013  |
| Derivatives designated as hedging instruments: |   |            |       |
| Foreign currency forward contracts             | Prepaid expenses and other current assets | \$334      | \$-   |
| Foreign currency forward contracts             | Accrued expenses                          | \$-        | \$577 |

The effects of foreign currency forward contracts designated as cash flow hedges on the Company's condensed consolidated statements of operations and comprehensive income (loss) for the three and six months ended June 30, 2014 and 2013, respectively, were as follows (in thousands):

|  | Three Months     |           | Six Months        |           |
|--|------------------|-----------|-------------------|-----------|
|  | Ended<br>June 30 |           | Ended<br>June 30, |           |
|  | 2014             | 2013      | 2014              | 2013      |
| Net gain recognized in OCI <sup>(1)</sup>                                    | \$259            | \$(1,977) | \$529             | \$(1,683) |
| Net gain (loss) reclassified from accumulated OCI into income <sup>(2)</sup> | \$4              | \$(39)    | \$(381)           | \$269     |
| Net gain recognized in income <sup>(3)</sup>                                 | \$-              | \$-       | \$-               | \$-       |

<sup>(1)</sup> Net change in fair value of the effective portion classified into other comprehensive income ("OCI")

<sup>(2)</sup> Effective portion classified within direct operating cost

(3) There were no effective portions for the period presented.

## 11. Financial Instruments

The carrying amounts of financial instruments, including cash and cash equivalents, accounts receivable and accounts payable approximated their fair value as of June 30, 2014 and December 31, 2013, because of the relative short maturity of these instruments.

“*Fair Value Measurements and Disclosures*” defines fair value as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

The accounting standard establishes a fair value hierarchy that prioritizes the inputs used to measure fair value into three levels. The three levels are defined as follows:

· *Level 1*: Unadjusted quoted price in active market for identical assets and liabilities.

· *Level 2*: Observable inputs other than those included in Level 1.

· *Level 3*: Unobservable inputs reflecting management’s own assumptions about the inputs used in pricing the asset or liability.

**INNODATA INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SIX MONTHS ENDED JUNE 30, 2014 AND 2013****(Unaudited)**

The following table sets forth the assets and liabilities as of June 30, 2014 and December 31, 2013 that the Company measured at fair value, on a recurring basis by level, within the fair value hierarchy (in thousands). As required by the standard, assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to their fair value measurement.

|                   |            |            |            |
|-------------------|------------|------------|------------|
| June 30, 2014     | Level<br>1 | Level<br>2 | Level<br>3 |
| Assets            |            |            |            |
| Derivatives       | \$ -       | \$ 334     | \$ -       |
| December 31, 2013 | Level<br>1 | Level<br>2 | Level<br>3 |
| Liabilities       |            |            |            |
| Derivatives       | \$ -       | \$ 577     | \$ -       |

The Level 2 assets and liabilities contain foreign currency forward contracts. Fair value is determined based on the observable market transactions of spot and forward rates. The fair value of these contracts as of June 30, 2014 is included in prepaid expenses and other current assets and December 31, 2013 is included in accrued expenses in the accompanying condensed consolidated balance sheets.

**12.****Subsequent Event**

On July 28, 2014, the Company acquired 100% of the common shares and 100% of the preferred shares of MediaMiser Ltd. (“MediaMiser”). These shares represent substantially all of the economic ownership interest of MediaMiser. A MediaMiser Employee Trust will retain special voting shares equivalent to 50% of the voting rights in MediaMiser for the term specified in the articles of amalgamation of MediaMiser. The Trustees of the MediaMiser Employee Trust are the former and continuing management of MediaMiser. MediaMiser is an Ottawa, Canada-based provider of automated, real-time traditional and social media monitoring services.

The purchase price for the acquisition aggregated C\$5.78 million (US\$5.38 million) of non-contingent consideration, plus up to a maximum of C\$5.0 million (US\$4.60 million) of contingent consideration. The purchase price is subject to certain adjustments. Canadian currency is valued at the U.S. dollar exchange rate effective July 28, 2014. Of the non-contingent portion of the purchase price, C\$4.40 million (US\$4.10 million) was paid by the Company in cash at closing; C\$0.63 million (US\$0.58 million) is payable by the Company on July 28, 2015 in shares of the Company's common stock, or at the Company's discretion in cash; and C\$0.75 million (US\$0.70 million) is payable by the Company on July 28, 2016 in shares of the Company's common stock, or at the Company's discretion in cash. The contingent portion of the purchase price is a potential earn-out of up to C\$5.0 million (US\$4.60 million) based on MediaMiser's revenues and EBITDA during the period from April 1, 2016 until March 31, 2017. The contingent consideration if earned is payable in May 2017 in cash, or at the Company's discretion in up to 70% in the Company's common stock with the balance in cash. Shares of the Company's common stock will be valued for any payment at the weighted average closing price for the ten consecutive trading days immediately preceding the date on which the payment is due.



**INNODATA INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SIX MONTHS ENDED JUNE 30, 2014 AND 2013**

**(Unaudited)**

For additional information see the Company's Report on Form 8-K dated July 28, 2014. The information in the financial statements of this Report on Form 10-Q is for the quarterly period ended June 30, 2014, and does not reflect any aspect of the MediaMiser transaction.

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

Disclosures in this Form 10-Q contain certain forward-looking statements, including without limitation, statements concerning our operations, economic performance, and financial condition. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The words “project,” “head start,” “believe,” “expect,” “should,” “anticipate,” “indicate,” “point to,” “forecast,” “likely” and other similar expressions generally identify forward-looking statements, which speak only as of their dates.

*These forward-looking statements are based largely on our current expectations, and are subject to a number of risks and uncertainties, including without limitation, that contracts may be terminated by clients, projected or committed volumes of work may not materialize; our Innodata Advanced Data Solutions segment (“IADS”) is a new venture with minimal revenues that has incurred losses since inception and has recorded impairment charges for all of its fixed assets; we currently intend to continue to invest in IADS; the primarily at-will nature of contracts with our Content Services clients and the ability of these clients to reduce, delay or cancel projects; continuing Content Services segment revenue concentration in a limited number of clients; continuing Content Services segment reliance on project-based work; inability to replace projects that are completed, canceled or reduced; depressed market conditions; changes in external market factors; the ability and willingness of our clients and prospective clients to execute business plans which give rise to requirements for digital content and professional services in knowledge processing; difficulty in integrating and deriving synergies from acquisitions, joint venture and strategic investments; potential undiscovered liabilities of companies that we acquire; changes in our business or growth strategy; the emergence of new or growing competitors; various other competitive and technological factors; and other risks and uncertainties indicated from time to time in our filings with the Securities and Exchange Commission.*

*Our actual results could differ materially from the results referred to in the forward-looking statements. In light of these risks and uncertainties, there can be no assurance that the results referred to in the forward-looking statements contained in this Form 10-Q will occur.*

*We undertake no obligation to update or review any guidance or other forward-looking information, whether as a result of new information, future developments or otherwise.*

*Note 12 to the financial statements notes as a Subsequent Event the acquisition by the Company of the common and preferred shares of MediaMiser Ltd. on July 28, 2014. The information in this Report on Form 10-Q is for the quarterly period ended June 30, 2014 and does not reflect any aspect of the MediaMiser transaction.*

## **Business Overview**

Innodata (NASDAQ: INOD) is a global provider of business process, information technology and professional services that are focused on digital enablement. Our clients comprise several of the world's leading digital retailers that sell digital content; preeminent publishers and other providers of online business information products; and enterprises in information-intensive industries (such as aerospace, defense, financial services, healthcare, high technology, insurance, and manufacturing) that create and manage large volumes of content to support their products or operations.

We operate in two reporting segments: Content Services (CS) and Innodata Advanced Data Solutions (IADS).

Our CS segment provides solutions to digital retailers, information services companies, publishers and enterprises that have one or more of the following broad business requirements: development of digital content (including eBooks); development of new digital information products; and operational support of existing digital information products and systems.

Many of our clients are driving or are responding to rapid and fundamental changes in the way end users discover, consume and create published information. For some of our publishing and information services clients, this means transforming information products from print to digital; for others, it means migrating already-digital products from web-only distribution to multiple-channel distribution that includes mobile and tablet devices and incorporates mobility, social platform and semantic search; and for others still it means re-tooling pure search-based information products into workflow-embedded analytical tools that combine content with software to enable context-aware decision-making; and for a select number of our information services clients, it means embracing the content-as-a-service model to integrate content with other tools, applications and data. Each of these transformations requires shifts in products, as well as the technology and the operations that support them.

For our enterprise publishing clients, changes in the way end users discover, consume and create published information often necessitates replacing old processes and technologies that generated static, whole documents with new processes and technologies that enable content to reside as modular components which are re-combined dynamically to create up-to-date, product-specific assembly guides, engineering diagrams/schematics, compliance documentation, field operations guides and clinical documentation destined simultaneously for the web, tablets and smartphones.

By blending consulting, technology and operations sourcing, along with deep domain expertise, we provide measurable outcomes for publishing companies, information services companies and enterprises through business transformation, accelerating innovation and efficient operations.

We are one of the largest producers of e-books, serving four of the five leading digital retailers of e-books as well as 80 leading trade, education and professional publishers that sell e-books. We manufacture both standard e-books and interactive e-books in a variety of formats (including EPUB, Mobi and Kindle) and in 12 major languages (including Japanese and Chinese). In addition, we distribute e-books on behalf of publishers and authors to more than 25 e-book retailers across North America, the United Kingdom, Australia and 24 countries in the European Union. Since the fall of 2011, we have produced over 1 million e-book titles.

We help our clients develop high-value information products and knowledge repositories. Our clients include four of the ten largest information industry companies in the world, spanning financial, legal, healthcare and scientific information.

We work with clients at a strategic business and technology level to address business process and technology challenges related to digital content supply chain optimization and strategy. By aligning operations and technology with business goals, we help businesses accelerate new product development and introduction; control cost; consolidate and leverage technology investment; and obtain benefits of scale.

Many enterprises are embracing new digital information technologies and workflow processes within their operations in order to improve internal decision-support systems. We formed our IADS segment in mid-2011 to design and develop new capabilities to enable clients in the financial services, insurance, medical and healthcare sectors to improve decision-support through digital technologies. We believe that by creating and commercializing innovative business strategies and technology solutions we will be able to accelerate our growth and reduce our revenue volatility.

IADS operates through its Synodex LLC and docGenix LLC subsidiaries. As of June 30, 2014 we owned 83% of Synodex and 94% of docGenix.

The main focus of the Synodex business is the extraction and classification of data from unstructured medical records in an innovative way to provide improved data service capabilities for insurance underwriting, insurance claims, medical records management and clinical trial support services. Synodex has developed and piloted its APS.Extract® product for specific use with life, disability and long-term care insurance underwriting and claims and has cultivated a large number of interested clients in both the U.S. and the U.K. Most recently, Synodex launched its Synodex.Connect® platform to facilitate digital data exchange for underwriting workflows between independent brokers and insurance carriers, including delivery of Synodex's APS.Extract data and reports.

The main focus of the docGenix business is the extraction and classification of data from unstructured legal documents in order to improve an organization's ability to analyze documentation and feed actionable data to downstream applications.

The IADS subsidiaries have incurred losses and have reported minimal revenues from inception through June 30, 2014. Our cumulative investment in these subsidiaries was approximately \$27 million as of June 30, 2014, consisting of \$20.0 million in operating expenses and \$7.0 million in capital expenditures. As of June 30, 2014, the Company wrote off all of the fixed assets of IADS, and has expensed all investments in IADS since that date. In the immediate future we intend to continue to invest in these subsidiaries at the combined rate of \$1.3 to \$1.5 million per quarter.

Our services are organized and managed around three vectors: a vertical industry focus, a horizontal service/process focus, and a supportive operations focus.

The vertically-aligned groups understand our clients' businesses and strategic initiatives. The vertical group for each particular industry includes experts hired from that industry.

Our service/process-aligned groups include engineering personnel and delivery personnel. Our engineering teams are responsible for creating secure and efficient custom workflows and integrating proprietary and third-party technologies to automate manual processes and improve the consistency and quality of our work product. These tools include categorization engines that utilize pattern recognition algorithms based on comprehensive rule sets and related heuristics, data extraction tools that automatically retrieve specific types of information from large data sources, and workflow systems that enable various tasks and activities to be performed across our multiple facilities.

Our globally distributed delivery personnel are responsible for executing our client engagements in accordance with service-level agreements. We deliver services from facilities in the United States, India, the Philippines, Sri Lanka and Israel.

Other support groups are responsible for managing diverse enabling functions including human resources, organizational development, network and communications technology infrastructure support and physical infrastructure and facilities management.

Our sales staff, program managers and consultants operate primarily from our North American and European locations, as well as from client sites.

*Revenues*

We price our services based on the quantity delivered or resources utilized, and we recognize revenue in the period in which the services are performed and delivered. Revenues for contracts billed on a time-and-materials basis are recognized as services are performed. Revenues under fixed-fee contracts, which are not significant to the overall revenues, are recognized on the percentage of completion method of accounting, as services are performed or milestones are achieved.

We consider standard accounting criteria for determining whether to report revenue gross as a principal versus net as an agent. Factors considered include whether we are the primary obligor, have risks and rewards of ownership, and bear the risk that a client may not pay for the services performed. If there are circumstances where the above criteria are not met and therefore we are not the principal in providing services, amounts received from clients are presented net of payments in the condensed consolidated statements of operations and comprehensive income.

Revenues include reimbursement of out-of-pocket expenses, with the corresponding out-of-pocket expenses included in direct operating costs.

#### *Direct Operating Costs*

Direct operating costs consist of direct payroll, occupancy costs, depreciation and amortization, travel, telecommunications, computer services and supplies, realized gain (loss) on forward contracts, foreign currency revaluation gain (loss), and other direct expenses that are incurred in providing services to our clients.

#### *Selling and Administrative Expenses*

Selling and administrative expenses consist of management and administrative salaries, sales and marketing costs, new services research and related software development, professional fees and consultant costs, and other administrative overhead costs.

### **Results of Operations**

#### **Three Months Ended June 30, 2014 and 2013**

##### *Revenues*

Total revenues were \$14.3 million for the three months ended June 30, 2014 compared to \$16.1 million for the three months ended June 30, 2013, a decline of \$1.8 million or approximately 11%. Revenues from the CS segment were \$14.1 million and \$16.0 million for the three months ended June 30, 2014 and 2013, respectively, a decline of \$1.9



million or approximately 12%. This decline is primarily attributable to a \$1.0 million decline in e-book-related services from one client and a \$1.3 million decline in other services from another client. Revenues from the IADS segment were \$0.2 million and \$0.1 million for the three months ended June 30, 2014 and 2013, respectively.

Two clients generated approximately 32% and 25% of our total revenues for the three months ended June 30, 2014 and 2013, respectively. Two other clients accounted for less than 10% of our total revenues for the three months ended June 30, 2014 but accounted for 29% of our total revenues for the three months ended June 30, 2013. No other client accounted for 10% or more of total revenues during these periods. Further, for the three months ended June 30, 2014 and 2013, revenues from non-U.S. clients accounted for 46% and 32%, respectively, of our total revenues.

#### *Direct Operating Costs*

Direct operating costs were \$11.3 million and \$13.4 million for the three months ended June 30, 2014 and 2013, respectively, a decline of \$2.1 million or 16%. Direct operating costs for the CS segment were \$10.2 million and \$11.8 million for the three months ended June 30, 2014 and 2013, respectively, a decline of \$1.6 million or 14%. Direct operating costs for the IADS segment were \$1.1 million and \$1.6 million for the respective periods, net of intersegment profits, a decrease of \$0.5 million.

Direct operating costs as a percentage of total revenues decreased to 79% for the three months ended June 30, 2014 compared to 83% for the three months ended June 30, 2013. Direct operating costs for the CS segment as a percentage of CS segment revenues were 72% for the three months ended June 30, 2014 compared to 74% for the three months ended June 30, 2013.

The decline in direct operating costs for the CS segment and as a percentage of CS segment revenues was principally attributable to a decrease in production headcount due to a decline in CS revenues and restructuring our operations, and achieving productivity gains. The productivity gains were principally the result of increased efficiency and improvements in our processes and technology.

Direct operating costs for the IADS segment represent certain production costs for initial engagements, including pilot engagements, and facility overhead costs for our delivery center in Asia.

#### *Selling and Administrative Expenses*

Selling and administrative expenses were \$3.9 million, or 27% as a percentage of total revenues during the three months ended June 30, 2014, and \$4.4 million, or approximately 27% as a percentage of total revenues for the three months ended June 30, 2013, and represents a decrease of \$0.5 million or approximately 11%. Selling and administrative expenses for the CS segment were \$3.5 million and \$3.8 million in these respective periods. Selling and administrative expenses for the IADS segment for the respective periods were \$0.4 million and \$0.6 million, net of intersegment profits. Selling and administrative expenses for the CS segment as a percentage of CS segment revenues were 25% for the three months ended June 30, 2014 and 24% for the three months ended 2013.

#### *Income Taxes*

For the three months ended June 30, 2014, we recorded a provision for income taxes in accordance with local tax regulations for our foreign subsidiaries. Some of our foreign subsidiaries are subject to tax holidays or preferential tax rates which reduces our overall effective tax rate when compared to the U.S. statutory tax rate. In addition, the earnings of our foreign subsidiaries are not subject to tax in the U.S. unless the earnings are repatriated.

We have a valuation allowance on all of our U.S. deferred tax assets on account of continuing losses incurred by our U.S. entity.

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For the three months ended June 30, 2013, we recorded a net benefit from income taxes, as our U.S. entity recorded a benefit from income tax on account of losses it incurred; and with respect to our foreign subsidiaries, we recorded a provision for income taxes in accordance with local tax regulations. Some of our foreign subsidiaries are subject to tax holidays or preferential tax rates which reduces our overall effective tax rate when compared to the U.S. statutory tax rate. In addition, the earnings of our foreign subsidiaries are not subject to tax in the U.S. unless the earnings are repatriated.

### *Net Loss*

We generated a net loss of \$0.7 million in the three months ended June 30, 2014 compared to net loss of \$0.1 million in the three months ended June 30, 2013.

Net income for the CS segment was \$0.7 million for the three months ended June 30, 2014, compared to net income of \$2.0 million for the three months ended June 30, 2013, net of intersegment profits. A significant contributor to the decline in net income of the CS segment was an increase in income tax expense; we recorded a \$0.1 million income tax expense for the three months ended June 30, 2014 compared to an income tax benefit amounting to \$1.0 million. Such benefit from income taxes was attributable to the losses incurred by our U.S. entity for the three months ended June 30, 2013.

Net loss for the IADS segment was \$1.4 million for the three months ended June 30, 2014 compared to \$2.1 million for the three months ended June 30, 2013, net of intersegment profits. The decline in net loss primarily reflects a reduction in headcount and other administrative costs.

### **Six Months Ended June 30, 2014 and 2013**

#### *Revenues*

Total revenues were \$28.4 million for the six months ended June 30, 2014 compared to \$33.1 million for the six months ended June 30, 2013, a decline of \$4.7 million or approximately 14%. Revenues from the CS segment were \$28.1 million and \$32.3 million for the six months ended June 30, 2014 and 2013, respectively, a decline of \$4.2 million or approximately 13%. This decline is primarily attributable to a \$2.0 million decline in e-book-related services from one client and a \$2.3 million decline in other services from another client. Revenues from the IADS segment were \$0.3 million and \$0.8 million for the six months ended June 30, 2014 and 2013, respectively.

Two clients generated approximately 32% and 24% of our total revenues for the six months ended June 30, 2014 and 2013, respectively. Two other clients accounted for less than 10% of our total revenues for the six months ended June 30, 2014 but accounted for 29% of our total revenues for the six months ended June 30, 2013. No other client accounted for 10% or more of total revenues during these periods. Further, for the six months ended June 30, 2014 and 2013, revenues from non-U.S. clients accounted for 45% and 31%, respectively, of our total revenues.

#### *Direct Operating Costs*

Direct operating costs were \$21.6 million and \$26.2 million for the six months ended June 30, 2014 and 2013, respectively, a decline of \$4.6 million or approximately 18%. Direct operating costs for the CS segment were \$19.4 million and \$23.6 million for the six months ended June 30, 2014 and 2013, respectively, a decline of \$4.2 million or approximately 18%. Direct operating costs for the IADS segment were \$2.2million and \$2.6 million for the respective

periods, net of intersegment profits.

Direct operating costs as a percentage of total revenues decreased to 76% for the six months ended June 30, 2014 compared to 79% for the six months ended June 30, 2013. Direct operating costs for the CS segment as a percentage of CS segment revenues were 69% for the six months ended June 30, 2014 compared to 73% for the six months ended June 30, 2013.

The decline in direct operating costs for the CS segment and as a percentage of CS segment revenues was principally attributable to a decrease in production headcount due to a decline in CS revenues and restructuring our operations, and achieving productivity gains. The productivity gains were principally the result of increased efficiency and improvements in our processes and technology.

Direct operating costs for the IADS segment represents certain production costs for initial engagements, including pilot engagements, and facility overhead costs for our new delivery center in Asia.

*Selling and Administrative Expenses*

Selling and administrative expenses were \$7.7 million, or approximately 27% as a percentage of total revenues during the six months ended June 30, 2014, and \$9.0 million, or 27% as a percentage of total revenues for the six months ended June 30, 2013, and represents a decrease of \$1.3 million or approximately 14%.

Selling and administrative expenses for the CS segment were \$6.8 million and \$7.7 million in these respective periods. Selling and administrative expenses for the IADS segment for the respective periods were \$0.9 million and \$1.3 million, net of intersegment profits. Selling and administrative expenses for the CS segment as a percentage of CS segment revenues was 24% for both the six months ended June 30, 2014 and 2013.

*Income Taxes*

For the six months ended June 30, 2014, we recorded a provision for income taxes in accordance with local tax regulations for our foreign subsidiaries. Some of our foreign subsidiaries are subject to tax holidays or preferential tax rates which reduces our overall effective tax rate when compared to the U.S. statutory tax rate. In addition, the earnings of our foreign subsidiaries are not subject to tax in the U.S. unless the earnings are repatriated. The provision for income taxes recorded by our foreign subsidiaries was partially offset by a reversal of a tax provision on account of a favorable outcome in one of the tax proceedings of our Indian subsidiary.

We have a valuation allowance on all of our U.S. deferred tax assets on account of continuing losses incurred by our U.S. entity.

For the six months ended June 30, 2013, we recorded a net benefit from income taxes, as our U.S. entity recorded a benefit from income tax on account of losses it incurred; and with respect to our foreign subsidiaries, we recorded a provision for income taxes of approximately \$0.5 million in accordance with local tax regulations. Some of our foreign subsidiaries are subject to tax holidays or preferential tax rates which reduces our overall effective tax rate when compared to the U.S. statutory tax rate. In addition, the earnings of our foreign subsidiaries are not subject to tax in the U.S. unless the earnings are repatriated.

*Net Income (Loss)*

We generated a net loss of \$0.5 million in the six months ended June 30, 2014 compared to net income of \$0.2 million in the six months ended June 30, 2013. Net income for the CS segment was \$2.3 million for the six months ended June 30, 2014, compared to \$3.3 million for the six months ended June 30, 2013, net of intersegment profits. The change was primarily attributable to increase in income tax expense partially offset by decline in selling and administrative expenses. We recorded an income tax expense of \$0.2 million for the six months ended June 30, 2014 compared to a benefit from income tax amounting to \$1.5 million. Such benefit from income taxes was attributable to the losses incurred by our U.S. entity. Net loss for the IADS segment was \$2.8 million for the six months ended June 30, 2014 compared to \$3.1 million for the six months ended June 30, 2013, net of intersegment profits.

## **Liquidity and Capital Resources**

Selected measures of liquidity and capital resources, expressed in thousands, are as follows:

|                           | June 30,<br>2014 | December<br>31, 2013 |
|---------------------------|------------------|----------------------|
| Cash and cash equivalents | \$28,103         | \$ 24,752            |
| Working Capital           | 30,099           | 28,844               |

At June 30, 2014 we had cash and cash equivalents of \$28.1 million, of which \$23.5 million was held by our foreign subsidiaries located in Asia and \$4.6 million was held in the United States. If needed amounts held by foreign subsidiaries could be repatriated to the United States to satisfy working capital needs of the U.S. entity. Under current law such amounts would be subject to United States federal income taxes. As of June 30, 2014, our intent is to permanently reinvest these funds outside the United States.

We have used, and plan to use, such cash for (i) investments in IADS, which are expected to be at the rate of \$1.3 million to \$1.5 million per quarter in the immediate future, (ii) the expansion of our other operations; (iii) general corporate purposes, including working capital; and (iv) possible business acquisitions. As of June 30, 2014, we had working capital of approximately \$30.1 million, as compared to working capital of approximately \$28.9 million as of December 31, 2013.

The Company's \$15.0 million uncommitted bank line expired in June 2014. The Company did not make any borrowings under this line.

We believe that our existing cash and cash equivalents and internally generated funds will provide sufficient sources of liquidity to satisfy our financial needs for the next 12 months. We have recently curtailed some of our ongoing investments in IADS and may curtail these investments further if internally generated funds are insufficient and outside financing is not available on terms we find attractive.

In the second quarter of 2012, we filed a shelf registration statement on Form S-3 to give us the ability to offer from time to time up to an aggregate of \$70 million of securities, which may consist of common stock, preferred stock, debt securities, warrants, or units consisting of any of the foregoing. The registration is intended to give us flexibility should financing opportunities arise.

*Net Cash Provided By Operating Activities*



Cash provided by our operating activities for the six months ended June 30, 2014 was \$4.4 million, resulting from a net loss of \$1.1 million, adjustments for non-cash items of \$2.1 million, and \$3.4 million provided by working capital changes. Adjustments for non-cash items primarily consisted of \$1.4 million for depreciation and amortization and stock option expense of \$0.5 million. Working capital activities primarily consisted of a source of cash of \$2.5 million as a result of net collections of accounts receivable and a source of cash of \$0.4 million for an increase in prepaid expenses and other current assets.

Cash provided by our operating activities for the six months ended June 30, 2013 was \$1.6 million, resulting from a net loss of \$0.4 million, adjustments for non-cash items of \$0.6 million, and \$1.4 million provided by working capital changes. Adjustment for non-cash items primarily consisted of \$1.9 million for depreciation and amortization and \$0.5 million for stock-based compensation expense but partially offset by tax benefits recognized amounting to \$2.0 million. Working capital activities primarily consisted of a source of cash of \$3.4 million as a result of net collections of accounts receivable, a use of cash of \$1.3 million for a decrease in accrued salaries, wages and related benefits and a use of cash of \$0.4 million for a decrease in income and other taxes.

Our days' sales outstanding (DSO) for the six months ended June 30, 2014 was approximately 68 days as compared to 74 days for the year ended December 31, 2013. The decrease is on account of the collection of outstanding amounts from one of our significant clients. We calculate DSO for a reported period by first dividing the total revenues for the period by the average net accounts receivable for the period (which is the sum of net accounts receivable at the beginning of the period and net accounts receivable at the end of the period, divided by two), to yield an amount we refer to as the "accounts receivable turnover." Then we divide the total number of days within the reported period by the accounts receivable turnover to yield DSO expressed in number of days.

*Net Cash Used in Investing Activities*

For the six months ended June 30, 2014 and 2013, cash used in our investing activities for capital expenditures was \$1.5 million and \$2.7 million, respectively. Capital spending in 2014 and 2013 principally consisted of the purchase of technology equipment including servers, network infrastructure and workstations. During the next twelve months, we anticipate that capital expenditures for ongoing technology, equipment, infrastructure upgrades and development of our proprietary software platform, tools and technologies will approximate \$3.0 to \$4.5 million, a portion of which we may finance. Also included in investing activities for the six months ended June 30, 2013 is the purchase of short-term investments primarily representing proceeds on maturity of \$0.3 million of certificates of deposit.

*Net Cash Provided by Financing Activities*

Cash provided by financing activities represents the net proceeds from a capital lease transaction we entered into during the first quarter of 2014 amounting to \$0.9 million. Total payments of long-term obligations approximated \$0.5 million and \$0.2 million for the six months ended June 30, 2014 and 2013, respectively. Proceeds from the exercise of stock options amounted to \$0.1 million during the six months ended June 30, 2014 and 2013.

**Contractual Obligations**

The table below summarizes our contractual obligations (in thousands) at June 30, 2014 and the effects that those obligations are expected to have on our liquidity and cash flows in future periods.

|                         | <u>Payments Due by Period</u> |                    |                    |                      |
|-------------------------|-------------------------------|--------------------|--------------------|----------------------|
| Contractual Obligations | <u>Total</u>                  | <u>1 - 3 years</u> | <u>4 - 5 years</u> | <u>After 5 years</u> |

**Less than**  
**1 year**

|                                    |         |         |         |       |         |
|------------------------------------|---------|---------|---------|-------|---------|
| Capital lease                      | \$773   | \$291   | \$482   | \$-   | \$-     |
| Vendor obligations                 | 909     | 251     | 658     | -     | -       |
| Non cancelable operating leases    | 4,453   | 798     | 1,497   | 748   | 1,410   |
| Total contractual cash obligations | \$6,135 | \$1,340 | \$2,637 | \$748 | \$1,410 |

Future expected obligations under our pension benefit plan have not been included in the contractual cash obligations in the table above.

### **Inflation, Seasonality and Prevailing Economic Conditions**

Our most significant costs are the salaries and related benefits of our employees in Asia. We are exposed to higher inflation in wage rates in the countries in which we operate. We generally perform work for our clients under project-specific contracts, requirements-based contracts or long-term contracts. We must adequately anticipate wage increases, particularly on our fixed-price contracts. There can be no assurance that we will be able to recover cost increases through increases in the prices that we charge for our services to our clients.

Our quarterly operating results are subject to certain fluctuations. We experience fluctuations in our revenue and earnings as we replace and begin new projects, which may have some normal start-up delays, or we may be unable to replace a project entirely. These and other factors may contribute to fluctuations in our operating results from quarter to quarter. In addition, as some of our Asian facilities are closed during holidays in the fourth quarter, we typically incur higher wages, due to overtime, that reduce our margins.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of our results of operations, liquidity and capital resources is based on our condensed consolidated financial statements which have been prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates and judgments, including those related to revenue recognition, allowance for doubtful accounts and billing adjustments, long-lived assets, goodwill, valuation of deferred tax assets, value of securities underlying stock-based compensation, litigation accruals, pension benefits, valuation of derivative instruments and estimated accruals for various tax exposures. We base our estimates on historical and anticipated results and trends and on various other assumptions that we believe are reasonable under the circumstances, including assumptions as to future events. These estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. By their nature, estimates are subject to an inherent degree of uncertainty. Actual results may differ from our estimates and could have a significant, adverse effect on our results of operations and financial position. For a discussion of our critical accounting policies see Part II, Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2013. There have been no material changes to our critical accounting policies during the three months ended June 30, 2014.

### **Recent Accounting Pronouncements**

In July 2013, the FASB issued guidance on presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. This update clarifies that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. In situations where a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction or the tax law of the jurisdiction does not require, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. This accounting guidance is effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2013. Retroactive application is permitted. The adoption of this guidance had no impact on our condensed consolidated financial statements.



In May 2014, the FASB issued guidance on revenue from contracts with customers. This update is a comprehensive new revenue recognition model that requires a company to recognize revenue to depict the transfer of goods or services to a customer at an amount that reflects the consideration it expects to receive in exchange for those goods or services. It also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. This accounting guidance is effective prospectively for annual reporting periods, and interim periods within that period, beginning after December 15, 2016 and early adoption is not permitted. Companies may use either a full retrospective or a modified retrospective approach to adopt the new standard when it takes effect. We have not yet determined the potential effects of the adoption of this standard on our consolidated financial statements.

In June 2014, the FASB issued guidance on accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. This new guidance requires that a performance target that affects vesting, and that could be achieved after the requisite service period, be treated as a performance condition. As such, the performance target should not be reflected in estimating the grant date fair value of the award. This update further clarifies that compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. This accounting guidance is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015, with early adoption permitted. We do not anticipate that the adoption of this standard will have a material impact on our consolidated financial statements.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

#### **Interest rate risk**

We had a \$15.0 million uncommitted bank line that expired in June 2014 and we had never made any borrowings under this line. As of June 30, 2014, we are not exposed to any market risk due to interest rate fluctuations.

#### **Foreign currency risk**

We have operations in several international markets that subject us to foreign currency fluctuations. Although the majority of our contracts are denominated in U.S. dollars, a substantial portion of the costs incurred to render services under these contracts is incurred in the local currencies of several international markets where we carry on our operations. Our significant operations are based in the Philippines, India, Sri Lanka and Israel where revenues are generated in U.S. dollars and the corresponding expenses are generated in Philippine peso, Indian rupee, Sri Lanka

rupee and Israeli shekel.

To mitigate the exposure of fluctuating future cash flows due to changes in foreign exchange rates, we have entered into foreign currency forward contracts. These foreign currency forward contracts were entered into with a maximum term of twelve months and have an aggregate notional amount of approximately \$17.5 million as of June 30, 2014. We may continue to enter into such instruments or other instruments in the future to reduce foreign currency exposure to appreciation or depreciation in the value of these foreign currencies.

The impact of foreign currency fluctuations will continue to present economic challenges to us and could negatively impact our overall results of operations. A 10% appreciation in the U.S. dollar's value relating to hedged currencies would decrease the forward contracts' fair value by approximately \$1.6 million as of June 30, 2014. Similarly, a 10% depreciation in the U.S. dollar's value relative to hedged currencies would increase the forward contracts' fair value by approximately \$1.9 million. Any increase or decrease in the fair value of our currency exchange rate sensitive forward contracts, if utilized, would be substantially offset by a corresponding decrease or increase in the fair value of the hedged underlying cash flows.

Other than the aforementioned forward contracts, we have not engaged in any hedging activities nor have we entered into off-balance-sheet transactions or arrangements.

As of June 30, 2014, our foreign locations held cash and short term investments totaling approximately \$23.5 million. These assets are exposed to foreign exchange risk arising from changes in foreign exchange rates. At present, we do not enter into any hedging instruments to mitigate foreign exchange risk on such assets; however, we may do so in the future.

#### **Item 4. Controls and Procedures**

As of the end of the period covered by this report, we performed an evaluation under the supervision, and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities and Exchange Act of 1934 (the Exchange Act)). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Quarterly Report, our disclosure controls and procedures were effective.

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



**PART II.      OTHER INFORMATION**

**Item 1. Legal Proceedings**

There were no material changes from the legal proceedings previously disclosed in Part I, Item 3. “Legal Proceedings” in our Annual Report on Form 10-K for the year ended December 31, 2013.

**Item 1A. Risk Factors**

There were no material changes from the risk factors previously disclosed in Part I, Item 1A. “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2013.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

None.

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

31.1 Certificate of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certificate of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101. INS XBRL Instance Document

101. SCH XBRL Taxonomy Extension Schema Document

101. CAL XBRL Taxonomy Extension Calculation Link base Document

101. DEF XBRL Taxonomy Extension Definition Link base Document

101. LAB XBRL Taxonomy Extension Label Link base Document

101. PRE XBRL Taxonomy Extension Presentation Link base Document

**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

INNODATA INC.

Date: August 8, 2014 /s/ Jack Abuhoff  
Jack Abuhoff  
Chairman of the Board,  
Chief Executive Officer and President

Date: August 8, 2014 /s/ O'Neil Nalavadi  
O'Neil Nalavadi  
Senior Vice President  
  
Chief Financial Officer  
  
and Principal Accounting Officer