LINCOLN NATIONAL CORP
Form 424B2
March 26, 2012
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The information in this preliminary prospectus supplement is not complete and may be changed. This preliminary prospectus supplement and the accompanying base prospectus are not an offer to sell these securities, and are not soliciting an offer to buy these securities, in any jurisdiction where the offer or sale is not permitted.

Filed Pursuant to Rule 424(b)(2)

Registration Statement No. 333-178946

SUBJECT TO COMPLETION, DATED MARCH 26, 2012

Prospectus Supplement

(To prospectus dated January 9, 2012)

$

Lincoln National Corporation

% Senior Notes due

We are offering $ aggregate principal amount of our % Senior Notes due (the notes).

Interest on the notes will accrue from , 2012. The notes will bear interest at a rate of % per year and will mature on .

We will pay interest on the notes on each and , commencing on , 2012.

The notes will be issued in denominations of $2,000 and integral multiples of $1,000 in excess thereof, will be our unsecured obligations and will rank equally in right of payment with all existing and future unsecured unsubordinated indebtedness.

We may redeem the notes in whole or in part prior to their maturity at any time at the redemption price described in Description of Notes Optional Redemption.

The notes are not savings accounts, deposits or other obligations of a bank or non-bank subsidiary of Lincoln National Corporation. They are not insured by the Federal Deposit Insurance Corporation or any other governmental agency.

The notes will not be subject to redemption at the option of the holder or to any sinking fund payments.

The notes will not be listed on any securities exchange. Currently, there is no public market for the notes.

Investing in the notes involves risks. See **Risk Factors beginning on page S-4 of this prospectus supplement.**

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying base prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Price to public(1)	Underwriting discounts and commissions	Proceeds to us, before expenses
Per Note	%	%	%
Total	$	$	$

(1) Plus accrued interest, if any, from the date of original issuance.

The underwriters expect to deliver the notes in book-entry form only, through the facilities of The Depository Trust Company, Clearstream, Luxembourg or Euroclear, as the case may be, on or about , 2012 against payment therefor in immediately available funds.

Joint Book-Running Managers

Credit Suisse **Morgan Stanley**

, 2012

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PROSPECTUS SUPPLEMENT

PROSPECTUS

No dealer, salesperson or other person is authorized to give any information or to represent anything not contained in this prospectus supplement and the accompanying base prospectus. You must not rely on any unauthorized information or representations. This prospectus supplement and the accompanying base prospectus are an offer to sell only the notes offered hereby, but only under circumstances and in jurisdictions where it is lawful to do so. The information contained in this prospectus supplement, the accompanying base prospectus and the documents incorporated by reference is accurate only as of their respective dates.

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ABOUT THIS PROSPECTUS SUPPLEMENT

You should rely only on the information contained, or incorporated by reference, in this prospectus supplement and the accompanying base prospectus. We have not, and the underwriters have not, authorized anyone to provide you with information that is different. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell the notes in any jurisdiction where the offer or sale is not permitted or in which the person making such offer or solicitation is not qualified to do so or to any person to whom it is unlawful to make such offer or solicitation. You should not assume that the information in this prospectus supplement, the accompanying base prospectus or any document incorporated by reference is accurate or complete as of any date other than the date of the applicable document. Our business, financial condition, results of operations and prospects may have changed since that date.

This document is in two parts. The first part is this prospectus supplement, which describes the specific terms of this offering and also adds to and updates information contained in the accompanying base prospectus and the documents incorporated by reference into this prospectus supplement and the accompanying base prospectus. The second part, the accompanying base prospectus, gives more general information, some of which may not apply to this offering. If the description of the offering varies between this prospectus supplement and the accompanying base prospectus, you should rely on the information contained in this prospectus supplement.

Unless otherwise indicated, or the context otherwise requires, references in this prospectus supplement and the accompanying base prospectus to LNC, we, us, and our or similar terms are to Lincoln National Corporation and not to its subsidiaries.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

Except for historical information contained or incorporated by reference in this prospectus supplement and the accompanying base prospectus, statements made, or incorporated by reference, in this prospectus supplement and the accompanying base prospectus are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (PSLRA). A forward-looking statement is a statement that is not a historical fact and, without limitation, includes any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain words like: believe, anticipate, expect, estimate, project, will, shall and other words or with similar meaning in connection with a discussion of future operating or financial performance. In particular, these include statements relating to future actions, trends in our business, prospective services or products, future performance or financial results and the outcome of contingencies, such as legal proceedings. We claim the protection afforded by the safe harbor for forward-looking statements provided by the PSLRA.

Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from the results contained in the forward-looking statements. Risks and uncertainties that may cause actual results to vary materially, some of which are described within the forward-looking statements, include, among others:

- Deterioration in general economic and business conditions that may affect account values, investment results, guaranteed benefit liabilities, premium levels, claims experience and the level of pension benefit costs, funding and investment results;

- Adverse global capital and credit market conditions could affect our ability to raise capital, if necessary, and may cause us to realize impairments on investments and certain intangible assets, including goodwill and a valuation allowance against deferred tax assets, which may reduce future earnings and/or affect our financial condition and ability to raise additional capital or refinance existing debt as it matures;

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Because of our holding company structure, the inability of our subsidiaries to pay dividends to the holding company in sufficient amounts could harm the holding company s ability to meet its obligations;

Legislative, regulatory or tax changes, both domestic and foreign, that affect the cost of, or demand for, our subsidiaries products, the required amount of reserves and/or surplus, or otherwise affect our ability to conduct business, including changes to statutory reserve requirements related to secondary guarantees under universal life such as a change to reserve calculations under Actuarial Guideline 38 (also known as The Application of the Valuation of Life Insurance Policies Model Regulation, or AG38) and variable annuity products such as Actuarial Guideline 43 (also known as Commissioners Annuity Reserve Valuation Method for Variable Annuities, or AG43); restrictions on revenue sharing and 12b-1 payments; and the potential for U.S. Federal tax reform;

Uncertainty about the effect of rules and regulations to be promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) on us and the economy and the financial services sector in particular;

The initiation of legal or regulatory proceedings against us, and the outcome of any legal or regulatory proceedings, such as: adverse actions related to present or past business practices common in businesses in which we compete; adverse decisions in significant actions including, but not limited to, actions brought by federal and state authorities and class action cases; new decisions that result in changes in law; and unexpected trial court rulings;

Changes in or sustained low interest rates causing a reduction in investment income, the interest margins of our businesses, estimated gross profits and demand for our products;

A decline in the equity markets causing a reduction in the sales of our subsidiaries products, a reduction of asset-based fees that our subsidiaries charge on various investment and insurance products, an acceleration of amortization of deferred acquisition costs (DAC), value of business acquired (VOBA), deferred sales inducements (DSI) and deferred front end sales loads (DFEL), and an increase in liabilities related to guaranteed benefit features of our subsidiaries variable annuity products;

Ineffectiveness of our risk management policies and procedures, including various hedging strategies used to offset the effect of changes in the value of liabilities due to changes in the level and volatility of the equity markets and interest rates;

A deviation in actual experience regarding future persistency, mortality, morbidity, interest rates or equity market returns from the assumptions used in pricing our subsidiaries products, in establishing related insurance reserves and in the amortization of DAC, VOBA, DSI and DFEL, which may reduce future earnings;

Changes in accounting principles generally accepted in the United States, or GAAP, including moving to International Financial Reporting Standards, that may result in unanticipated changes to our net income;

Lowering of one or more of our debt ratings issued by nationally recognized statistical rating organizations and the adverse effect such action may have on our ability to raise capital and on our liquidity and financial condition;

Lowering of one or more of the insurer financial strength ratings of our insurance subsidiaries and the adverse effect such action may have on the premium writings, policy retention, profitability of our insurance subsidiaries and liquidity;

Significant credit, accounting, fraud, corporate governance or other issues that may adversely affect the value of certain investments in our portfolios as well as counterparties to which we are exposed to credit risk requiring that we realize losses on investments;

The effect of acquisitions and divestitures, restructurings, product withdrawals and other unusual items, including our ability to integrate acquisitions and to obtain the anticipated results and synergies from acquisitions;

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- The adequacy and collectibility of reinsurance that we have purchased;

- Acts of terrorism, a pandemic, war or other man-made and natural catastrophes that may adversely affect our businesses and the cost and availability of reinsurance;

- Competitive conditions, including pricing pressures, new product offerings and the emergence of new competitors, that may affect the level of premiums and fees that our subsidiaries can charge for their products;

- The unknown effect on our subsidiaries businesses resulting from changes in the demographics of their client base, as aging baby-boomers move from the asset-accumulation stage to the asset-distribution stage of life; and

- Loss of key management, financial planners or wholesalers.

The risks included here are not exhaustive. Other sections of this prospectus supplement, including Risk Factors beginning on page S-4, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and other documents filed with the Securities and Exchange Commission (the SEC) include additional factors that could impact our business and financial performance. Moreover, we operate in a rapidly changing and competitive environment. New risk factors emerge from time to time, and it is not possible for management to predict all such risk factors.

Further, it is not possible to assess the impact of all risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results. In addition, we disclaim any obligation to update any forward-looking statements to reflect events or circumstances that occur after the date of this prospectus supplement.

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SUMMARY

This summary highlights information contained elsewhere in this prospectus supplement, the accompanying base prospectus and the documents incorporated by reference. This summary sets forth the material terms of this offering, but does not contain all of the information you should consider before investing in our notes. You should read carefully this entire prospectus supplement and the accompanying base prospectus, including the documents incorporated by reference in this prospectus supplement and the accompanying base prospectus, before making an investment decision to purchase our notes, especially the risks of investing in our notes discussed in the section entitled Risk Factors in this prospectus supplement as well as the consolidated financial statements and notes to those consolidated financial statements incorporated by reference in this prospectus supplement and the accompanying base prospectus.

LNC

For the latest financial statements of LNC, a detailed description of LNC s business, management s discussion and analysis of LNC s financial condition and results of operations, and other important information concerning LNC, please refer to our Annual Report on Form 10-K for the year ended December 31, 2011 and other documents filed with the SEC, which are incorporated by reference into this prospectus supplement and the accompanying base prospectus. For more information, see Documents Incorporated by Reference in the accompanying base prospectus.

LNC is a holding company, which operates multiple insurance and retirement businesses through subsidiary companies. Through our business segments, we sell a wide range of wealth protection, accumulation and retirement income products and solutions. These products include fixed and indexed annuities, variable annuities, universal life insurance (UL), variable universal life insurance (VUL), linked-benefit UL, term life insurance, mutual funds and group life, disability and dental. LNC was organized under the laws of the state of Indiana in 1968. We currently maintain our principal executive offices at 150 N. Radnor Chester Road, Radnor, Pennsylvania 19087, and our telephone number is (484) 583-1400. Lincoln Financial Group is the marketing name for LNC and its subsidiary companies. As of December 31, 2011, LNC had consolidated assets of $202.9 billion and consolidated stockholders equity of $14.2 billion. For the year ended December 31, 2011, LNC had total revenue of $10.6 billion and net income of $294 million.

We provide products and services and report results through the following four business segments: Annuities, Retirement Plan Services, Life Insurance and Group Protection.

We also have Other Operations, which includes the financial data for operations that are not directly related to the business segments. Other Operations also includes investments related to the excess capital in our insurance subsidiaries; investments in media properties and other corporate investments; benefit plan net liability; the unamortized deferred gain on indemnity reinsurance related to the sale of reinsurance to Swiss Re Life & Health America Inc., referred to as Swiss Re, in 2001; the results of certain disability income business; our run-off institutional pension business; and debt costs.

Our former subsidiaries, Delaware Management Holdings, Inc. and Lincoln UK are reported in discontinued operations for all periods presented. See Part II Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Introduction Acquisitions and Dispositions and Part II Item 8. Financial Statements and Supplementary Data Note 3 in our Annual Report on Form 10-K for the year ended December 31, 2011.

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SUMMARY OF THE OFFERING

Issuer	Lincoln National Corporation.
Securities Offered	$ aggregate principal amount of % Senior Notes due (the notes).
Denominations	The notes will be issued in denominations of $2,000 principal amount and integral multiples of $1,000 in excess thereof.
Maturity Date	The notes will mature on .
Interest	Interest on the notes will accrue from the issue date until maturity at % per year.
	We will pay interest on the notes on each and , commencing on , 2012. Interest will be calculated using a 360-day year comprised of twelve 30-day months.
Further Issuances	The notes will initially be limited to $ in aggregate principal amount. We may, however, without the consent of any then-existing holders of the notes, reopen the notes and issue an unlimited principal amount of additional notes in the future. These additional notes will be deemed part of the same series as the notes offered hereby.
Use of Proceeds	We estimate that, after deducting underwriting discounts and commissions and estimated expenses payable by us, our net proceeds from this offering will be approximately $ million. We intend to use the net proceeds from this offering to repay all or a portion of the $300 million aggregate principal amount of our 5.65% senior notes maturing on August 27, 2012, with the remaining proceeds from this offering, if any, to be used for general corporate purposes.
Risk Factors	See Risk Factors beginning on page S-4 of this prospectus supplement and other information included or incorporated by reference in this prospectus supplement and the accompanying base prospectus for a discussion of factors you should consider carefully before investing in the notes.
Indenture	We will issue the notes under an indenture between us and The Bank of New York Mellon, as indenture trustee.
Ranking	The notes will be our senior unsecured debt obligations and will rank equally among themselves and with all of our other present and future unsecured unsubordinated indebtedness.

As of December 31, 2011, our consolidated indebtedness aggregated approximately $5.7 billion. See Capitalization for the pro forma effect of this offering on our capitalization.

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	The indenture places no limitation on the amount of additional senior indebtedness that may be incurred by us, which will rank equally to the notes. We expect from time to time to incur additional indebtedness constituting senior indebtedness. In addition, the indenture does not limit our ability to grant security interests over our assets.
Optional Redemption	We may redeem the notes in whole or in part prior to maturity at any time at the redemption price described in Description of Notes Optional Redemption.
Form	The notes will be represented by one or more global securities registered in the name of Cede & Co., as nominee for The Depository Trust Company, referred to as DTC. Beneficial interests in the notes will be evidenced by, and transfers thereof will be effected only through, records maintained by participants in DTC.
Trustee and Principal Paying Agent	The Bank of New York Mellon.
Delivery and Clearance	We will deposit the global security representing the notes with DTC in New York. You may hold an interest in the notes through DTC, Clearstream, Luxembourg or Euroclear Bank, as operator of the Euroclear System, directly as a participant of any such system or indirectly through organizations that are participants in such systems.
Governing Law	New York.

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RISK FACTORS

Your investment in the notes involves risks. You should carefully consider the risks described below as well as other information contained or incorporated by reference in this prospectus supplement and the accompanying base prospectus, including our financial statements and the notes thereto, before making an investment decision. The risks and uncertainties described below and incorporated by reference into this prospectus supplement and the accompanying base prospectus are not the only ones facing our company. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations. If any of these risks actually occur, our business, financial condition and results of operations could be materially affected. In that case, the value of the notes could decline substantially.

Risk Factors Relating to the Ownership of the Notes

We operate through our subsidiaries and, as a result, the notes will effectively be subordinated to the liabilities of our subsidiaries.

We are a holding company operating primarily through our insurance subsidiaries, and our primary assets are our equity interests in those subsidiaries. As a result, our right to receive assets upon the liquidation or recapitalization of any of our subsidiaries and your consequent right to participate in those assets, is subject to the claims of such subsidiary s creditors. Accordingly, our obligations, including the notes, are effectively subordinated to all existing and future indebtedness and other liabilities, including insurance policy-related liabilities, of our subsidiaries, other than any such obligations guaranteed on a senior basis by our subsidiaries. As of December 31, 2011, our subsidiaries had approximately $89 billion of outstanding liabilities that effectively rank and would effectively rank senior to our current and future senior debt securities. Our subsidiaries may incur further indebtedness in the future. The notes are exclusively obligations of LNC. Our subsidiaries are not guarantors of the notes and have no obligation to pay any amounts due on the notes. Our subsidiaries are not required to provide us with funds for our payment obligations, whether by dividends, distributions, loans or other payments. In addition, any payment of dividends, distributions, loans or advances by our subsidiaries to us could be subject to statutory or contractual restrictions. Payments to us by our subsidiaries will also be contingent upon our subsidiaries earnings and business considerations. The notes are unsecured.

We and our subsidiaries may incur additional indebtedness that may adversely affect our ability to meet our financial obligations under the notes.

The terms of the indenture and the notes do not limit the incurrence by us or our subsidiaries of indebtedness. We and our subsidiaries may incur additional indebtedness in the future, which could have important consequences to holders of the notes. For example, we may have insufficient cash to meet our financial obligations, including our obligations under the notes. Furthermore, our ability to obtain additional financing for the repayment of the notes, working capital, capital expenditures or general corporate purposes could be impaired. Additional debt could make us more vulnerable to changes in general economic conditions and also could affect the financial strength ratings of our insurance subsidiaries and the ratings of our notes.

We may be unable to repay the notes if our subsidiaries are unable to pay dividends or make advances to us.

At maturity, the entire outstanding principal amount of the notes will become due and payable by us. We may not have sufficient funds to pay the principal amount due. If we do not have sufficient funds on hand or available through existing borrowing facilities or through the declaration and payment of dividends by our subsidiaries, we will need to seek additional financing. Additional financing may not be available to us in the amounts necessary. We, as a holding company, are dependent upon dividends from our subsidiaries to enable us to service our outstanding debt, including the notes. For more information, see Liquidity and Capital Position Because we are a holding company with no direct operations, the inability of our subsidiaries to pay dividends to us in sufficient amounts would harm our ability to meet our obligations below.

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An active trading market for the notes may not develop.

The notes are a new issue of securities for which there is currently no public market. Any trading of the notes may be at a discount from their initial offering price, depending on prevailing interest rates, the market for similar securities, our performance and other factors. In addition, we do not know whether an active trading market will develop for the notes. To the extent that an active trading market does not develop, the liquidity and trading prices for the notes may be harmed.

We do not intend to apply for the notes to be listed on any securities exchange or to arrange for the notes to be quoted on any quotation system. The underwriters have advised us that they currently intend to make a market in the notes. However, they are not obligated to do so, and may discontinue any market making with respect to the notes at any time, for any reason or for no reason, without notice. If the underwriters cease to act as a market maker for the notes, we cannot assure you another firm or person will make a market in the notes.

The liquidity of any market for the notes will depend upon the number of holders of the notes, our results of operations and financial condition, the market for similar securities, the interest of securities dealers in making a market in the notes and other factors. An active or liquid trading market for the notes may not develop. We cannot assure you that you will be able to sell your notes at favorable prices or at all.

A downgrade, suspension or withdrawal of the rating assigned by a rating agency to the notes, if any, could cause the liquidity or market value of the notes to decline significantly.

Our credit ratings are an assessment by rating agencies of our ability to pay our debts when due. Consequently, real or anticipated changes in our credit ratings will generally affect the market value of the notes. These credit ratings may not reflect the potential impact of risks relating to the structure or marketing of the notes. Credit ratings are not a recommendation to buy, sell or hold any security, and may be revised or withdrawn at any time by the issuing organization in its sole discretion. Neither we nor any underwriter undertakes any obligation to maintain the ratings or to advise holders of notes of any changes in ratings. Each agency s rating should be evaluated independently of any other agency s rating.

In addition, credit rating agencies continually review their ratings for the companies that they follow, including us. The credit rating agencies also evaluate the insurance industry as a whole and may change their credit rating for us based on their overall view of our industry. A negative change in our rating could have an adverse effect on the price of the notes.

The notes will be rated by Standard & Poor s Ratings Services (S&P), Moody s Investors Service, Inc. (Moody s) and/or Fitch Ratings (Fitch). There can be no assurance that these ratings will remain for any given period of time or that these ratings will not be lowered or withdrawn entirely by a rating agency if in that rating agency s judgment future circumstances relating to the basis of the rating, such as adverse changes in our company, so warrant. For more information, see Liquidity and Capital Position A decrease in the capital and surplus of our insurance subsidiaries may result in a downgrade to our credit and insurer financial strength ratings below.

We have made only limited covenants in the indenture, which may not protect your investment if we experience significant adverse changes in our financial condition or results of operations.

The indenture governing the notes does not:

- require us to maintain any financial ratios or specified levels of net worth, revenues, income, cash flow or liquidity, and therefore, does not protect holders of the notes in the event that we experience significant adverse changes in our financial condition, results of operations or liquidity;

- limit our ability or the ability of any of our subsidiaries to incur additional indebtedness, including indebtedness that is equal in right of payment to the notes or, subject to certain exceptions, indebtedness that is secured by liens on capital stock of our subsidiaries; or

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limit the aggregate principal amount of senior debt securities that may be issued.

Our ability to incur additional debt and take a number of other actions that are not limited by the terms of the notes could negatively affect the value of the notes.

Legislative, Regulatory and Tax

Our businesses are heavily regulated and changes in regulation may affect our insurance subsidiary capital requirements or reduce our profitability.

Our insurance subsidiaries are subject to extensive supervision and regulation in the states in which we do business. The supervision and regulation relate to numerous aspects of our business and financial condition. The primary purpose of the supervision and regulation is the protection of our insurance contract holders, and not our investors. The extent of regulation varies, but generally is governed by state statutes. These statutes delegate regulatory, supervisory and administrative authority to state insurance departments. This system of supervision and regulation covers, among other things:

- Standards of minimum capital requirements and solvency, including RBC measurements;
- Restrictions of certain transactions between our insurance subsidiaries and their affiliates;
- Restrictions on the nature, quality and concentration of investments;
- Restrictions on the types of terms and conditions that we can include in the insurance policies offered by our primary insurance operations;
- Limitations on the amount of dividends that insurance subsidiaries can pay;
- Licensing status of the company;
- Certain required methods of accounting;
- Reserves for unearned premiums, losses and other purposes; and
- Assignment of residual market business and potential assessments for the provision of funds necessary for the settlement of covered claims under certain policies provided by impaired, insolvent or failed insurance companies.

Although we endeavor to maintain all required licenses and approvals our businesses may not fully comply with the wide variety of applicable laws and regulations or the relevant authority s interpretation of the laws and regulations, which may change from time to time. Also, regulatory authorities have relatively broad discretion to grant, renew or revoke licenses and approvals. If we do not have the requisite licenses and approvals or do not comply with applicable regulatory requirements, the insurance regulatory authorities could preclude or temporarily suspend us from carrying on some or all of our activities or impose substantial fines. Further, insurance regulatory authorities have relatively broad discretion to issue orders of supervision, which permit such authorities to supervise the business and operations of an insurance company. As of December 31, 2011, no state insurance regulatory authority had imposed on us any substantial fines or revoked or suspended any of our licenses to conduct insurance business in any state or issued an order of supervision with respect to our insurance subsidiaries, which would have a material adverse effect on our results of operations or financial condition.

In addition, Lincoln Financial Advisors, Lincoln Financial Securities and Lincoln Financial Distributors, as well as our variable annuities and variable life insurance products, are subject to regulation and supervision by the SEC and the Financial Institutions Industry Regulatory Authority (FINRA). These laws and regulations generally grant supervisory agencies and self-regulatory organizations broad administrative powers, including the power to limit or restrict the subsidiaries from carrying on their businesses in the event that they fail to comply with such laws and regulations.

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Recently, there has been an increase in potential federal initiatives that would affect the financial services industry. On July 21, 2010, President Obama signed into law the Dodd-Frank Act, a wide-ranging Act that includes a number of reforms of the financial services industry and financial products. The Dodd-Frank Act includes, among other things, changes to the rules governing derivatives; restrictions on proprietary trading by certain entities; the imposition of capital and leverage requirements on bank and savings and loan holding companies; a study by the SEC of the rules governing broker-dealers and investment advisers with respect to individual investors and investment advice, followed potentially by rulemaking; the creation of a new Federal Insurance Office within the U.S. Treasury to gather information regarding the insurance industry; the creation of a resolution authority to unwind failing institutions, funded on a post-event basis; the creation of a new Consumer Financial Protection Bureau to protect consumers of certain financial products; and changes to executive compensation and certain corporate governance rules, among other things. The Dodd-Frank Act requires significant rulemaking across numerous agencies within the federal government. Although the rulemaking process began in the second half of 2010, it is proceeding substantially slower than the aggressive schedule contemplated at the time of enactment. Consequently, the ultimate impact of these provisions on our businesses (including product offerings), results of operations, liquidity or capital resources is currently indeterminable.

Many of the foregoing regulatory or governmental bodies have the authority to review our products and business practices and those of our agents and employees. In recent years, there has been increased scrutiny of our businesses by these bodies, which has included more extensive examinations, regular sweep inquiries and more detailed review of disclosure documents. These regulatory or governmental bodies may bring regulatory or other legal actions against us if, in their view, our practices, or those of our agents or employees, are improper. These actions can result in substantial fines, penalties or prohibitions or restrictions on our business activities and could have a material adverse effect on our business, results of operations or financial condition.

Changes to the calculation of reserves and attempts to mitigate the impact of Regulation XXX and Actuarial Guideline 38 may fail in whole or in part resulting in an adverse effect on our financial condition and results of operations.

The Valuation of Life Insurance Policies Model Regulation (XXX) requires insurers to establish additional statutory reserves for term life insurance policies with long-term premium guarantees and UL policies with secondary guarantees. In addition, Actuarial Guideline 38 (AG38), commonly known as AXXX, clarifies the application of XXX with respect to certain UL insurance policies with secondary guarantees. Virtually all of our newly issued term and the majority of our newly issued UL insurance products are now affected by XXX and AG38. The application of both AG38 and XXX involve numerous interpretations. In the fourth quarter of 2011, the Life Actuarial Task Force, an advisory group to the Life Insurance and Annuities (A) Committee of the NAIC, submitted a draft statement on the application of AG38 (the Statement) to the Committee. The NAIC s Executive Committee set up a joint working group (the Joint Working Group) comprised of members of the Life Insurance and Annuities (A) Committee and the Financial Condition (E) Committee to review the Statement and the current application of AG38 to determine whether new interim guidelines should be developed for the products within the scope of AG38. The Joint Working Group has developed a draft framework that proposes to evaluate in-force reserves based on an asset adequacy analysis incorporating moderately adverse scenarios. New business written after a certain date, yet to be specified, would be reserved using a formulaic approach consistent with the Statement, as modified or clarified by the NAIC. Any interim guidelines would be in place only until principles-based reserving is implemented. Because the draft framework contains many open issues, we cannot predict its impact on our statutory reserves. However, a change to the method for calculating reserves may require us to significantly increase our statutory reserves for UL policies with secondary guarantees. Further, changes in the method of calculating reserves may also impact the future profitability and sales of our UL insurance policies with secondary guarantees.

We have implemented reinsurance and capital management actions to mitigate the capital impact of XXX and AG38, including the use of letters of credit to support the reinsurance provided by captive reinsurance subsidiaries. Although formal details have not been provided, we anticipate the rating agencies may require a portion of these letters of credit to be included in our leverage calculations, which would pressure our leverage ratios and potentially our ratings. Therefore, we cannot provide assurance that there will not be regulatory, rating agency or other challenges to the actions we have taken to date. The result of those potential challenges could require us to increase statutory reserves or incur higher operating and/or tax costs.

We also cannot provide assurance that we will be able to continue to implement actions to mitigate the impact of XXX or AG38 on future sales of term and UL insurance products. If we are unable to continue to implement those actions, we may have lower returns on such products sold than we currently anticipate and/or reduce our sales of these products.

Changes in U.S. federal income tax law could increase our tax costs and make the products that we sell less desirable.

Changes to the Internal Revenue Code, administrative rulings or court decisions could increase our effective tax rate, make our products less desirable and lower our net income. For example, on February 13, 2012, the Obama Administration released its fiscal year 2013 budget proposal including proposals which, if enacted, would affect the taxation of life insurance companies and certain life insurance products. If enacted into law, the statutory changes contemplated by the Administration s revenue proposals would, among other things, change the method used to determine the amount of dividend income received by a life insurance company on assets held in separate accounts used to support products, including variable life insurance and variable annuity contracts, that are eligible for the dividend received deduction. The dividend received deduction reduces the amount of dividend income subject to tax and is a significant component of the difference between our actual tax expense and expected amount determined using the federal statutory tax rate of 35%. Our income tax provision for the year ended December 31, 2011 included a separate account dividend received deduction benefit of $112 million. In addition, the proposals would affect the treatment of COLI policies by limiting the availability of certain interest deductions for companies that purchase those policies. If proposals of this type were enacted, our sale of COLI, variable annuities and variable life products could be adversely affected and our actual tax expense could increase, reducing earnings.

Legal and regulatory actions are inherent in our businesses and could result in financial losses or harm our businesses.

We are, and in the future may be, subject to legal and regulatory actions in the ordinary course of our insurance and retirement operations. Pending legal actions include proceedings relating to aspects of our businesses and operations that are specific to us and proceedings that are typical of the businesses in which we operate. Some of these proceedings have been brought on behalf of various alleged classes of complainants. In certain of these matters, the plaintiffs are seeking large and/or indeterminate amounts, including punitive or exemplary damages. Substantial legal liability in these or future legal or regulatory actions could have a material financial effect or cause significant harm to our reputation, which in turn could materially harm our business prospects. See Note 13 of our Annual Report on Form 10-K for the year ended December 31, 2011 for a description of legal and regulatory proceedings and actions. These actions include ongoing audits on behalf of multiple states treasury and controllers offices for compliance with laws and regulations concerning the identification, reporting and escheatment of unclaimed contract benefits or abandoned funds.

Changes in accounting standards issued by the Financial Accounting Standards Board or other standard-setting bodies may adversely affect our financial statements.

Our financial statements are prepared in accordance with GAAP as identified in the Financial Accounting Standards Board (FASB) Accounting Standards Codifications™ (ASC). From time to time, we are required to adopt new or revised accounting standards or guidance that are incorporated into the FASB ASC. It is possible

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that future accounting standards we are required to adopt could change the current accounting treatment that we apply to our consolidated financial statements and that such changes could have a material adverse effect on our financial condition and results of operations.

For example, the FASB issued Accounting Standards Update (ASU) No. 2010-26, Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (ASU 2010-26), which clarifies the types of costs that insurance companies may capitalize and amortize over the life of the business. ASU 2010-26 significantly reduces the amount of acquisition cost that we will be able to defer in connection with sales of our insurance products. Although this will not affect the ultimate profitability of our products, we expect it could materially alter the pattern of our earnings. For further information, see Part II Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies DAC, VOBA, DSI and DFEL New DAC Methodology in our Annual Report on Form 10-K for the year ended December 31, 2011.

In addition, the FASB is working on several projects with the International Accounting Standards Board, which could result in significant changes as GAAP and International Financial Reporting Standards (IFRS) attempt to converge, including how we account for our insurance contracts and financial instruments and how our financial statements are presented. Furthermore, the SEC is considering whether and how to incorporate IFRS into the U.S. financial reporting system. The accounting changes being proposed by the FASB may result in a complete change to how we account for and report significant areas of our business, such as insurance contracts and deferred acquisition costs (DAC). The effective dates and transition methods are not known; however, issuers may be required to or may choose to adopt the new standards retrospectively. In this case, the issuer will report results under the new accounting method as of the effective date, as well as for all periods presented. The changes to GAAP and potential incorporation of IFRS into the U.S. financial reporting system will impose special demands on issuers in the areas of governance, employee training, internal controls, contract fulfillment and disclosure and will likely affect how we manage our business, as it will likely affect other business processes such as design of compensation plans, product design, etc.

Anti-takeover provisions could delay, deter or prevent our change in control, even if the change in control would be beneficial to LNC shareholders.

We are an Indiana corporation subject to Indiana state law. Certain provisions of Indiana law could interfere with or restrict takeover bids or other change in control events affecting us. Also, provisions in our articles of incorporation, bylaws and other agreements to which we are a party could delay, deter or prevent our change in control, even if a change in control would be beneficial to shareholders. In addition, under Indiana law, directors may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers and customers of the corporation and the communities in which offices and other facilities are located, and other factors the directors consider pertinent. One statutory provision prohibits, except under specified circumstances, LNC from engaging in any business combination with any shareholder who owns 10% or more of our common stock (which shareholder, under the statute, would be considered an interested shareholder) for a period of five years following the time that such shareholder became an interested shareholder, unless such business combination is approved by the board of directors prior to such person becoming an interested shareholder. In addition, our articles of incorporation contain a provision requiring holders of at least three-fourths of our voting shares then outstanding and entitled to vote at an election of directors, voting together, to approve a transaction with an interested shareholder rather than the simple majority required under Indiana law.

In addition to the anti-takeover provisions of Indiana law, there are other factors that may delay, deter or prevent our change in control. As an insurance holding company, we are regulated as an insurance holding company and are subject to the insurance holding company acts of the states in which our insurance company subsidiaries are domiciled. The insurance holding company acts and regulations restrict the ability of any person to obtain control of an insurance company without prior regulatory approval. Under those statutes and regulations, without such approval (or an exemption), no person may acquire any voting security of a domestic insurance company, or an insurance holding company which controls an insurance company, or merge with such a holding company, if as a result of such transaction such person would control the insurance holding company or insurance company. Control is generally defined as the direct or indirect power to direct or cause the direction of the management and policies of a person and is presumed to exist if a person directly or indirectly owns or controls 10% or more of the voting securities of another person.

Market Conditions

Difficult conditions in the global capital markets and the economy generally may materially adversely affect our business and results of operations.

Our results of operations are materially affected by conditions in the global capital markets and the economy generally, both in the U.S. and elsewhere around the world. Concerns over the viability of the European Union and its ability to resolve the European debt crisis, the ability of the U.S. government to reign in the U.S. deficit, continued high unemployment and a stagnant real estate market in the U.S. have contributed to increased volatility and diminished expectations for the economy and the markets going forward. These events may have an adverse effect on us given our credit and equity market exposure. Our revenues are likely to decline in such circumstances and our profit margins could erode. In addition, in the event of extreme prolonged market events, such as the global credit crisis and recession that occurred during 2008 and 2009, we could incur significant losses. Even in the absence of a market downturn, we are exposed to substantial risk of loss due to market volatility.

Factors such as consumer spending, business investment, domestic and foreign government spending, the volatility and strength of the capital markets, the potential for inflation or deflation and uncertainty over domestic and foreign government actions all affect the business and economic environment and, ultimately, the amount and profitability of our business. In an economic downturn characterized by higher unemployment, lower family income, lower corporate earnings, lower business investment and lower consumer spending, the demand for our financial and insurance products could be adversely affected. In addition, we may experience an elevated incidence of claims and lapses or surrenders of policies. Our contract holders may choose to defer paying insurance premiums or stop paying insurance premiums altogether. Adverse changes in the economy could affect earnings negatively and could have a material adverse effect on our business, results of operations and financial condition.

Changes in interest rates and sustained low interest rates may cause interest rate spreads to decrease and changes in interest rates may also result in increased contract withdrawals.

Interest rate fluctuations and/or a sustained period of low interest rates could negatively affect our profitability. Some of our products, principally fixed annuities, interest-sensitive whole life, UL and the fixed portion of VUL, have interest rate guarantees that expose us to the risk that changes in interest rates will reduce our spread, or the difference between the amounts that we are required to pay under the contracts and the amounts we are able to earn on our general account investments intended to support our obligations under the contracts. Spreads are an important component of our net income. Declines in our spread or instances where the returns on our general account investments are not enough to support the interest rate guarantees on these products could have a material adverse effect on our businesses or results of operations.

In periods when interest rates are declining or remain at low levels, we may have to reinvest the cash we receive as interest or return of principal on our investments in lower yielding instruments reducing our spread. Moreover, borrowers may prepay fixed-income securities, commercial mortgages and mortgage-backed securities in our general account in order to borrow at lower market rates, which exacerbates this risk. Lowering interest crediting rates helps to mitigate the effect of spread compression on some of our products. However, because we are entitled to reset the interest rates on our fixed rate annuities only at limited, pre-established intervals, and since many of our contracts have guaranteed minimum interest or crediting rates, our spreads could

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still decrease. As of December 31, 2011, 85% of our annuities business, 93% of our retirement plan services business and 92% of our life insurance business with guaranteed minimum interest or crediting rates are at their guaranteed minimums.

Our expectation for future spreads is an important component in the amortization of DAC and value of business acquired (VOBA) as it affects the future profitability of the business. Currently, new money rates continue to be at historically low levels. The Federal Reserve Board recently announced that it will keep rates low until at least late 2014. If interest rates were to remain low over a sustained period of time, this will put additional pressure on our spreads, potentially resulting in unlocking of our DAC and VOBA assets, thereby reducing net income in the affected reporting period. We would expect the effect to be most pronounced in our Life Insurance segment. For additional information on interest rate risks, see Part II Item 7A. Quantitative and Qualitative Disclosures About Market Risk Interest Rate Risk in our Annual Report on Form 10-K for the year ended December 31, 2011.

A decline in market interest rates could also reduce our return on investments that do not support particular policy obligations. During periods of sustained lower interest rates, our recorded policy liabilities may not be sufficient to meet future policy obligations and may need to be strengthened, thereby reducing net income in the affected reporting period. Accordingly, declining interest rates may materially affect our results of operations, financial position and cash flows and significantly reduce our profitability.

Increases in market interest rates may also negatively affect our profitability. In periods of rapidly increasing interest rates, we may not be able to replace the assets in our general account with higher yielding assets needed to fund the higher crediting rates necessary to keep our interest-sensitive products competitive. We therefore may have to accept a lower spread and thus lower profitability or face a decline in sales and greater loss of existing contracts and related assets. Increases in interest rates may cause increased surrenders and withdrawals of insurance products. In periods of increasing interest rates, policy loans and surrenders and withdrawals of life insurance policies and annuity contracts may increase as contract holders seek to buy products with perceived higher returns. This process may lead to a flow of cash out of our businesses. These outflows may require investment assets to be sold at a time when the prices of those assets are lower because of the increase in market interest rates, which may result in realized investment losses. A sudden demand among consumers to change product types or withdraw funds could lead us to sell assets at a loss to meet the demand for funds. Furthermore, unanticipated increases in withdrawals and termination may cause us to unlock our DAC and VOBA assets, which would reduce net income. An increase in market interest rates could also have a material adverse effect on the value of our investment portfolio, for example, by decreasing the estimated fair values of the fixed income securities that comprise a substantial portion of our investment portfolio. An increase in interest rates could also result in decreased fee income associated with a decline in the value of variable annuity account balances invested in fixed income funds.

Because the equity markets and other factors impact the profitability and expected profitability of many of our products, changes in equity markets and other factors may significantly affect our business and profitability.

The fee revenue that we earn on equity-based variable annuities and VUL insurance policies is based primarily upon account values. Because strong equity markets result in higher account values, strong equity markets positively affect our net income through increased fee revenue. Conversely, a weakening of the equity markets results in lower fee income and may have a material adverse effect on our results of operations and capital resources.

The increased fee revenue resulting from strong equity markets increases the expected gross profits (EGPs) from variable insurance products as do better than expected lapses, mortality rates and expenses. As a result, higher EGPs may result in lower net amortized costs related to DAC, deferred sales inducements (DSI), VOBA, deferred front-end loads (DFEL) and changes in future contract benefits. However, a decrease in the equity markets, as well as worse than expected increases in lapses, mortality rates and expenses, depending upon

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their significance, may result in higher net amortized costs associated with DAC, DSI, VOBA, DFEL and changes in future contract benefits and may have a material adverse effect on our results of operations and capital resources. If we were to have unlocked our reversion to the mean (RTM) assumption in the corridor as of December 31, 2011, we would have recorded a favorable prospective unlocking of approximately $175 million, pre-tax, for our Annuities segment, approximately $20 million, pre-tax, for our Retirement Plan Services segment and approximately $15 million, pre-tax, for our Life Insurance segment. For further information about our RTM process, see Critical Accounting Policies and Estimates DAC, VOBA, DSI and DFEL Reversion to the Mean in the Management s Discussion and Analysis (MD&A) in our Annual Report on Form 10-K for the year ended December 31, 2011.

Changes in the equity markets, interest rates and/or volatility affect the profitability of our products with guaranteed benefits; therefore, such changes may have a material adverse effect on our business and profitability.

Certain of our variable annuity products include guaranteed benefit riders. These include guaranteed death benefit (GDB), guaranteed withdrawal benefit (GWB) and guaranteed income benefit (GIB) riders. Our GWB, GIB and 4LATER® (a form of GIB rider) features have elements of both insurance benefits accounted for under the Financial Services Insurance Claim Costs and Liabilities for Future Policy Benefits Subtopic of the FASB ASC (benefit reserves) and embedded derivatives accounted for under the Derivatives and Hedging and the Fair Value Measurements and Disclosures Topics of the FASB ASC (embedded derivative reserves). We calculate the value of the embedded derivative reserve and the benefit reserves based on the specific characteristics of each guaranteed living benefit feature. The amount of reserves related to GDB for variable annuities is tied to the difference between the value of the underlying accounts and the GDB, calculated using a benefit ratio approach. The GDB reserves take into account the present value of total expected GDB payments, the present value of total expected GDB assessments over the life of the contract, claims paid to date and assessments to date. Reserves for our GIB and certain GWB with lifetime benefits are based on a combination of fair value of the underlying benefit and a benefit ratio approach that is based on the projected future payments in excess of projected future account values. The benefit ratio approach takes into account the present value of total expected GIB payments, the present value of total expected GIB assessments over the life of the contract, claims paid to date and assessments to date. The amount of reserves related to those GWB that do not have lifetime benefits is based on the fair value of the underlying benefit.

Both the level of expected payments and expected total assessments used in calculating the reserves not carried at fair value are affected by the equity markets. The liabilities related to fair value are impacted by changes in equity markets, interest rates and volatility. Accordingly, strong equity markets, increases in interest rates and decreases in volatility will generally decrease the reserves calculated using fair value. Conversely, a decrease in the equity markets along with a decrease in interest rates and an increase in volatility will generally result in an increase in the reserves calculated using fair value.

Increases in reserves would result in a charge to our earnings in the quarter in which the increase occurs. Therefore, we maintain a customized dynamic hedge program that is designed to mitigate the risks associated with income volatility around the change in reserves on guaranteed benefits. However, the hedge positions may not be effective to exactly offset the changes in the carrying value of the guarantees due to, among other things, the time lag between changes in their values and corresponding changes in the hedge positions, high levels of volatility in the equity markets and derivatives markets, extreme swings in interest rates, contract holder behavior different than expected, a strategic decision to under- or over-hedge in reaction to extreme market conditions or inconsistencies between economic and statutory reserving guidelines and divergence between the performance of the underlying funds and hedging indices. For example, for the years ended December 31, 2011, 2010 and 2009, we experienced a breakage on our variable annuity net derivatives results of $(106) million, $(27) million and $103 million, respectively, pre-tax and before the associated amortization of DAC, VOBA, DSI and DFEL and changes in other contract holder funds and funds withheld reinsurance liabilities. Breakage is defined as the difference between the change in the value of the liabilities, excluding the amount related to the non-performance risk component, and the change in the fair value of the derivatives. Breakage can be positive or negative. The non-performance risk factor is required under the Fair Value Measurements and Disclosures Topic of the FASB ASC, which requires us to consider our own credit standing, which is not hedged, in the valuation of certain of these liabilities. A decrease in our own credit spread could cause the value of these liabilities to increase, resulting in a reduction to net income. Conversely, an increase in our own credit spread could cause the value of these liabilities to decrease, resulting in an increase to net income.

In addition, we remain liable for the guaranteed benefits in the event that derivative counterparties are unable or unwilling to pay, and we are also subject to the risk that the cost of hedging these guaranteed benefits increases, resulting in a reduction to net income. These, individually or collectively, may have a material adverse effect on net income, financial condition or liquidity.

Liquidity and Capital Position

Adverse capital and credit market conditions may affect our ability to meet liquidity needs, access to capital and cost of capital.

We need liquidity to pay our operating expenses, interest on our debt and dividends on our capital stock, to maintain our securities lending activities and to replace certain maturing liabilities. Without sufficient liquidity, we will be forced to curtail our operations, and our business will suffer. When considering our liquidity and capital position, it is important to distinguish between the needs of our insurance subsidiaries and the needs of the holding company.

For our insurance and other subsidiaries, the principal sources of liquidity are insurance premiums and fees, annuity considerations and cash flow from our investment portfolio and assets, consisting mainly of cash or assets that are readily convertible into cash.

In the event that current resources do not satisfy our needs, we may have to seek additional financing. The availability of additional financing will depend on a variety of factors such as market conditions, the general availability of credit, the volume of trading activities, the overall availability of credit to the financial services industry, our credit ratings and credit capacity, as well as the possibility that customers or lenders could develop a negative perception of our long- or short-term financial prospects if we incur large investment losses or if the level of our business activity decreases due to a market downturn. Similarly, our access to funds may be impaired if regulatory authorities or rating agencies take negative actions against us. See Item 7. MD&A Review of Consolidated Financial Condition Liquidity and Capital Resources Sources of Liquidity and Cash Flows in our Annual Report on Form 10-K for the year ended December 31, 2011 for a description of our credit ratings. Our internal sources of liquidity may prove to be insufficient, and in such case, we may not be able to successfully obtain additional financing on favorable terms, or at all.

Disruptions, uncertainty or volatility in the capital and credit markets may also limit our access to capital required to operate our business, most significantly our insurance operations. Such market conditions may limit our ability to replace, in a timely manner, maturing liabilities; satisfy statutory capital requirements; generate fee income and market-related revenue to meet liquidity needs; and access the capital necessary to grow our business. As such, we may be forced to delay raising capital, issue shorter term securities than we prefer or bear an unattractive cost of capital which could decrease our profitability and significantly reduce our financial flexibility. Our results of operations, financial condition, cash flows and statutory capital position could be materially adversely affected by disruptions in the financial markets.

Because we are a holding company with no direct operations, the inability of our subsidiaries to pay dividends to us in sufficient amounts would harm our ability to meet our obligations.

We are a holding company and we have no direct operations. Our principal asset is the capital stock of our insurance subsidiaries. Our ability to meet our obligations for payment of interest and principal on outstanding debt obligations and to pay dividends to shareholders, repurchase our securities and pay corporate expenses depends primarily on the ability of our subsidiaries to pay dividends or to advance or repay funds to us. Under Indiana laws and regulations, our Indiana insurance subsidiaries, including Lincoln National Life Insurance Company (LNL), our primary insurance subsidiary, may pay dividends to us without prior approval of the Indiana Insurance Commissioner (the Commissioner) up to a certain threshold, or must receive prior approval of the Commissioner to pay a dividend if such dividend, along with all other dividends paid within the preceding 12 consecutive months, exceed the statutory limitation. The current Indiana statutory limitation is the greater of 10% of the insurer s contract holders surplus, as shown on its last annual statement on file with the Commissioner, or the insurer s statutory net gain from operations for the prior calendar year.

In addition, payments of dividends and advances or repayment of funds to us by our insurance subsidiaries are restricted by the applicable laws of their respective jurisdictions requiring that our insurance subsidiaries hold a specified amount of minimum reserves in order to meet future obligations on their outstanding policies. These regulations specify that the minimum reserves shall be calculated to be sufficient to meet future obligations, after giving consideration to future required premiums to be received, and are based on certain specified mortality and morbidity tables, interest rates and methods of valuation, which are subject to change. In order to meet their claims-paying obligations, our insurance subsidiaries regularly monitor their reserves to ensure we hold sufficient amounts to cover actual or expected contract and claims payments. At times, we may determine that reserves in excess of the minimum may be needed to ensure sufficiency.

Changes in, or reinterpretations of, these laws can constrain the ability of our subsidiaries to pay dividends or to advance or repay funds to us in sufficient amounts and at times necessary to meet our debt obligations and corporate expenses. Requiring our insurance subsidiaries to hold additional reserves has the potential to constrain their ability to pay dividends to the holding company. See Legislative, Regulatory and Tax Changes to the calculation of reserves and attempts to mitigate the impact of Regulation XXX and Actuarial Guideline 38 may fail in whole or in part resulting in an adverse effect on our financial condition and results of operations in our Annual Report on Form 10-K for the year ended December 31, 2011 for additional information on potential changes in these laws.

The earnings of our insurance subsidiaries impact contract holders surplus. Lower earnings constrain the growth in our insurance subsidiaries capital, and therefore, can constrain the payment of dividends and advances or repayment of funds to us.

In addition, the amount of surplus that our insurance subsidiaries could pay as dividends is constrained by the amount of surplus they hold to maintain their financial strength ratings, to provide an additional layer of margin for risk protection and for future investment in our businesses. Notwithstanding the foregoing, we believe that our insurance subsidiaries have sufficient liquidity to meet their contract holder obligations and maintain their operations.

A decrease in the capital and surplus of our insurance subsidiaries may result in a downgrade to our credit and insurer financial strength ratings.

In any particular year, statutory surplus amounts and RBC ratios may increase or decrease depending on a variety of factors, including the amount of statutory income or losses generated by our insurance subsidiaries (which itself is sensitive to equity market and credit market conditions), the amount of additional capital our insurance subsidiaries must hold to support business growth, changes in reserving requirements, such as AG38 and principles based reserving, our inability to secure capital market solutions to provide reserve relief, such as issuing letters of credit to support captive reinsurance structures, changes in equity market levels, the value of certain fixed-income and equity securities in our investment portfolio, the value of certain derivative instruments that do not get hedge accounting, changes in interest rates and foreign currency exchange rates, as well as changes to the NAIC RBC formulas. The RBC ratio is also affected by the product mix of the in-force book of business (i.e., the amount of business without guarantees is not subject to the same level of reserves as the business with guarantees). Most of these factors are outside of our control. Our credit and insurer financial strength ratings are significantly influenced by the statutory surplus amounts and RBC ratios of our insurance company subsidiaries. The RBC ratio of LNL is an important factor in the determination of the credit and financial strength ratings of LNC and its subsidiaries. In addition, rating agencies may implement changes to their internal models that have the effect of increasing or decreasing the amount of statutory capital we must hold in order to maintain our current ratings. In addition, in extreme scenarios of equity market declines, the amount of additional statutory reserves that we are required to hold for our variable annuity guarantees may increase at a rate greater than the rate of change of the markets. Increases in reserves reduce the statutory surplus used in calculating our RBC ratios. To the extent that our statutory capital resources are deemed to be insufficient to maintain a particular rating by one or more rating agencies, we may seek to raise additional capital through public or private equity or debt financing, which may be on terms not as favorable as in the past. Alternatively, if we were not to raise additional capital in such a scenario, either at our discretion or because we were unable to do so, our financial strength and credit ratings might be downgraded by one or more rating agencies. For more information on risks regarding our ratings, see Covenants and Ratings A downgrade in our financial strength or credit ratings could limit our ability to market products, increase the number or value of policies being surrendered and/or hurt our relationships with creditors below.

Assumptions and Estimates

Our reserves for future policy benefits and claims related to our current and future business as well as businesses we may acquire in the future may prove to be inadequate.

We establish and carry, as a liability, reserves based on estimates of how much we will need to pay for future benefits and claims. For our insurance products, we calculate these reserves based on many assumptions and estimates, including, but not limited to, estimated premiums we will receive over the assumed life of the policies, the timing of the events covered by the insurance policies, the lapse rate of the policies, the amount of benefits or claims to be paid and the investment returns on the assets we purchase with the premiums we receive.

The sensitivity of our statutory reserves and surplus established for our variable annuity base contracts and riders to changes in the equity markets will vary depending on the magnitude of the decline. The sensitivity will be affected by the level of account values relative to the level of guaranteed amounts, product design and reinsurance. Statutory reserves for variable annuities depend upon the cumulative equity market impacts on the business in force, and therefore, result in non-linear relationships with respect to the level of equity market performance within any reporting period.

The assumptions and estimates we use in connection with establishing and carrying our reserves are inherently uncertain. Accordingly, we cannot determine with precision the ultimate amount or the timing of the payment of actual benefits and claims or whether the assets supporting the policy liabilities will grow to the level we assume prior to payment of benefits or claims. If our actual experience is different from our assumptions or estimates, our reserves may prove to be inadequate in relation to our estimated future benefits and claims. Increases in reserves have a negative effect on income from operations in the quarter incurred.

If our businesses do not perform well and/or their estimated fair values decline or the price of our common stock does not increase, we may be required to recognize an impairment of our goodwill or to establish a valuation allowance against the deferred income tax asset, which could have a material adverse effect on our results of operations and financial condition.

Goodwill represents the excess of the acquisition price incurred to acquire subsidiaries and other businesses over the fair value of their net assets as of the date of acquisition. As of December 31, 2011, we had a total of $2.3 billion of goodwill on our Consolidated Balance Sheets, of which $1.5 billion related to our Life Insurance segment and $440 million related to our Annuities segment. We test goodwill at least annually for indications of value impairment with consideration given to financial performance, mergers and acquisitions and other relevant

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factors. In addition, certain events, including a significant and adverse change in legal factors, accounting standards or the business climate, an adverse action or assessment by a regulator or unanticipated competition, would cause us to review the carrying amounts of goodwill for impairment. Impairment testing is performed based upon estimates of the fair value of the reporting unit to which the goodwill relates. As of December 31, 2011, we recorded a goodwill impairment of $747 million, primarily related to our Life Insurance segment. Subsequent reviews of goodwill could result in impairment of goodwill, and such write downs could have a material adverse effect on our net income and book value, but will not affect the statutory capital of our insurance subsidiaries. For more information on goodwill, see Note 10 and Critical Accounting Policies and Estimates Goodwill and Other Intangible Assets in the MD&A in our Annual Report on Form 10-K for the year ended December 31, 2011.

Deferred income tax represents the tax effect of the differences between the book and tax basis of assets and liabilities. Deferred tax assets are assessed periodically by management to determine if they are realizable. As of December 31, 2011, we had a deferred tax asset of $2.5 billion. Factors in management s determination include the performance of the business, including the ability to generate capital gains from a variety of sources and tax planning strategies. If, based on available information, it is more likely than not that the deferred income tax asset will not be realized, then a valuation allowance must be established with a corresponding charge to net income. Such valuation allowance could have a material adverse effect on our results of operations and financial position.

The determination of the amount of allowances and impairments taken on our investments is highly subjective and could materially impact our results of operations or financial position.

The determination of the amount of allowances and impairments varies by investment type and is based upon our periodic evaluation and assessment of known and inherent risks associated with the respective asset class. Such evaluations and assessments are revised as conditions change and new information becomes available. Management updates its evaluations regularly and reflects changes in allowances and impairments in operations as such evaluations are revised. There can be no assurance that our management has accurately assessed the level of impairments taken and allowances reflected in our financial statements. Furthermore, additional impairments may need to be taken or allowances provided for in the future. Historical trends may not be indicative of future impairments or allowances.

We regularly review our available-for-sale (AFS) securities for declines in fair value that we determine to be other-than-temporary. For an equity security, if we do not have the ability and intent to hold the security for a sufficient period of time to allow for a recovery in value, we conclude that an other-than-temporary-impairment (OTTI) has occurred, and the amortized cost of the equity security is written down to the current fair value, with a corresponding change to realized gain (loss) on our Consolidated Statements of Income (Loss). When assessing our ability and intent to hold the equity security to recovery, we consider, among other things, the severity and duration of the decline in fair value of the equity security as well as the cause of decline, a fundamental analysis of the liquidity, business prospects and overall financial condition of the issuer.

For a debt security, if we intend to sell a security or it is more likely than not we will be required to sell a debt security before recovery of its amortized cost basis and the fair value of the debt security is below amortized cost, we conclude that an OTTI has occurred and the amortized cost is written down to current fair value, with a corresponding charge to realized loss on our Consolidated Statements of Income. If we do not intend to sell a debt security or it is not more likely than not we will be required to sell a debt security before recovery of its amortized cost basis but the present value of the cash flows expected to be collected is less than the amortized cost of the debt security (referred to as the credit loss), we conclude that an OTTI has occurred and the amortized cost is written down to the estimated recovery value with a corresponding charge to realized loss on our Consolidated Statements of Income (Loss), as this is also deemed the credit portion of the OTTI. The remainder of the decline to fair value is recorded in other comprehensive income (loss) (OCI) to unrealized OTTI on AFS securities on our Consolidated Statements of Stockholders Equity, as this is considered a noncredit (i.e., recoverable) impairment. Net OTTI recognized in net income (loss) was $118 million, $152 million and $392 million, pre-tax, for the years ended December 31, 2011, 2010 and 2009, respectively. The portion of OTTI recognized in OCI for the years ended December 31, 2011 and 2010 was $47 million and $88 million, pre-tax, respectively.

Related to our unrealized losses, we establish deferred tax assets for the tax benefit we may receive in the event that losses are realized. The realization of significant realized losses could result in an inability to recover the tax benefits and may result in the establishment of valuation allowances against our deferred tax assets. Realized losses or impairments may have a material adverse impact on our results of operations and financial position.

Our valuation of fixed maturity, equity and trading securities may include methodologies, estimations and assumptions which are subject to differing interpretations and could result in changes to investment valuations that may materially adversely affect our results of operations or financial condition.

Fixed maturity, equity and trading securities and short-term investments, which are reported at fair value on our Consolidated Balance Sheets, represented the majority of our total cash and invested assets. Pursuant to the Fair Value Measurements and Disclosures Topics of the FASB ASC, we have categorized these securities into a three-level hierarchy, based on the priority of the inputs to the respective valuation technique. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

The determination of fair values in the absence of quoted market prices is based on valuation methodologies, securities we deem to be comparable and assumptions deemed appropriate given the circumstances. The fair value estimates are made at a specific point in time, based on available market information and judgments about financial instruments, including estimates of the timing and amounts of expected future cash flows and the credit standing of the issuer or counterparty. Factors considered in estimating fair value include coupon rate, maturity, estimated duration, call provisions, sinking fund requirements, credit rating, industry sector of the issuer and quoted market prices of comparable securities. The use of different methodologies and assumptions may have a material effect on the estimated fair value amounts.

During periods of market disruption, including periods of significantly increasing/decreasing or high/low interest rates, rapidly widening credit spreads or illiquidity, it may be difficult to value certain securities if trading becomes less frequent and/or market data becomes less observable. There may be certain asset classes that were in active markets with significant observable data that become illiquid due to the current financial environment. In such cases, more securities may fall to Level 3 and thus require more subjectivity and management judgment. As such, valuations may include inputs and assumptions that are less observable or require greater estimation, as well as valuation methods which are more sophisticated or require greater estimation, thereby resulting in values which may be less than the value at which the investments may be ultimately sold. Further, rapidly changing and unprecedented credit and equity market conditions could materially impact the valuation of securities as reported within our consolidated financial statements and the period-to-period changes in value could vary significantly. Decreases in value may have a material adverse effect on our results of operations or financial condition.

Significant adverse mortality experience may result in the loss of, or higher prices for, reinsurance.

We reinsure a significant amount of the mortality risk on fully underwritten, newly issued, individual life insurance contracts. We regularly review retention limits for continued appropriateness and they may be changed in the future. If we were to experience adverse mortality or morbidity experience, a significant portion of that would be reimbursed by our reinsurers. Prolonged or severe adverse mortality or morbidity experience could result in increased reinsurance costs, and ultimately, reinsurers not willing to offer coverage. If we are unable to maintain our current level of reinsurance or purchase new reinsurance protection in amounts that we consider

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sufficient, we would either have to be willing to accept an increase in our net exposures or revise our pricing to reflect higher reinsurance premiums. If this were to occur, we may be exposed to reduced profitability and cash flow strain or we may not be able to price new business at competitive rates.

Catastrophes may adversely impact liabilities for contract holder claims and the availability of reinsurance.

Our insurance operations are exposed to the risk of catastrophic mortality, such as a pandemic, an act of terrorism, natural disaster or other event that causes a large number of deaths or injuries. Significant influenza pandemics have occurred three times in the last century, but the likelihood, timing or severity of a future pandemic cannot be predicted. Additionally, the impact of climate change could cause changes in weather patterns, resulting in more severe and more frequent natural disasters such as forest fires, hurricanes, tornados, floods and storm surges. In our group insurance operations, a localized event that affects the workplace of one or more of our group insurance customers could cause a significant loss due to mortality or morbidity claims. These events could cause a material adverse effect on our results of operations in any period and, depending on their severity, could also materially and adversely affect our financial condition.

The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Pandemics, natural disasters and man-made catastrophes, including terrorism, may produce significant damage in larger areas, especially those that are heavily populated. Claims resulting from natural or man-made catastrophic events could cause substantial volatility in our financial results for any fiscal quarter or year and could materially reduce our profitability or harm our financial condition. Also, catastrophic events could harm the financial condition of our reinsurers and thereby increase the probability of default on reinsurance recoveries. Accordingly, our ability to write new business could also be affected.

Consistent with industry practice and accounting standards, we establish liabilities for claims arising from a catastrophe only after assessing the probable losses arising from the event. We cannot be certain that the liabilities we have established or applicable reinsurance will be adequate to cover actual claim liabilities, and a catastrophic event or multiple catastrophic events could have a material adverse effect on our business, results of operations and financial condition.

Operational Matters

Our enterprise risk management policies and procedures may leave us exposed to unidentified or unanticipated risk, which could negatively affect our businesses or result in losses.

We have devoted significant resources to develop our enterprise risk management policies and procedures and expect to continue to do so in the future. Nonetheless, our policies and procedures to identify, monitor and manage risks may not be fully effective. Many of our methods of managing risk and exposures are based upon our use of observed historical market behavior or statistics based on historical models. As a result, these methods may not predict future exposures, which could be significantly greater than the historical measures indicate, such as the risk of pandemics causing a large number of deaths. Other risk management methods depend upon the evaluation of information regarding markets, clients, catastrophe occurrence or other matters that is publicly available or otherwise accessible to us, which may not always be accurate, complete, up-to-date or properly evaluated. Management of operational, legal and regulatory risks requires, among other things, policies and procedures to record properly and verify a large number of transactions and events, and these policies and procedures may not be fully effective.

We face a risk of non-collectibility of reinsurance, which could materially affect our results of operations.

We follow the insurance practice of reinsuring with other insurance and reinsurance companies a portion of the risks under the policies written by our insurance subsidiaries (known as ceding). As of December 31, 2011, we ceded $331.7 billion of life insurance in force to reinsurers for reinsurance protection. Although reinsurance does not discharge our subsidiaries from their primary obligation to pay contract holders for losses insured under the policies we issue, reinsurance does make the assuming reinsurer liable to the insurance subsidiaries for the reinsured portion of the risk. As of December 31, 2011, we had $6.5 billion of reinsurance receivables from reinsurers for paid and unpaid losses, for which they are obligated to reimburse us under our reinsurance contracts. Of this amount, $2.8 billion related to the sale of our reinsurance business to Swiss Re in 2001 through an indemnity reinsurance agreement. Swiss Re has funded a trust to support this business. The balance in the trust changes as a result of ongoing reinsurance activity and was $2.2 billion as of December 31, 2011. Furthermore, approximately $1.0 billion of the Swiss Re treaties are funds withheld structures where we have a right of offset on assets backing the reinsurance receivables.

The balance of the reinsurance is due from a diverse group of reinsurers. The collectibility of reinsurance is largely a function of the solvency of the individual reinsurers. We perform annual credit reviews on our reinsurers, focusing on, among other things, financial capacity, stability, trends and commitment to the reinsurance business. We also require assets in trust, letters of credit or other acceptable collateral to support balances due from reinsurers not authorized to transact business in the applicable jurisdictions. Despite these measures, a reinsurer s insolvency, inability or unwillingness to make payments under the terms of a reinsurance contract, especially Swiss Re, could have a material adverse effect on our results of operations and financial condition.

Competition for our employees is intense, and we may not be able to attract and retain the highly skilled people we need to support our business.

Our success depends, in large part, on our ability to attract and retain key people. Intense competition exists for the key employees with demonstrated ability, and we may be unable to hire or retain such employees. The unexpected loss of services of one or more of our key personnel could have a material adverse effect on our operations due to their skills, knowledge of our business, their years of industry experience and the potential difficulty of promptly finding qualified replacement employees. We compete with other financial institutions primarily on the basis of our products, compensation, support services and financial position. Sales in our businesses and our results of operations and financial condition could be materially adversely affected if we are unsuccessful in attracting and retaining key employees, including financial advisors, wholesalers and other employees, as well as independent distributors of our products.

We may not be able to protect our intellectual property and may be subject to infringement claims.

We rely on a combination of contractual rights and copyright, trademark, patent and trade secret laws to establish and protect our intellectual property. Although we use a broad range of measures to protect our intellectual property rights, third parties may infringe or misappropriate our intellectual property. We may have to litigate to enforce and protect our copyrights, trademarks, patents, trade secrets and know-how or to determine their scope, validity or enforceability, which represents a diversion of resources that may be significant in amount and may not prove successful. Additionally, complex legal and factual determinations and evolving laws and court interpretations make the scope of protection afforded our intellectual property uncertain, particularly in relation to our patents. While we believe our patents provide us with a competitive advantage, we cannot be certain that any issued patents will be interpreted with sufficient breadth to offer meaningful protection. In addition, our issued patents may be successfully challenged, invalidated, circumvented or found unenforceable so that our patent rights would not create an effective competitive barrier. The loss of intellectual property protection or the inability to secure or enforce the protection of our intellectual property assets could have a material adverse effect on our business and our ability to compete.

We also may be subject to costly litigation in the event that another party alleges our operations or activities infringe upon another party s intellectual property rights. Third parties may have, or may eventually be issued, patents that could be infringed by our products, methods, processes or services. Any party that holds such a patent could make a claim of infringement against us. We may also be subject to claims by third parties for breach of copyright, trademark, trade secret or license usage rights. Any such claims and any resulting litigation could result in significant liability for damages. If we were found to have infringed a third-party patent or other intellectual property rights, we could incur substantial liability, and in some circumstances could be enjoined from providing certain products or services to our customers or utilizing and benefiting from certain methods, processes, copyrights, trademarks, trade secrets or licenses, or alternatively could be required to enter into costly licensing arrangements with third parties, all of which could have a material adverse effect on our business, results of operations and financial condition.

Our information systems may experience interruptions or breaches in security.

Our information systems are critical to the operation of our business. We collect, process, maintain, retain and distribute large amounts of personal financial and health information and other confidential and sensitive data about our customers in the ordinary course of our business. Our business therefore depends on our customers willingness to entrust us with their personal information. Any failure, interruption or breach in security could result in disruptions to our critical systems and adversely affect our customer relationships. While we employ a robust and tested information security program, there can be no assurance that any such failure, interruption or security breach will not occur or, if any does occur, that it can be sufficiently remediated. The occurrence of any such failure, interruption or security breach of our systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and financial liability.

Covenants and Ratings

A downgrade in our financial strength or credit ratings could limit our ability to market products, increase the number or value of policies being surrendered and/or hurt our relationships with creditors.

Nationally recognized rating agencies rate the financial strength of our principal insurance subsidiaries and rate our debt. Ratings are not recommendations to buy our securities. Each of the rating agencies reviews its ratings periodically, and our current ratings may not be maintained in the future.

Our financial strength ratings, which are intended to measure our ability to meet contract holder obligations, are an important factor affecting public confidence in most of our products and, as a result, our competitiveness. A downgrade of the financial strength rating of one of our principal insurance subsidiaries could affect our competitive position in the insurance industry by making it more difficult for us to market our products as potential customers may select companies with higher financial strength ratings and by leading to increased withdrawals by current customers seeking companies with higher financial strength ratings. This could lead to a decrease in fees as net outflows of assets increase, and therefore, result in lower fee income. Furthermore, sales of assets to meet customer withdrawal demands could also result in losses, depending on market conditions. The interest rates we pay on our borrowings are largely dependent on our credit ratings. A downgrade of our debt ratings could affect our ability to raise additional debt, including bank lines of credit, with terms and conditions similar to our current debt, and accordingly, likely increase our cost of capital.

All of our ratings and ratings of our principal insurance subsidiaries are subject to revision or withdrawal at any time by the rating agencies, and therefore, no assurance can be given that our principal insurance subsidiaries or we can maintain these ratings. See Item 1. Business Financial Strength Ratings and Item 7. MD&A Review of Consolidated Financial Condition Liquidity and Capital Resources Sources of Liquidity and Cash Flows in our Annual Report on Form 10-K for the year ended December 31, 2011 for a description of our ratings.

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We will be required to pay interest on our capital securities with proceeds from the issuance of qualifying securities if we fail to achieve capital adequacy or net income and stockholders equity levels.

As of December 31, 2011, we had approximately $1.2 billion in principal amount of capital securities outstanding. All of the capital securities contain covenants that require us to make interest payments in accordance with an alternative coupon satisfaction mechanism (ACSM) if we determine that one of the following triggers exists as of the 30th day prior to an interest payment date, or the determination date :

1. LNL s RBC ratio is less than 175% (based on the most recent annual financial statement filed with the State of Indiana); or

2. (i) The sum of our consolidated net income for the four trailing fiscal quarters ending on the quarter that is two quarters prior to the most recently completed quarter prior to the determination date is zero or negative, and (ii) our consolidated stockholders equity (excluding accumulated OCI and any increase in stockholders equity resulting from the issuance of preferred stock during a quarter), adjusted stockholders equity, as of (x) the most recently completed quarter and (y) the end of the quarter that is two quarters before the most recently completed quarter, has declined by 10% or more as compared to the quarter that is ten fiscal quarters prior to the last completed quarter, or the benchmark quarter.

The ACSM would generally require us to use commercially reasonable efforts to satisfy our obligation to pay interest in full on the capital securities with the net proceeds from sales of our common stock and warrants to purchase our common stock with an exercise price greater than the market price. We would have to utilize the ACSM until the trigger events above no longer existed, and, in the case of test 2 above, until our adjusted stockholders equity amount increased or declined by less than 10% as compared to the adjusted stockholders equity at the end of the benchmark quarter for each interest payment date as to which interest payment restrictions were imposed by test 2 above.

If we were required to utilize the ACSM and were successful in selling sufficient shares of common stock or warrants to satisfy the interest payment, we would dilute the current holders of our common stock. Furthermore, while a trigger event is occurring and if we do not pay accrued interest in full, we may not, among other things, pay dividends on or repurchase our capital stock. Our failure to pay interest pursuant to the ACSM will not result in an event of default with respect to the capital securities, nor will a nonpayment of interest, unless it lasts for ten consecutive years, although such breaches may result in monetary damages to the holders of the capital securities.

The calculations of RBC, net income (loss) and adjusted stockholders equity are subject to adjustments and the capital securities are subject to additional terms and conditions as further described in supplemental indentures filed as exhibits to our Forms 8-K filed on March 13, 2007, May 17, 2006, and April 20, 2006.

Certain blocks of our insurance business purchased from third-party insurers under indemnity reinsurance agreements may require us to place assets in trust, secure letters of credit or return the business, if the financial strength ratings and/or capital ratios of certain insurance subsidiaries are not maintained at specified levels.

Under certain indemnity reinsurance agreements, one of our insurance subsidiaries, Lincoln Life & Annuity Co. of New York (LLANY), provides 100% indemnity reinsurance for the business assumed, however, the third-party insurer, or the cedent, remains primarily liable on the underlying insurance business. Under these types of agreements, as of December 31, 2011, we held statutory reserves of $3.1 billion. These indemnity reinsurance arrangements require that our subsidiary, as the reinsurer, maintain certain insurer financial strength ratings and capital ratios. If these ratings or capital ratios are not maintained, depending upon the reinsurance agreement, the cedent may recapture the business, or require us to place assets in trust or provide letters of credit at least equal to the relevant statutory reserves. Under the largest indemnity reinsurance arrangement, we held

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$2.1 billion of statutory reserves as of December 31, 2011. LLANY must maintain an A.M. Best financial strength rating of at least B+, an S&P financial strength rating of at least BB+ and a Moody s financial strength rating of at least Ba1, as well as maintain an RBC ratio of at least 160% or an S&P capital adequacy ratio of 100%, or the cedent may recapture the business. Under two other arrangements, by which we established approximately $875 million of statutory reserves, LLANY must maintain an A.M. Best financial strength rating of at least B++, an S&P financial strength rating of at least BBB- and a Moody s financial strength rating of at least Baa3. One of these arrangements also requires LLANY to maintain an RBC ratio of at least 185%, or an S&P capital adequacy ratio of 115%. Each of these arrangements may require LLANY to place assets in trust equal to the relevant statutory reserves. As of December 31, 2011, LLANY s RBC ratio exceeded the required ratio. See Item 1. Business Financial Strength Ratings in our Annual Report on Form 10-K for the year ended December 31, 2011 for a description of our financial strength ratings.

If the cedent recaptured the business, LLANY would be required to release reserves and transfer assets to the cedent. Such a recapture could adversely impact our future profits. Alternatively, if LLANY established a security trust for the cedent, the ability to transfer assets out of the trust could be severely restricted, thus negatively impacting our liquidity.

Investments

Some of our investments are relatively illiquid and are in asset classes that have been experiencing significant market valuation fluctuations.

We hold certain investments that may lack liquidity, such as privately placed fixed maturity securities, mortgage loans, policy loans and other limited partnership interests. These asset classes represented 21% of the carrying value of our total cash and invested assets as of December 31, 2011.

If we require significant amounts of cash on short notice in excess of normal cash requirements or are required to post or return collateral in connection with our investment portfolio, derivatives transactions or securities lending activities, we may have difficulty selling these investments in a timely manner, be forced to sell them for less than we otherwise would have been able to realize, or both.

The reported value of our relatively illiquid types of investments, our investments in the asset classes described in the paragraph above and, at times, our high quality, generally liquid asset classes, do not necessarily reflect the lowest current market price for the asset. If we were forced to sell certain of our assets in the current market, there can be no assurance that we would be able to sell them for the prices at which we have recorded them and we might be forced to sell them at significantly lower prices.

We invest a portion of our invested assets in investment funds, many of which make private equity investments. The amount and timing of income from such investment funds tends to be uneven as a result of the performance of the underlying investments, including private equity investments. The timing of distributions from the funds, which depends on particular events relating to the underlying investments, as well as the funds schedules for making distributions and their needs for cash, can be difficult to predict. As a result, the amount of income that we record from these investments can vary substantially from quarter to quarter. Recent equity and credit market volatility may reduce investment income for these types of investments.

Defaults on our mortgage loans and write downs of mortgage equity may adversely affect our profitability.

Our mortgage loans face default risk and are principally collateralized by commercial properties. The performance of our mortgage loan investments may fluctuate in the future. In addition, some of our mortgage loan investments have balloon payment maturities. An increase in the default rate of our mortgage loan investments could have a material adverse effect on our business, results of operations and financial condition.

Further, any geographic or sector exposure in our mortgage loans may have adverse effects on our investment portfolios and consequently on our consolidated results of operations or financial condition. While we seek to mitigate this risk by having a broadly diversified portfolio, events or developments that have a negative effect on any particular geographic region or sector may have a greater adverse effect on the investment portfolios to the extent that the portfolios are exposed.

The difficulties faced by other financial institutions could adversely affect us.

We have exposure to many different industries and counterparties, and routinely execute transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks and other institutions. Many of these transactions expose us to credit risk in the event of default of our counterparty. In addition, with respect to secured transactions, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure due to it. We also may have exposure to these financial institutions in the form of unsecured debt instruments, derivative transactions and/or equity investments. These parties may default on their obligations to us due to bankruptcy, lack of liquidity, downturns in the economy or real estate values, operational failure, corporate governance issues or other reasons. A further downturn in the U.S. and other economies could result in increased impairments. There can be no assurance that any such losses or impairments to the carrying value of these assets would not materially and adversely affect our business and results of operations.

Our requirements to post collateral or make payments related to declines in market value of specified assets may adversely affect our liquidity and expose us to counterparty credit risk.

Many of our transactions with financial and other institutions, including settling futures positions, specify the circumstances under which the parties are required to post collateral. The amount of collateral we may be required to post under these agreements may increase under certain circumstances, which could adversely affect our liquidity. In addition, under the terms of some of our transactions, we may be required to make payments to our counterparties related to any decline in the market value of the specified assets.

Our investments are reflected within our consolidated financial statements utilizing different accounting bases, and, accordingly, there may be significant differences between cost and fair value that are not recorded in our consolidated financial statements.

Our principal investments are in fixed maturity and equity securities, mortgage loans on real estate, policy loans, short-term investments, derivative instruments, limited partnerships and other invested assets. The carrying value of such investments is as follows:

- Fixed maturity and equity securities are classified as AFS, except for those designated as trading securities, and are reported at their estimated fair value. The difference between the estimated fair value and amortized cost of such securities (i.e., unrealized investment gains and losses) is recorded as a separate component of OCI, net of adjustments to DAC, contract holder related amounts and deferred income taxes;

- Fixed maturity and equity securities designated as trading securities, which in certain cases support reinsurance arrangements, are recorded at fair value with subsequent changes in fair value recognized in realized gain (loss). However, in certain cases, the trading securities support reinsurance arrangements. In those cases, offsetting the changes to fair value of the trading securities are corresponding changes in the fair value of the embedded derivative liability associated with the underlying reinsurance arrangement. In other words, the investment results for the trading securities, including gains and losses from sales, are passed directly to the reinsurers through the contractual terms of the reinsurance arrangements. These types of securities represent 60% of our trading securities;

- Short-term investments include investments with remaining maturities of one year or less, but greater than three months, at the time of acquisition and are stated at amortized cost, which approximates fair value;

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- Mortgage loans on real estate are carried at unpaid principal balances, adjusted for any unamortized premiums or discounts and deferred fees or expenses, net of valuation allowances;

- Policy loans are carried at unpaid principal balances;

- Real estate joint ventures and other limited partnership interests are carried using the equity method of accounting; and

- Other invested assets consist principally of derivatives with positive fair values. Derivatives are carried at fair value with changes in fair value reflected in income from non-qualifying derivatives and derivatives in fair value hedging relationships. Derivatives in cash flow hedging relationships are reflected as a separate component of OCI.

Investments not carried at fair value on our consolidated financial statements, principally, mortgage loans, policy loans and real estate, may have fair values which are substantially higher or lower than the carrying value reflected on our consolidated financial statements. In addition, unrealized losses are not reflected in net income unless we realize the losses by either selling the security at below amortized cost or determine that the decline in fair value is deemed to be other-than-temporary (i.e., impaired). Each of such asset classes is regularly evaluated for impairment under the accounting guidance appropriate to the respective asset class.

Competition

Intense competition could negatively affect our ability to maintain or increase our profitability.

Our businesses are intensely competitive. We compete based on a number of factors, including name recognition, service, the quality of investment advice, investment performance, product features, price, perceived financial strength and claims-paying and credit ratings. Our competitors include insurers, broker-dealers, financial advisors, asset managers and other financial institutions. A number of our business units face competitors that have greater market share, offer a broader range of products or have higher financial strength or credit ratings than we do.

In recent years, there has been substantial consolidation and convergence among companies in the financial services industry resulting in increased competition from large, well-capitalized financial services firms. Many of these firms also have been able to increase their distribution systems through mergers or contractual arrangements. Furthermore, larger competitors may have lower operating costs and an ability to absorb greater risk while maintaining their financial strength ratings, thereby allowing them to price their products more competitively. We expect consolidation to continue and perhaps accelerate in the future, thereby increasing competitive pressure on us.

Our sales representatives are not captive and may sell products of our competitors.

We sell our annuity and life insurance products through independent sales representatives. These representatives are not captive, which means they may also sell our competitors products. If our competitors offer products that are more attractive than ours, or pay higher commission rates to the sales representatives than we do, these representatives may concentrate their efforts in selling our competitors products instead of ours.

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USE OF PROCEEDS

We estimate that, after deducting underwriting discounts and commissions and estimated expenses payable by us, our net proceeds from this offering will be approximately $ million. We intend to use the net proceeds from this offering to repay all or a portion of the $300 million aggregate principal amount of our 5.65% senior notes maturing on August 27, 2012, with the remaining net proceeds, if any, to be used for general corporate purposes.

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RATIO OF EARNINGS TO FIXED CHARGES

	For the Years Ended December 31,				
	2011	2010	2009	2008	2007
	(dollars in millions)				
Income (loss) from continuing operations before taxes	$ 599	$ 1,234	$ (521)	$ (137)	$ 1,675
Sub-total of fixed charges	308	307	292	303	325
Sub-total of adjusted income (loss)	907	1,541	(229)	166	2,000
Interest on annuities and financial products	2,488	2,499	2,513	2,538	2,525
Adjusted income base	$ 3,395	$ 4,040	$ 2,284	$ 2,704	$ 4,525
Fixed Charges					
Interest and debt expense(1)	$ 286	$ 286	$ 261	$ 281	$ 284
Interest expense related to uncertain tax positions	9	7	13	2	21
Portion of rent expense representing interest	13	14	18	20	20
Sub-total of fixed charges excluding interest on annuities and financial products	308	307	292	303	325
Interest on annuities and financial products	2,488	2,499	2,513	2,538	2,525
Total fixed charges	$ 2,796	$ 2,806	$ 2,805	$ 2,841	$ 2,850
Ratio of sub-total of adjusted income to sub-total of fixed charges excluding interest on annuities and financial products(2)	2.94	5.02			6.15
Ratio of adjusted income base to total fixed charges(2)	1.21	1.44			1.59

(1) Interest and debt expense excludes an $8 million loss, a $5 million loss and a $64 million gain related to the early retirement of debt in 2011, 2010 and 2009, respectively.

(2) The ratios of earnings to fixed charges for the years ended December 31, 2009 and 2008 indicated a less than one-to-one coverage and are therefore not presented. Additional earnings of $521 million and $137 million would have been required for the years ended December 31, 2009 and 2008, respectively, to achieve ratios of one-to-one coverage.

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CAPITALIZATION

The following table sets forth our consolidated capitalization as of December 31, 2011:

- on an actual basis; and
- on an as adjusted basis to give effect to the receipt of estimated net proceeds of approximately $ million in this offering and to the use of the net proceeds from this offering.

The following data is qualified in its entirety by, and should be read in conjunction with, our audited consolidated financial statements and notes thereto incorporated in this prospectus supplement and the accompanying base prospectus by reference.

	As of December 31, 2011	
	Actual	As adjusted for this offering and the use of proceeds(1)
	(In millions)	
Short-term debt	**$**	**$**
Commercial paper(2)		
5.65% notes due 2012	300	
Other short-term debt		
Total short-term debt	$ 300	$
Long-term debt, excluding current portion		
Senior notes:	$	$
% notes, due , offered hereby		
LIBOR + 175 bps notes, due 2013	200	200
4.75% notes, due 2014	300	300
4.75% notes, due 2014	200	200
4.30% notes, due 2015(3)	250	250
LIBOR + 3 bps notes, due 2017	250	250
7.00% notes, due 2018	200	200
8.75% notes, due 2019(3)	500	500
6.25% notes, due 2020(3)	300	300
4.85% notes, due 2021(3)	300	300
6.15% notes, due 2036	500	500
6.30% notes, due 2037	375	375
7.00% notes, due 2040(3)	500	500
Total senior notes	3,875	
Capital securities:		
7.00%, due 2066	722	722
6.05%, due 2067	491	491
Total capital securities	1,213	1,213
Unamortized premiums (discounts)	(16)	(16)
Fair value hedge on interest rate swap agreements	319	319
Total unamortized premiums (discounts) and fair value hedge on interest rate swap agreements	303	303

Total long-term debt	5,391
Total debt	5,391

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	As of December 31, 2011	
	Actual	As adjusted for this offering and the use of proceeds(1)
	(In millions)	
Stockholders equity		
Series A preferred stock		
Common stock	7,590	7,590
Retained earnings	4,126	4,126
Accumulated other comprehensive income (loss)	2,448	2,448
Total stockholders equity	14,164	14,164
Total capitalization	$ 19,555	$ 19,555

(1) Includes adjustments related to the notes offered hereby. Does not reflect other increases or decreases, including increases or decreases in our commercial paper balance after December 31, 2011.

(2) The weighted-average interest rate of commercial paper was 0.20% as of December 31, 2011.

(3) We have the option to repurchase the outstanding notes by paying the greater of 100% of the principal amount of the notes to be redeemed or the make-whole amount (as defined in each indenture or supplemental indenture), plus in each case any accrued and unpaid interest as of the date of redemption.

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SELECTED CONSOLIDATED HISTORICAL FINANCIAL DATA OF LNC

The following selected financial data should be read together with our consolidated financial statements and accompanying notes and 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, 2011 which are incorporated herein by reference. Our historical results are not necessarily indicative of our future results. The selected financial data set forth below are derived from our consolidated financial statements for the years ended December 31, 2011, 2010, 2009, 2008 and 2007. Some previously reported amounts have been reclassified to conform to the presentation as of and for the year ended December 31, 2011.

	Year ended December 31,				
	2011	2010	2009	2008	2007
	(In millions, except per share data) (audited)				
Statement of operations data:					
Total revenues	$ 10,636	$ 10,407	$ 8,499	$ 9,224	$ 9,614
Income (loss) from continuing operations	302	951	(415)	(10)	1,199
Net income (loss)	294	980	(485)	57	1,215
Per Common Share Data(1)(2):					
Income (loss) from continuing operations basic	$ 0.99	$ 2.53	$ (1.60)	$ (0.04)	$ 4.44
Income (loss) from continuing operations diluted	0.95	2.45	(1.60)	(0.04)	4.37
Net income (loss) basic	0.96	2.62	(1.85)	0.22	4.50
Net income (loss) diluted	0.92	2.54	(1.85)	0.22	4.43
Common stock dividends	0.230	0.080	0.040	1.455	1.600

	As of December 31,				
	2011	2010	2009	2008	2007
	(audited)				
Balance sheet data:					
Assets	$ 202,906	$ 193,824	$ 177,433	$ 163,136	$ 191,435
Long-term debt	5,391	5,399	5,050	4,731	4,618
Stockholders equity	14,164	12,806	11,700	7,977	11,718
Per Common Share Data(1)					
Stockholders equity including accumulated other comprehensive income(3)	$ 48.59	$ 40.54	$ 36.02	$ 31.15	$ 44.32
Stockholders equity excluding accumulated other comprehensive income(3)	40.19	38.17	36.89	42.09	43.46
Market value of common stock	19.42	27.81	24.88	18.84	58.22

(1) Per share amounts were affected by the retirement of 24.7 million, 1.1 million, less than 1 million, 9.3 million and 15.4 million shares of common stock during the years ended December 31, 2011, 2010, 2009, 2008 and 2007, respectively.
(2) For discussion of the reduction of net income (loss) available to common shareholders, see Part II Item 8. Financial Statements and Supplementary Data Note 14 in our Annual Report on Form 10-K for the year ended December 31, 2011.
(3) Per share amounts are calculated under the assumption that our Series A preferred stock has been converted to common stock, but exclude Series B preferred stock balances as it was non-convertible.

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DESCRIPTION OF NOTES

The following description of the particular terms of the notes offered hereby supplements, and to the extent inconsistent therewith replaces, the description of the general terms and provisions described under the caption Description of Securities We May Sell Senior and Subordinated Debt Securities in the accompanying base prospectus.

General

The notes will be issued under an indenture dated as of March 10, 2009, between us and The Bank of New York Mellon, as trustee, referred to as the indenture. The notes will mature on , .

The notes will initially be limited to $ in aggregate principal amount. We may, however, without the consent of any then-existing holders of the notes, reopen the notes and issue an unlimited principal amount of additional notes in the future. These additional notes will be deemed part of the same series as the notes offered hereby.

Unless previously redeemed or purchased and cancelled, we will repay the notes in cash at 100% of their principal amount together with accrued and unpaid interest thereon at maturity. We will pay principal and interest on the notes in U.S. dollars.

The notes will be our senior unsecured debt obligations and will rank equally among themselves and with all of our other present and future unsecured unsubordinated obligations. The indenture does not limit the aggregate principal amount of senior debt securities that may be issued.

The notes will be redeemable by us at any time prior to maturity as described below under Optional Redemption.

The notes will not be subject to a sinking fund. The notes will be issued in fully registered book-entry form only in minimum denominations of $2,000 and integral multiples of $1,000 in excess thereof. The notes will be issued in the form of one or more global securities. The global security will be deposited with, or on behalf of, DTC, and registered in the name of DTC or a nominee, as further described below.

The provisions of the indenture relating to defeasance, which are described under the caption Description of the Securities We May Sell Senior and Subordinated Debt Securities Defeasance and Covenant Defeasance in the accompanying base prospectus, will apply to the notes.

If the scheduled maturity date falls on a day that is not a business day, the payment of interest and principal will be made on the next succeeding business day, and no interest on such payment shall accrue for the period from and after the scheduled maturity date.

Interest

The notes will bear interest at a rate of %. Interest on the notes will accrue from , 2012 or from the most recent interest payment date to which interest has been paid or provided for, to but excluding the relevant interest payment date. We will make interest payments on the notes semi-annually in arrears on and of each year, beginning on , 2012, to the person in whose name such notes are registered at the close of business on the immediately preceding or , as applicable. Interest on the notes will be computed on the basis of a 360-day year comprised of twelve 30-day months.

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If an interest payment date for the notes falls on a day that is not a business day, the interest payment shall be postponed to the next succeeding business day, and no interest on such payment shall accrue for the period from and after such interest payment date.

Optional Redemption

The notes are redeemable, in whole or in part, at our option, at any time or from time to time, upon mailed notice to the registered holders of the applicable notes at their addresses as shown on the security register at least 30 days but not more than 60 days prior to the redemption. The redemption price will be the greater of (i) 100% of the principal amount of the notes to be redeemed and (ii) the make-whole amount, plus in each case accrued and unpaid interest to the date of redemption.

Make-whole amount means the sum of the present values of the remaining scheduled payments (as defined below) on the notes to be redeemed, discounted to the date of redemption on a semi-annual basis (assuming a 360-day year consisting of twelve 30-day months), at a rate equal to the sum of the applicable treasury rate (as defined below) plus basis points.

Comparable treasury issue means the U.S. Treasury security selected by a reference treasury dealer as having an actual or interpolated maturity comparable to the remaining term of the notes, that would be utilized, at the time of selection and in accordance with customary financial practice, in pricing new issues of corporate debt securities with a term comparable to such period.

Comparable treasury price means, with respect to a redemption date, (1) the average of five reference treasury dealer quotations for such redemption date, after excluding the highest and lowest reference treasury dealer quotations, or (2) if the quotation agent obtains fewer than five such reference treasury dealer quotations, the average of all such quotations.

Quotation agent means the entity appointed by us, which in any case shall not be the trustee, to determine the make-whole amount.

Reference treasury dealer means (1) Credit Suisse Securities (USA) LLC and Morgan Stanley & Co. LLC and (2) any additional primary U.S. government securities dealers, including dealers outside New York City (each, a primary treasury dealer), selected by us and their successors; provided, however, that if any of them ceases to be a primary treasury dealer we will substitute another primary treasury dealer.

Reference treasury dealer quotations means, with respect to each reference treasury dealer and any redemption date, the average, as determined by the quotation agent, of the bid and ask prices for the comparable treasury issue (expressed in each case as a percentage of its principal amount) quoted in writing to the quotation agent at 5:00 p.m., New York City time, on the third business day preceding such redemption date.

Remaining scheduled payments means the remaining scheduled payments of principal and interest on the notes that would be due after the related redemption date but for that redemption. If that redemption date is not an interest payment date with respect to the notes called for redemption, the amount of the next succeeding scheduled interest payment on such notes will be reduced by the amount of interest accrued to such redemption date.

Treasury rate means, with respect to any redemption date, the rate per annum equal to the semi-annual equivalent yield to maturity (computed as of the third business day immediately preceding that redemption date) of the comparable treasury issue, assuming a price for the comparable treasury issue (expressed as a percentage of its principal amount) equal to the comparable treasury price for that redemption date.

We will prepare and mail a notice of redemption to each holder of notes to be redeemed by first-class mail at least 30 but not more than 60 days prior to the date fixed for redemption. On and after a redemption date, interest will cease to accrue on the notes called for redemption (unless we default in the payment of the redemption price and accrued interest). On or before a redemption date, we will deposit with a paying agent (or the trustee) money sufficient to pay the redemption price of and accrued interest on the notes to be redeemed on that date. If less than all of the notes are to be redeemed, the notes to be redeemed shall be selected by the trustee pro rata or by lot or by a method the trustee deems to be fair and appropriate.

Regarding the Trustee

We and our affiliates maintain various commercial and service relationships with the trustee and its affiliates in the ordinary course of business. In particular, the trustee is a lender in our $2 billion credit facility.

Book-Entry System

Upon issuance, the notes will be represented by one or more fully registered global certificates, each of which we refer to as a global security. Each such global security will be deposited with, or on behalf of, DTC, and registered in the name of DTC or a nominee thereof. Unless and until it is exchanged in whole or in part for notes in definitive form, no global security may be transferred except as a whole by DTC to a nominee of DTC or by a nominee of DTC to DTC or another nominee of DTC or by DTC or any such nominee to a successor of DTC or a nominee of such successor.

Beneficial interests in the notes will be represented through book-entry accounts of financial institutions acting on behalf of beneficial owners as direct and indirect participants in DTC. Investors may elect to hold interest in the notes held by DTC through Clearstream Bank, société anonyme, referred to as Clearstream, Luxembourg, or Euroclear Bank S.A./N.V., as operator of the Euroclear System, referred to as the Euroclear operator, if they are participants in such systems, or indirectly through organizations that are participants in such systems. Clearstream, Luxembourg and the Euroclear operator will hold interests on behalf of their participants through customers securities accounts in Clearstream, Luxembourg s and the Euroclear operator s names on the books of their respective depositaries, which in turn will hold such interests in customers securities accounts in the depositaries names on the books of DTC.

So long as DTC, or its nominee, is a registered owner of a note, DTC or its nominee, as the case may be, will be considered the sole owner or holder of the notes represented by such note for all purposes under the indenture or other governing documents. Except as provided below, the actual owners of the notes represented by a note, referred to as the beneficial owner, will not be entitled to have the notes represented by such note registered in their names, will not receive or be entitled to receive physical delivery of the notes in definitive form and will not be considered the registered owners or holders thereof under the indenture.

Accordingly, each person owning a beneficial interest in a note must rely on the procedures of DTC and, if such person is not a participant of DTC, referred to as a participant, on the procedures of the participant through which such person owns its interest, to exercise any rights of a holder under the indenture. We understand that under existing industry practices, in the event that LNC requests any action of holders or that an owner of a beneficial interest that a holder is entitled to give or take under the indenture, DTC would authorize the participants holding the relevant beneficial interests to give or take such action, and such participants would authorize beneficial owners owning through such participants to give or take such action or would otherwise act upon the instructions of beneficial owners. Conveyance of notices and other communications by DTC to participants, by participants to indirect participants, as defined below, and by participants and indirect participants to beneficial owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

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The following is based on information furnished by DTC:

DTC will act as securities depository for the notes. Offered securities will be issued as fully registered securities registered in the name of Cede & Co. (DTC s partnership nominee) or such other name as may be requested by an authorized representative of DTC. One or more fully registered global securities will be issued for the notes, in the aggregate principal amount of the notes, and will be deposited with DTC.

DTC is a limited-purpose trust company organized under the New York Banking Law, a banking organization within the meaning of the New York Banking Law, a member of the Federal Reserve System, a clearing corporation within the meaning of the New York Uniform Commercial Code, and a clearing agency registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934, as amended. DTC holds securities that its participants deposit with DTC. DTC also facilitates the post-trade settlement among participants of sales and other securities transactions in deposited securities, through electronic computerized book-entry transfers and pledges between participants accounts, thereby eliminating the need for physical movement of securities certificates. Direct participants of DTC, referred to as direct participants, include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation, referred to as DTCC. DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to DTC s system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks and trust companies, and clearing corporations that clear through or maintain a custodial relationship with a direct participant, either directly or indirectly, referred to as indirect participants. The rules applicable to DTC and its participants are on file with the SEC.

Purchases of the notes under DTC s system must be made by or through direct participants, which will receive a credit for the notes on DTC s records. The ownership interest of each beneficial owner is in turn to be recorded on the records of direct participants and indirect participants. Beneficial owners will not receive written confirmation from DTC of their purchase, but beneficial owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the direct participants or indirect participants through which such beneficial owner entered into the transaction. Transfers of ownership interests in the notes are to be accomplished by entries made on the books of direct participants and indirect participants acting on behalf of beneficial owners. Beneficial owners will not receive certificates representing their ownership interests in the notes, except in the event that the use of the book-entry system for the notes is discontinued or other limited circumstances that may be provided in the indenture.

To facilitate subsequent transfers, all notes deposited by direct participants with DTC are registered in the name of DTC s partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of the notes with DTC and their registration in the name of Cede & Co. or such other DTC nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual beneficial owners of the notes. DTC s records reflect only the identity of the direct participants to whose accounts such notes are credited, which may or may not be the beneficial owners. The direct participants and indirect participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to direct participants, by direct participants to indirect participants, and by direct participants and indirect participants to beneficial owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the notes. Under its usual procedures, DTC mails an Omnibus Proxy to LNC as soon as possible after the applicable record date. The Omnibus Proxy assigns Cede & Co. s consenting or voting rights to those direct participants to whose accounts securities are credited on the applicable record date (identified in a listing attached to the Omnibus Proxy).

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Payments on the notes will be made in immediately available funds to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC s practice is to credit direct participants accounts upon DTC s receipt of funds and corresponding detail information from LNC or the applicable agent, on the applicable payment date in accordance with their respective holdings shown on DTC s records. Payments by participants to beneficial owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in street name, and will be the responsibility of such participant and not of DTC, the applicable agent or LNC, subject to any statutory or regulatory requirements as may be in effect from time to time. Any payment to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of LNC or the applicable agent, disbursement of such payments to direct participants shall be the responsibility of DTC, and disbursement of such payments to the beneficial owners shall be the responsibility of direct participants and indirect participants.

DTC may discontinue providing its services as securities depository with respect to the notes at any time by giving reasonable notice to LNC or the applicable agent. Under such circumstances, in the event that a successor securities depository is not obtained, offered security certificates are required to be printed and delivered. LNC may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depositary). In that event, offered security certificates will be printed and delivered.

Clearstream, Luxembourg advises that it is incorporated under the laws of Luxembourg as a professional depository. Clearstream, Luxembourg holds securities for its participating organizations, referred to as Clearstream participants, and facilitates the clearance and settlement of securities transactions between Clearstream participants through electronic book- entry changes in accounts of Clearstream participants, thereby eliminating the need for physical movement of certificates. Clearstream, Luxembourg provides to Clearstream participants, among other things, services for safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Clearstream, Luxembourg interfaces with domestic markets in several countries. As a professional depository, Clearstream, Luxembourg is subject to regulation by the Luxembourg Monetary Institute.

Clearstream participants are recognized financial institutions around the world, including underwriters, securities brokers and dealers, trust companies, clearing corporations and certain other organizations and may include the underwriters. Indirect access to Clearstream, Luxembourg is also available to others, such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a Clearstream participant either directly or indirectly.

Distributions with respect to the notes held beneficially through Clearstream, Luxembourg will be credited to cash accounts of Clearstream participants in accordance with its rules and procedures, to the extent received by the U.S. depositary for Clearstream, Luxembourg.

Euroclear advises that it was created in 1968 to hold securities for its participants, referred to as Euroclear participants, and to clear and settle transactions between Euroclear participants through simultaneous electronic book-entry delivery against payment, thereby eliminating the need for physical movement of certificates and any risk from lack of simultaneous transfers of securities and cash. Euroclear includes various other services, including securities lending and borrowing and interfaces with domestic markets in several countries. Euroclear is owned by Euroclear Clearance System Public Limited Company and operated through a license agreement by the Euroclear operator.

Euroclear participants include banks (including central banks), securities brokers and dealers and other professional financial intermediaries and may include the underwriters or agents for the notes. Indirect access to Euroclear is also available to others that clear through or maintain a custodial relationship with a Euroclear participant, either directly or indirectly.

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The Euroclear operator is regulated and examined by the Belgian Banking and Finance Commission and the National Bank of Belgium. Securities clearance accounts and cash accounts with the Euroclear operator are governed by the Terms and Conditions Governing Use of Euroclear and the related Operating Procedures of Euroclear, and applicable Belgian law, collectively referred to as the Terms and Conditions. The Terms and Conditions govern transfers of securities and cash within Euroclear, withdrawals of securities and cash from Euroclear, and receipts of payments with respect to securities in Euroclear. All securities in Euroclear are held on a fungible basis without attribution of specific certificates to specific securities clearance accounts. The Euroclear operator acts under the Terms and Conditions only on behalf of Euroclear participants, and has no record of or relationship with persons holding through Euroclear participants.

Distributions with respect to the notes held beneficially through Euroclear will be credited to the cash accounts of Euroclear participants in accordance with the Terms and Conditions, to the extent received by the U.S. depositary for Euroclear.

Global Clearance and Settlement Procedures

Initial settlement for the notes will be made in immediately available funds. Secondary market trading between DTC participants will occur in the ordinary way in accordance with DTC s rules and will be settled in immediately available funds using DTC s Same-Day Funds Settlement System. If and to the extent this prospectus supplement with respect to any of the notes indicates that investors may elect to hold interests in the notes through Clearstream, Luxembourg or Euroclear, secondary market trading between Clearstream participants and/or Euroclear participants will occur in the ordinary way in accordance with the applicable rules and operating procedures of Clearstream, Luxembourg and Euroclear and will be settled using the procedures applicable to conventional eurobonds in immediately available funds. No assurance can be given as to the effect, if any, of settlement in immediately available funds on trading activity in the notes.

Cross-market transfers between persons holding directly or indirectly through DTC, on the one hand, and directly or indirectly through Clearstream or Euroclear participants, on the other, will be effected in DTC in accordance with DTC rules on behalf of the relevant European international clearing system by its U.S. depositary; however, such cross-market transactions will require delivery of instructions to the relevant European international clearing system by the counterparty in such system in accordance with its rules and procedures and within its established deadlines (European time). The relevant European international clearing system will, if the transaction meets its settlement requirements, deliver instructions to its U.S. depositary to take action to effect final settlement on its behalf by delivering or receiving the notes in DTC, and making or receiving payment in accordance with normal procedures for same-day funds settlement applicable to DTC. Clearstream participants and Euroclear participants may not deliver instructions directly to DTC.

Because of time-zone differences, credits of the notes received in Clearstream, Luxembourg or Euroclear as a result of a transaction with a DTC participant will be made during subsequent securities settlement processing and will be credited the business day following the DTC settlement date. Such credits or any transactions in the notes settled during such processing will be reported to the relevant Euroclear or Clearstream participants on such business day. Cash received in Clearstream, Luxembourg or Euroclear as a result of sales of the notes by or through a Clearstream participant or a Euroclear participant to a DTC participant will be received with value on the DTC settlement date but will be available in the relevant Clearstream, Luxembourg or Euroclear cash account only as of the business day following settlement in DTC.

Although DTC, Clearstream, Luxembourg and Euroclear have agreed to the foregoing procedures in order to facilitate transfers of the notes among participants of DTC, Clearstream, Luxembourg and Euroclear, they are under no obligation to perform or continue to perform such procedures and such procedures may be discontinued at any time.

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MATERIAL U.S. FEDERAL INCOME TAX CONSEQUENCES

General

The following is a general summary of the material U.S. federal income tax consequences of the acquisition, ownership and disposition of the notes applicable to U.S. and non-U.S. beneficial owners who acquire such notes pursuant to this offering. This summary is based on the Internal Revenue Code of 1986, as amended, which we refer to as the Code, U.S. Treasury regulations promulgated thereunder, judicial opinions, published positions of the Internal Revenue Service (the IRS) and other applicable authorities, all of which are subject to change (possibly with retroactive effect).

This summary is for general information only and does not address all aspects of U.S. federal income taxation that may be relevant to a particular investor in light of that investor s individual circumstances, nor does it address the effects of any state, local or non-U.S. tax laws or any U.S. federal estate, gift, generation-skipping transfer or alternative minimum tax considerations. This discussion deals only with notes held as capital assets, within the meaning of Section 1221 of the Code, and does not purport to be applicable to holders subject to special rules, such as banks, financial institutions, insurance companies, tax-exempt entities, dealers in securities or currencies, traders in securities that elect the mark-to-market method of accounting for their securities holdings, persons subject to the alternative minimum tax, entities classified as partnerships, controlled foreign corporations or passive foreign investment companies for U.S. federal income tax purposes, pass-through entities, certain former citizens or long-term residents of the United States subject to tax as expatriates, persons holding the notes through a hybrid entity, or persons holding the notes as a hedge against currency risks, as a position in a straddle or as part of a wash sale, hedging, conversion, constructive sale, or integrated transaction for tax purposes.

If a partnership or an entity treated as a partnership for U.S. federal income tax purposes holds the notes, the tax treatment of a partner in the partnership or an equity interest owner of such other entity will generally depend upon the status of the person and the activities of the partnership or other entity treated as a partnership. Thus, persons who are partners in a partnership or equity interest owners of another entity treated as a partnership holding any of the notes should consult their own tax advisors. We have not sought any ruling from the IRS with respect to the statements made and the conclusions reached in this discussion and there can be no assurance that the IRS will agree with such statements and conclusions.

Under certain circumstances, we will be discharged from any and all obligations in respect of the indenture. Such discharge may be treated as a taxable exchange for U.S. federal income tax purposes. Holders should consult their own tax advisors regarding the U.S. federal, state, and local tax consequences of such a discharge.

THIS SUMMARY OF U.S. FEDERAL INCOME TAX ISSUES IS FOR GENERAL INFORMATION ONLY AND IS NOT INTENDED TO CONSTITUTE A COMPLETE DESCRIPTION OF ALL TAX CONSEQUENCES FOR U.S. AND NON-U.S. HOLDERS RELATING TO THE PURCHASE, OWNERSHIP AND DISPOSITION OF THE NOTES. PROSPECTIVE HOLDERS SHOULD CONSULT WITH THEIR TAX ADVISORS REGARDING THE TAX CONSEQUENCES TO THEM OF THE PURCHASE, OWNERSHIP AND DISPOSITION OF THE NOTES, INCLUDING THE APPLICATION AND EFFECT OF ANY STATE, LOCAL, FOREIGN INCOME, ESTATE AND OTHER TAX LAWS.

U.S. Holder of the Notes

As used in this discussion, the term U.S. holder means a holder that is a beneficial owner of a note that is, for U.S. federal income tax purposes:

- an individual who is a citizen or resident of the United States;

- a corporation (or any other entity treated as a corporation for U.S. federal income tax purposes) created or organized in or under the laws of the United States, any state thereof or the District of Columbia (and certain non-U.S. entities taxed as U.S. corporations under specialized sections of the Code);

- an estate, the income of which is subject to U.S. federal income taxation regardless of its source; or

- a trust, if it (1) is subject to the primary supervision of a court within the United States and one or more U.S. persons have authority to control all substantial decisions of the trust or (2) has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

Interest on the Notes. It is expected, and this discussion assumes, that the notes will be issued with no more than a de minimis amount of original issue discount for U.S. federal tax purposes. Accordingly, a U.S. holder will generally be required to recognize as ordinary income any interest paid or accrued on the notes in accordance with its regular method of accounting for U.S. federal income tax purposes.

In certain circumstances, we may pay amounts on the notes that are in excess of the stated interest on or principal of the notes. We intend to take the position that the possibility that any such payment will be made is deemed not to occur under applicable U.S. Treasury regulations. Therefore, such possibility will not affect the timing or amount of interest income that you recognize, as discussed above, unless and until any such excess payment is made. If we do pay amounts on the notes that are in excess of the stated interest on or principal of the notes, you should consult your own tax advisor about the tax treatment of such amounts.

Disposition of Notes. Upon the sale, exchange, redemption, retirement or other disposition of a note, a U.S. holder generally will recognize taxable gain or loss equal to the difference between the amount realized on the sale, exchange, redemption, retirement or other disposition (except to the extent of accrued but unpaid interest, which will be taxable as ordinary income) and such holder s adjusted tax basis in the notes. Any such gain or loss will be capital gain or loss, and will be long-term capital gain or loss if a U.S. holder has held the note for more than one year. Long-term capital gains of noncorporate U.S. holders are generally subject to tax at preferential rates. In addition, for taxable years beginning after December 31, 2012, a 3.8% Medicare tax will be imposed on interest income and capital gains (other than on property held in a trade or business) realized by certain noncorporate taxpayers whose income exceeds certain thresholds. The deductibility of capital losses is subject to limitations.

Information Reporting and Backup Withholding. Information reporting requirements generally apply in connection with payments on the notes to, and the proceeds from a sale, exchange or other disposition of the notes by, noncorporate U.S. holders. Under the Code and applicable U.S. Treasury regulations, a U.S. holder may be subject to backup withholding (currently at a rate of 28%) with respect to any payments on the notes, or the proceeds of a sale, exchange or other disposition of the notes, unless such U.S. holder (a) comes within certain exempt categories and, when required, demonstrates this fact in the manner required, or (b) within a reasonable period of time, provides a correct taxpayer identification number, certifies that it is not subject to backup withholding and otherwise complies with applicable requirements of the backup withholding rules. The amount of any backup withholding from a payment to a U.S. holder will generally be allowed as a credit against such U.S. holder s U.S. federal income tax liability and may entitle such U.S. holder to a refund, provided that the required information is timely furnished to the IRS.

Non-U.S. Holder of the Notes

As used in this discussion, the term non-U.S. holder means a beneficial owner of a note that is not, for U.S. federal income tax purposes, a U.S. holder as defined above, other than an entity or arrangement that is treated as a partnership for U.S. federal income tax purposes.

Interest on the Notes. Subject to the discussion of backup withholding below, U.S. federal withholding tax will not apply to any payment of interest on a note to a non-U.S. holder if the interest qualifies for the portfolio interest exemption. This will be the case provided that the non-U.S. holder:

- does not actually or constructively own 10% or more of the total combined voting power of all classes of our stock entitled to vote;
- is not a controlled foreign corporation that is related directly or constructively to us through stock ownership;
- is not a bank that acquired the notes in consideration for an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business; and
- either (a) provides its name and address, and certifies, under penalties of perjury, that it is not a U.S. person, which certification may be made on an IRS Form W-8BEN or other appropriate form, or (b) holds its notes through various foreign intermediaries and satisfies the certification requirements of applicable U.S. Treasury regulations.

Special certification and other rules apply to certain non-U.S. holders that are entities rather than individuals, particularly entities treated as partnerships for U.S. federal income tax purposes and certain other flow through entities, and to non-U.S. holders acting as (or holding notes through) intermediaries.

If the portfolio interest exemption does not apply, payments of interest will be subject to U.S. federal withholding tax at a 30% tax rate, unless the non-U.S. holder provides us with a properly executed: (1) IRS Form W-8BEN, or successor form, claiming an exemption from or reduction in withholding under the benefit of a tax treaty or (2) IRS Form W-8ECI, or successor form, stating that interest paid on the note is not subject to withholding tax because it is effectively connected with its conduct of a trade or business in the United States.

If a non-U.S. holder is engaged in a trade or business in the United States and interest on a note is effectively connected with the conduct of that trade or business (and, if an income tax treaty applies, is attributable to a U.S. permanent establishment maintained by the non-U.S. holder), such holder (although exempt from U.S. federal withholding tax at the 30% tax rate) will be subject to U.S. federal income tax on that interest on a net income basis in the same manner as if the holder were a U.S. holder. In addition, if such holder is a foreign corporation, it may be subject to a branch profits tax equal to 30% of its dividend equivalent amount, as determined under the Code, for the taxable year. However, any branch profits tax that would otherwise apply may not apply, or may apply at a reduced rate, under an applicable income tax treaty.

Disposition of Notes. Subject to the discussion of backup withholding below, any gain realized on the disposition of a note by a non-U.S. holder generally will not be subject to U.S. federal income tax unless: (i) that gain is effectively connected with the conduct of a trade or business in the United States by the holder (and, if an income tax treaty applies, is attributable to a U.S. permanent establishment maintained by the non-U.S. holder), or (ii) the holder is an individual who is present in the United States for 183 days or more in the taxable year of that disposition and other conditions are met in which case such holder will generally be subject to a U.S. federal income tax of 30% (or, if applicable, a lower treaty rate) on such gain. If (i) applies and the non-U.S. holder is a corporation, such holder may be subject to the branch profits tax referred to above, unless the holder qualifies for a lower rate or an exemption from such branch profits tax under an applicable income tax treaty.

Backup Withholding, Information Reporting and Other Reporting Requirements. In general, backup withholding will not apply to a payment of interest on a note to a non-U.S. holder, or to proceeds from the disposition of a note by a non-U.S. holder, in each case, if the holder certifies under penalties of perjury that it is a non-U.S. holder and neither we nor our paying agent has actual knowledge to the contrary. Any amounts withheld under the backup withholding rules will be allowed as a credit against the non-U.S. holder s U.S. federal income tax liability and may entitle the non-U.S. holder to a refund, provided the required information is timely furnished to the IRS.

Information reporting and backup withholding generally are not required with respect to the amount of any proceeds from the sale or other disposition of our notes by a non-U.S. holder outside the United States through a foreign office of a foreign broker that does not have certain specified connections to the United States unless the proceeds are transferred to an account maintained by the holder in the United States, the payment of proceeds or the confirmation of the sale is mailed to the holder at a United States address or the sale has some other specified connection to the United States. However, if a non-U.S. holder sells or otherwise disposes of our notes through a U.S. broker or the U.S. offices of a foreign broker, the broker will generally be required to report the amount of proceeds paid to the non-U.S. holder to the IRS and also to backup withhold on that amount unless such non-U.S. holder provides appropriate certification to the broker of its status as a non-U.S. person or otherwise establishes an exemption (and the payor does not have actual knowledge or reason to know that such holder is a U.S. person as defined under the Code). Information reporting will also apply if a non-U.S. holder sells our notes through a foreign broker which derives more than a specified percentage of its income from U.S. sources or having certain other connections to the United States, unless such broker has documentary evidence in its records that such non-U.S. holder is a non-U.S. person and certain other conditions are met, or such non-U.S. holder otherwise establishes an exemption (and the payor does not have actual knowledge or reason to know that such holder is a U.S. person as defined under the Code).

Backup withholding is not an additional income tax. Any amounts withheld under the backup withholding rules from a payment to a non-U.S. holder generally can be credited against the non-U.S. holder s U.S. federal income tax liability, if any, or refunded, provided that the required information is furnished to the IRS in a timely manner. Non-U.S. holders should consult their tax advisors regarding the application of the information reporting and backup withholding rules to them.

THE FOREGOING SUMMARY DOES NOT DISCUSS ALL ASPECTS OF U.S. FEDERAL INCOME TAXATION THAT MAY BE RELEVANT TO INVESTORS IN LIGHT OF THEIR PARTICULAR CIRCUMSTANCES AND INCOME TAX SITUATION. INVESTORS SHOULD CONSULT THEIR OWN TAX ADVISORS AS TO THE SPECIFIC TAX CONSEQUENCES THAT WOULD RESULT FROM THEIR PURCHASE, OWNERSHIP AND DISPOSITION OF THE NOTES, INCLUDING THE APPLICATION AND EFFECT OF STATE, LOCAL AND OTHER TAX LAWS AND THE POSSIBLE EFFECTS OF CHANGES IN FEDERAL OR OTHER TAX LAWS.

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CERTAIN ERISA CONSIDERATIONS

Each person considering the use of plan assets of a pension, profit-sharing or other employee benefit plan, individual retirement account, Keogh plan or other retirement plan, account or arrangement, or a plan, to acquire or hold the notes should consider whether an investment in the notes would be consistent with the documents and instruments governing the plan and with its fiduciary duties, including satisfaction of applicable prudence and diversification requirements, and whether the investment would involve a prohibited transaction under Section 406 of the Employee Retirement Income Security Act of 1974, as amended (ERISA) or Section 4975 of the Code, or under any other applicable federal, state, local or non-U.S. or other laws, rules or regulations that are similar to the provisions of ERISA or Section 4975 of the Code, or Similar Laws.

Section 406 of ERISA and Section 4975 of the Code prohibit plans subject to Title I of ERISA and/or Section 4975 of the Code, including entities such as collective investment funds, partnerships and separate accounts or insurance company pooled separate accounts or insurance company general accounts whose underlying assets include the assets of such plans, or collectively, Plans, from engaging in certain transactions involving Plan assets with persons who are parties in interest under ERISA or disqualified persons under the Code with respect to the Plan. A violation of these prohibited transaction rules may result in civil penalties or other liabilities under ERISA, loss of tax-exempt status and/or an excise tax under Section 4975 of the Code for those persons, unless exemptive relief is available under an applicable statutory, regulatory or administrative exemption. Certain plans including those that are governmental plans (as defined in Section 3(32) of ERISA), certain church plans (as defined in Section 3(33) of ERISA) and foreign plans (as described in Section 4(b)(4) of ERISA) are not subject to the requirements of ERISA or Section 4975 of the Code, but may be subject to similar provisions under Similar Laws.

The acquisition or holding of the notes by or on behalf of a Plan with respect to which we or certain of our affiliates are or become a party in interest or a disqualified person may constitute or result in prohibited transactions under ERISA or Section 4975 of the Code, unless the notes are acquired or held pursuant to and in accordance with an applicable exemption.

Certain prohibited transaction class exemptions (PTCEs) issued by the U.S. Department of Labor may provide exemptive relief for direct or indirect prohibited transactions resulting from the purchase or holding of the notes. Those class exemptions are PTCE 96-23 (for certain transactions determined by in-house asset managers), PTCE 95-60 (for certain transactions involving insurance company general accounts), PTCE 91-38 (for certain transactions involving bank collective investment funds), PTCE 90-1 (for certain transactions involving insurance company separate accounts) and PTCE 84-14 (for certain transactions determined by independent qualified asset managers). In addition, ERISA Section 408(b)(17) and Section 4975(d)(20) of the Code may provide a limited exemption for the purchase and sale of the notes and related lending transactions, provided that neither the issuer of the notes nor any of its affiliates have or exercise any discretionary authority or control or render any investment advice with respect to the assets of the Plan involved in the transaction and provided further that the Plan pays no more, and receives no less, than adequate consideration in connection with the transaction (the so-called service provider exemption). There can be no assurance that any of these statutory or class exemptions will be available with respect to transactions involving the notes.

Accordingly, the notes may not be purchased or held by
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(18

)

(5

)

Comprehensive loss

$

(8,213

)

$

(1,443

)

$

(13,138

)

$

(6,902

)

Net loss per share:

Basic

$

(0.26

)

$

(0.05

)

$

(0.41

)

$

(0.20

)

Diluted

$

(0.26

)

$

(0.05

)

$

(0.41

)

$

(0.20

)

Weighted average common shares outstanding:

Basic

35,649

35,351

35,628

35,331

Diluted

35,649

35,351

35,628

35,331

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

SEACHANGE INTERNATIONAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, amounts in thousands)

	Six Months Ended July 31, 2018	2017
Cash flows from operating activities:		
Net loss	$(14,551)	$(6,900)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization of property and equipment	737	1,198
Amortization of intangible assets	815	1,214
Stock-based compensation expense	1,802	1,530
Deferred income taxes	(758)	79
Other	76	8
Changes in operating assets and liabilities:		
Accounts receivable	10,115	4,358
Unbilled receivables	(2,335)	2,558
Inventories	(165)	57
Prepaid expenses and other assets	(1,584)	8
Accounts payable	371	(2,594)
Accrued expenses	(10,640)	(3,193)
Deferred revenues	(5,729)	(870)
Other operating activities	2,430	230
Total cash used in operating activities	(19,416)	(2,317)
Cash flows from investing activities:		
Purchases of property and equipment	(284)	(274)
Purchases of marketable securities	(4,354)	(4,501)
Proceeds from sale and maturity of marketable securities	2,761	4,449
Other investing activities	(60)	287
Total cash used in investing activities	(1,937)	(39)
Cash flows from financing activities:		
Proceeds from issuance of common stock	73	26
Payments of withholding tax on RSU vesting	(34)	(36)
Total cash provided by (used in) financing activities	39	(10)
Effect of exchange rate changes on cash, cash equivalents and restricted cash	2,593	(742)
Net decrease in cash, cash equivalents and restricted cash	(18,721)	(3,108)
Cash, cash equivalents and restricted cash, beginning of period	43,661	28,411
Cash, cash equivalents and restricted cash, end of period	$24,940	$25,303
Supplemental disclosure of cash flow information:		
Income taxes paid	$2,735	$183

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

SEACHANGE INTERNATIONAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Nature of Business and Basis of Presentation
The Company

SeaChange International, Inc. and its consolidated subsidiaries (collectively “SeaChange”, “we”, or the “Company”) is an industry leader in the delivery of multiscreen video, advertising and premium over-the-top (“OTT”) video management solutions. Our products and services are designed to empower video providers to create, manage and monetize the increasingly personalized, highly engaging experiences that viewers demand.

Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of SeaChange International, Inc. and its subsidiaries (“SeaChange” or the “Company”) and are prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial reports as well as rules and regulations of the Securities and Exchange Commission (“SEC”). All intercompany transactions and balances have been eliminated. Certain information and footnote disclosures normally included in financial statements prepared under U.S. GAAP have been condensed or omitted pursuant to such regulations. However, we believe that the disclosures are adequate to make the information presented not misleading. In the opinion of management, the accompanying financial statements include all adjustments, consisting of only normal recurring items, necessary to present a fair presentation of the consolidated financial statements for the periods shown. These consolidated financial statements should be read in conjunction with our most recently audited financial statements and related footnotes included in our Annual Report on Form 10-K (“Form 10-K”) as filed with the SEC. The balance sheet data as of January 31, 2018 that is included in this Quarterly Report on Form 10-Q (“Form 10-Q”) was derived from our audited financial statements. Certain prior period amounts have been reclassified to conform to current period presentation.

The preparation of these financial statements in conformity with U.S. GAAP, 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. Interim results are not necessarily indicative of the operating results for the full fiscal year or any future periods and actual results may differ from our estimates. During the three months ended July 31, 2018, there have been no material changes to our significant accounting policies that were described in our fiscal 2018 Form 10-K, as filed with the SEC. As noted in our Form 10-Q for the quarterly period ended April 30, 2018, in the three months ended April 30, 2018, our policy for revenue recognition was updated as a result of adopting the new revenue recognition guidance.

2. Significant Accounting Policies
Cash, cash equivalents and restricted cash

Cash and cash equivalents include cash on hand and on deposit and highly liquid investments in money market mutual funds, government sponsored enterprise obligations, treasury bills, commercial paper and other money market securities with remaining maturities at date of purchase of 90 days or less. All cash equivalents are carried at cost, which approximates fair value. Restricted cash represents cash that is restricted as to withdrawal or usage and consists primarily of cash held as collateral for performance obligations with our customers.

The following table provides a summary of cash, cash equivalents and restricted cash that constitutes the total amounts shown in the consolidated statements of cash flows for the six months ended July 31, 2018 and 2017:

	Six Months Ended July 31,	
	2018	2017
	(Amounts in thousands)	
Cash and cash equivalents	$24,393	$25,295
Restricted cash	547	8
Total cash, cash equivalents, and restricted cash	$24,940	$25,303

Revenue Recognition

The Company adopted Accounting Standards Codification No. (“ASC”) 606, “Revenue from Contracts with Customers,” on February 1, 2018 using the modified retrospective method for all contracts not completed as of the date of adoption. The adoption of ASC 606 did not have a material impact on the Company’s consolidated financial statements. The reported results for fiscal

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2019 reflect the application of ASC 606 guidance while the reported results for fiscal 2018 were prepared under the guidance of ASC 605, "Revenue Recognition," which is also referred to herein as "legacy U.S. GAAP" or the "previous guidance." The adoption of ASC 606 represents a change in accounting principle that will more closely align revenue recognition with the delivery of the Company's goods and services and will provide financial statement readers with enhanced disclosures. In accordance with ASC 606, revenue is recognized when a customer obtains control of promised goods or services. The amount of revenue recognized reflects the consideration to which the Company expects to be entitled to receive in exchange for these goods or services, and excludes any sales incentives or taxes collected from a customer which are subsequently remitted to government authorities. To achieve this core principle, the Company applies the following five steps:

1) Identify the contract(s) with a customer - A contract with a customer exists when (i) the Company enters into an enforceable contract with a customer that defines each party's rights regarding the goods or services to be transferred and identifies the payment terms related to those goods or services, (ii) the contract has commercial substance and, (iii) the Company determines that collection of substantially all consideration for goods or services that are transferred is probable based on the customer's intent and ability to pay the promised consideration.

2) Identify the performance obligations in the contract - Performance obligations promised in a contract are identified based on the goods or services that will be transferred to the customer that are both capable of being distinct, whereby the customer can benefit from the good or service either on its own or together with other resources that are readily available from third parties or from the Company, and are distinct in the context of the contract, whereby the transfer of the goods or services is separately identifiable from other promises in the contract. To the extent a contract includes multiple promised goods or services, the Company must apply judgment to determine whether promised goods or services are capable of being distinct and distinct in the context of the contract. If these criteria are not met the promised goods or services are accounted for as a combined performance obligation.

3) Determine the transaction price - The transaction price is determined based on the consideration to which the Company will be entitled in exchange for transferring goods or services to the customer. To the extent the transaction price includes variable consideration, the Company estimates the amount of variable consideration that should be included in the transaction price utilizing either the expected value method or the most likely amount method depending on the nature of the variable consideration. Variable consideration is included in the transaction price if, in the Company's judgment, it is probable that a significant future reversal of cumulative revenue under the contract will not occur. Determining the transaction price requires significant judgment, which is discussed by revenue category in further detail below.

4) Allocate the transaction price to the performance obligations in the contract - If the contract contains a single performance obligation, the entire transaction price is allocated to the single performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative standalone selling price basis unless the transaction price is variable and meets the criteria to be allocated entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation. The Company determines standalone selling price based on the price at which the performance obligation is sold separately. If the standalone selling price is not observable through past transactions, the Company estimates the standalone selling price taking into account available information such as market conditions and internally approved pricing guidelines related to the performance obligations.

5) Recognize revenue when (or as) the Company satisfies a performance obligation - The Company satisfies performance obligations either over time or at a point in time as discussed in further detail below. Revenue is recognized at the time the related performance obligation is satisfied by transferring a promised good or service to a customer.

The Company's revenue is derived from sales of hardware, software licenses, professional services, and maintenance fees related to the hardware and the Company's software licenses.

Contracts with multiple performance obligations

The Company's contracts often contain multiple performance obligations. For contracts with multiple performance obligations, the Company accounts for individual performance obligations separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative stand-alone selling price basis. If the transaction price contains discounts or the Company expects to provide future price concessions, these elements are considered when determining the transaction price prior to allocation. Variable fees within the transaction price will be estimated and recognized in revenue as the Company satisfies its performance obligations to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable fee is resolved. If the contract grants the client the option to acquire additional products or services, the Company assesses whether or not any discount on the products and services is in excess of levels normally available to similar clients and, if so, accounts for that discount as an additional performance obligation.

Hardware

The Company has concluded that hardware is either (1) a distinct performance obligation as the client can benefit from the product on its own or (2) a combined performance obligation with software licenses. This conclusion is dependent on the nature of the promise to the customer. In either scenario, hardware revenue is typically recognized at a point in time when control is transferred to the client, which is defined as the point in time when the client can use and benefit from the hardware. In situations where the hardware is distinct, it is delivered before services are provided and is functional without services, therefore the point in time when control is transferred is upon delivery or acceptance by the customer. When hardware and software are combined, the Company has determined stand-alone selling price for hardware utilizing the relative allocation method based on observable evidence.

Software licenses

The Company has concluded that its software licenses are either (1) a distinct performance obligation as the client can benefit from the software on its own or (2) a combined performance obligation with hardware, depending on the nature of the promise to the customer. In either scenario software license revenue is typically recognized at a point in time when control is transferred to the client, which is defined as the point in time when the client can use and benefit from the license. The software license is delivered before related services are provided and is functional without services, updates, and technical support. The Company's license arrangements generally contain multiple performance obligations, including hardware, installation services, training, and maintenance. The Company has determined stand-alone selling price for software utilizing the relative allocation method based on observable evidence.

Maintenance

Maintenance revenue, which is included in services revenue in our consolidated statements of operations and comprehensive loss, includes revenue from client support and related professional services. Client support includes software upgrades on a when and-if available basis, telephone support, bug fixes or patches, and general hardware maintenance support. Maintenance is priced as a percentage of the list price of the related software license and hardware. The Company determined the standalone selling price of maintenance based on this pricing relationship and observable data from standalone sales of maintenance.

The Company has identified three separate distinct performance obligations of maintenance:

- Software upgrades and updates;
- Technical support; and
- Hardware support.

These performance obligations are distinct within the contract and, although they are not sold separately, the components are not essential to the functionality of the other components. Each of the performance obligations included in maintenance revenue is a stand ready obligation that is recognized ratably over the passage of the contractual term, which is typically one year.

Services

The Company's services revenue is comprised of software license implementation services, engineering services, training and reimbursable expenses. The Company has concluded that services are distinct performance obligations, with the exception of engineering services. Engineering services may be provided on a stand-alone basis, or bundled with a license, when the Company is providing custom development.

The stand-alone selling price for services in time and materials contracts is determined by observable prices in stand-alone services arrangements and recognized as revenue as the services are performed based on an input measure of hours incurred to total estimated hours.

The Company estimates the stand-alone selling price for fixed price services based on estimated hours adjusted for historical experience, at time and material rates charged in stand-alone services arrangements. Revenue for fixed price services is recognized over time as the services are provided based on an input measure of hours incurred to total estimated hours.

Contract modifications

The Company occasionally enters into amendments to previously executed contracts that constitute contract modifications. The Company assesses each of these contract modifications to determine:

- If the additional products and services are distinct from the product and services in the original arrangement, and

- If the amount of consideration expected for the added products and services reflects the stand-alone selling price of those products and services.

A contract modification meeting both criteria is accounted for as a separate contract. A contract modification not meeting both criteria is considered a change to the original contract and is accounted for on either a prospective basis as a termination of the existing contract and the creation of a new contract, or a cumulative catch-up basis.

Impairment of Assets

Indefinite-lived intangible assets, such as goodwill, are not amortized but are evaluated for impairment at the reporting unit level annually, in our third quarter beginning August 1st. Indefinite-lived intangible assets may be tested for impairment on an interim basis in addition to the annual evaluation if an event occurs or circumstances change such as declines in sales, earnings or cash flows, decline in the Company's stock price, or material adverse changes in the business climate, which would more likely than not reduce the fair value of a reporting unit below its carrying amount.

We also evaluate other long-lived assets such as property and equipment and intangible assets with finite useful lives, on a regular basis for the existence of facts or circumstances, both internal and external that may suggest an asset is not recoverable. If such circumstances exist, we evaluate the carrying value of long-lived assets to determine if impairment exists based upon estimated undiscounted future cash flows over the remaining useful life of the assets and compares that value to the carrying value of the assets. Our cash flow estimates contain management's best estimates, using appropriate and customary assumptions and projections at the time.

In the second quarter of fiscal 2019, we determined there to be a triggering event that prompted us to test our goodwill for impairment as of July 31, 2018. As a result of the quantitative goodwill impairment test performed as of July 31, 2018, the Company determined that the fair value of the reporting unit exceeded its carrying value. Therefore, no impairment charges on our goodwill or other long-lived assets were recorded in the second quarter of fiscal 2019. See Note 5, "Goodwill and Intangible Assets," for more information.

Liquidity

We continue to realize savings related to our previous restructuring activities. These measures are important steps in restoring SeaChange to profitability and positive cash flow. The Company believes that existing funds and cash expected to be provided by future operating activities are adequate to satisfy our working capital, capital expenditure requirements and other contractual obligations for the foreseeable future, including at least the next 12 months.

3. Fair Value Measurements
Definition and Hierarchy

The applicable accounting guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The guidance establishes a framework for measuring fair value and expands required disclosure about the fair value measurements of assets and liabilities. This guidance requires us to classify and disclose assets and liabilities measured at fair value on a recurring basis, as well as fair value measurements of assets and liabilities measured on a non-recurring basis in periods subsequent to initial measurement, in a fair value hierarchy.

The fair value hierarchy is broken down into three levels based on the reliability of inputs and requires an entity to maximize the use of observable inputs, where available. The following summarizes the three levels of inputs required, as well as the assets and liabilities that we value using those levels of inputs:

- Level 1 – Observable inputs that reflect quoted prices for identical assets or liabilities in active markets.

- Level 2 – Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not very active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Valuation Techniques

Inputs to valuation techniques are observable and unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions. When developing fair value estimates for certain financial assets and liabilities, we maximize the use of observable inputs and minimize the use of unobservable inputs. When available, we use quoted market prices, market comparables and discounted cash flow projections. Financial assets include money market funds, U.S. treasury notes or bonds, U.S. government agency bonds and corporate bonds.

In general, and where applicable, we use quoted prices in active markets for identical assets or liabilities to determine fair value. If quoted prices in active markets for identical assets or liabilities are not available to determine fair value, then we use quoted prices for similar assets and liabilities or inputs that are observable either directly or indirectly. In periods of market inactivity, the observability of prices and inputs may be reduced for certain instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or from Level 2 to Level 3.

Assets and Liabilities that are Measured at Fair Value on a Recurring Basis

The following tables set forth our financial assets and liabilities that were accounted for at fair value on a recurring basis as of July 31, 2018 and January 31, 2018. There were no fair value measurements of our financial assets and liabilities using significant Level 3 inputs for the periods presented:

	July 31, 2018	Fair Value at July 31, 2018 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
	(Amounts in thousands)		
Financial assets:			
Money market accounts [1]	$3,056	$2,649	$ 407
Available-for-sale marketable securities:			
Current marketable securities:			
U.S. treasury notes and bonds - conventional	1,992	1,992	—
Non-current marketable securities:			
U.S. treasury notes and bonds - conventional	4,758	4,758	—
U.S. government agency issues	985	—	985
Corporate bonds	2,283	—	2,283
Total	$13,074	$9,399	$ 3,675

	January 31, 2018	Fair Value at January 31, 2018 Using Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)

		(Level 1)	
	(Amounts in thousands)		
Financial assets:			
Money market accounts [1]	$4,568	$—	$ 4,568
Available-for-sale marketable securities:			
Current marketable securities:			
U.S. treasury notes and bonds - conventional	1,993	1,993	—
U.S. government agency issues	1,998	—	1,998
Non-current marketable securities:			
U.S. treasury notes and bonds - conventional	1,724	1,724	—
U.S. government agency issues	985	—	985
Corporate bonds	1,740	—	1,740
Total	$13,008	$3,717	$ 9,291

(1) Money market funds and U.S. treasury bills are included in cash and cash equivalents on the accompanying consolidated balance sheets and are valued at quoted market prices for identical instruments in active markets.

Assets and Liabilities that are Measured at Fair Value on a Nonrecurring Basis

Assets and liabilities that are measured at fair value on a nonrecurring basis relate primarily to our tangible property and equipment, goodwill, and other intangible assets, which are re-measured when the derived fair value is below carrying value on our consolidated balance sheets. For these assets and liabilities, we do not periodically adjust carrying value to fair value except in the event of impairment. If we determine that impairment has occurred, the carrying value of the asset is reduced to fair value and

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the difference is recorded to loss from impairment of long-lived assets in our consolidated statements of operations and comprehensive loss.

In the second quarter of fiscal 2019, we determined there to be a triggering event that prompted us to test our goodwill for impairment as of July 31, 2018. The triggering event was a decline in actual revenue for the quarter compared to projected amounts, which was reported in a Current Report on Form 8-K furnished to the SEC on August 21, 2018. The Company performed a quantitative goodwill impairment test, utilizing the single-step approach under ASU 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test of Goodwill Impairment," comparing the carrying value of the reporting unit to its estimated fair value, which was calculated using the income approach. As a result of the quantitative goodwill impairment test performed as of July 31, 2018, the Company determined that the fair value of the reporting unit exceeded its carrying value. Therefore, no impairment charges on our goodwill or other long-lived assets were recorded in the second quarter of fiscal 2019. See Note 5, "Goodwill and Intangible Assets," for more information.

Available-For-Sale Securities

We determine the appropriate classification of debt investment securities at the time of purchase and reevaluate such designation as of each balance sheet date. Our investment portfolio consists of money market funds, U.S. treasury notes and bonds, U.S. government agency notes and bonds and corporate bonds as of July 31, 2018 and January 31, 2018. All highly liquid investments with an original maturity of three months or less when purchased are considered to be cash equivalents. All cash equivalents are carried at cost, which approximates fair value. Our marketable securities are classified as available-for-sale and are reported at fair value with unrealized gains and losses, net of tax, reported in stockholders' equity as a component of accumulated other comprehensive loss. The amortization of premiums and accretion of discounts to maturity are computed under the effective interest method and are included in other (expenses) income, net, in our consolidated statements of operations and comprehensive loss. Interest on securities is recorded as earned and is also included in other (expenses) income, net. Any realized gains or losses would be shown in the accompanying consolidated statements of operations and comprehensive loss in other (expenses) income, net. We provide fair value measurement disclosures of available-for-sale securities in accordance with one of the three levels of fair value measurement mentioned above.

The following is a summary of cash, cash equivalents and available-for-sale securities, including the cost basis, aggregate fair value and gross unrealized gains and losses, for short- and long-term marketable securities portfolio as of July 31, 2018 and January 31, 2018:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(Amounts in thousands)			
July 31, 2018:				
Cash	$21,337	$ —	$ —	$ 21,337
Cash equivalents	3,045	11	—	3,056
Cash and cash equivalents	24,382	11	—	24,393
U.S. treasury notes and bonds - short-term	1,999	—	(7)	1,992

U.S. treasury notes and bonds - long-term	4,788	—	(30)	4,758
U.S. government agency issues - long-term	1,001	—	(16)	985
Corporate bonds - long-term	2,313	—	(30)	2,283
Total cash, cash equivalents and marketable securities	$34,483	$ 11	$ (83)	$ 34,411
January 31, 2018:				
Cash	$39,084	$ —	$ —	$ 39,084
Cash equivalents	4,568	—	—	4,568
Cash and cash equivalents	43,652	—	—	43,652
U.S. treasury notes and bonds - short-term	2,001	—	(8)	1,993
U.S. treasury notes and bonds - long-term	1,740	—	(16)	1,724
U.S. government agency issues - short-term	1,991	9	(2)	1,998
U.S. government agency issues - long-term	1,002	—	(17)	985
Corporate bonds - long-term	1,760		(20)	1,740
Total cash, cash equivalents and marketable securities	$52,146	$ 9	$ (63)	$ 52,092

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The gross realized gains and losses on sale of available-for-sale securities as of July 31, 2018 and January 31, 2018 were immaterial. For purposes of determining gross realized gains and losses, the cost of securities is based on specific identification.

Contractual maturities of available-for-sale investments as of July 31, 2018 are as follows (amounts in thousands):

	Estimated Fair Value
Maturity of one year or less	$ 1,992
Maturity between one and five years	8,026
Total	$ 10,018

Cash, Cash Equivalents and Marketable Securities

Cash and cash equivalents consist primarily of highly liquid investments in money market mutual funds, government sponsored enterprise obligations, treasury bills, commercial paper and other money market securities with remaining maturities at date of purchase of 90 days or less.

The fair value of cash, cash equivalents, restricted cash and marketable securities at July 31, 2018 and January 31, 2018 was $35.0 million and $52.1 million, respectively.

Restricted Cash

At times, we may be required to maintain cash held as collateral for performance obligations with our customers which we classify as restricted cash on our consolidated balance sheets. Restricted cash was $0.5 million as of July 31, 2018 and was not material as of January 31, 2018.

4. Consolidated Balance Sheet Detail
Inventories, net

Inventories consist primarily of hardware and related component parts and are stated at the lower of cost (on a first-in, first-out basis) or market. Inventories consist of the following:

	As of July 31, 2018	January 31, 2018
	(Amounts in thousands)	
Components and assemblies	$ 579	$ 426
Finished products	197	240

Total inventories, net	$776	$ 666

Property and equipment, net

Property and equipment, net consists of the following:

	Estimated Useful Life (Years)	As of July 31, 2018	January 31, 2018
		(Amounts in thousands)	
Land		$2,780	$2,780
Buildings	20	11,861	11,839
Office furniture and equipment	5	748	774
Computer equipment, software and demonstration equipment	3	12,472	12,770
Service and spare components	5	1,158	1,158
Leasehold improvements	1-7	505	537
		29,524	29,858
Less - Accumulated depreciation and amortization		(20,570)	(20,387)
Total property and equipment, net		$8,954	$9,471

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Depreciation and amortization expense on property and equipment, net was $0.4 million and $0.7 million for the three and six months ended July 31, 2018 and $0.6 million and $1.2 million for the three and six months ended July 31, 2017.

Other accrued expenses

Other accrued expenses consist of the following:

	As of July 31, 2018	January 31, 2018
	(Amounts in thousands)	
Accrued compensation and commissions	$749	$1,414
Accrued bonuses	759	2,715
Employee benefits	330	601
Sales tax and VAT payable	253	4,001
Income taxes payable	162	2,869
Accrued other	2,114	3,779
Total other accrued expenses	$4,367	$15,379

5. Goodwill and Intangible Assets

Goodwill

Goodwill represents the difference between the purchase price and the estimated fair value of identifiable assets acquired and liabilities assumed. We are required to perform impairment tests related to our goodwill annually, which we perform during the third quarter of each fiscal year, or when we identify certain triggering events or circumstances that would more likely than not reduce the estimated fair value of the goodwill of the Company below its carrying amount.. The following table represents the changes in the carrying amount of goodwill for the six months ended July 31, 2018 (amounts in thousands):

Balance as of January 31, 2017:	
Goodwill, gross	$62,566
Accumulated impairment losses	(39,279)
Goodwill, net	23,287
Cumulative translation adjustment	2,292
Balance as of January 31, 2018:	
Goodwill, gross	64,858
Accumulated impairment losses	(39,279)

Goodwill, net	25,579
Cumulative translation adjustment	(970)
Balance as of July 31, 2018:	
Goodwill, gross	63,888
Accumulated impairment losses	(39,279)
Goodwill, net	$24,609

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In the second quarter of fiscal 2019, we determined there to be a triggering event that prompted us to test our goodwill for impairment as of July 31, 2018. The triggering event was a decline in actual revenue for the quarter compared to projected amounts, which was reported in a Current Report on Form 8-K furnished to the SEC on August 21, 2018. The Company performed a quantitative goodwill impairment test, utilizing the single-step approach under ASU 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test of Goodwill Impairment," comparing the carrying value of the reporting unit to its estimated fair value, which was calculated using a discounted cash flow analysis, a form of income approach. We considered three generally accepted approaches for valuing businesses: the market approach, the income approach and the asset-based (cost) approach to arrive at fair value. The discounted cash flow analysis relied on certain assumptions regarding future net free cash flows based on industry market data, historical performance and expected future performance. Future net free cash flows were discounted to present value using a risk-adjusted discount rate, which reflects the Weighted Average Cost of Capital ("WACC"). The WACC was developed using information from same or similar industry participants and publicly available market data. As a result of the quantitative goodwill impairment test performed as of July 31, 2018, the Company determined that the estimated fair value of the reporting unit exceeded its carrying value, including goodwill, by 28.7%. Therefore, no impairment charges on our goodwill or other long-lived assets were recorded in the second quarter of fiscal 2019.

Intangible Assets

Intangible assets, net, consisted of the following at July 31, 2018 and January 31, 2018:

	As of July 31, 2018				As of January 31, 2018		
	Weighted average remaining life (Years)	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
	(Amounts in thousands)						
Finite-life intangible assets:							
Customer contracts	1.8	$18,263	$ (17,679)	$584	$30,818	$ (29,836)	$982
Non-compete agreements	—	2,530	(2,530)	—	2,639	(2,635)	4
Completed technology	1.8	9,867	(9,717)	150	11,479	(11,203)	276
Trademarks, patents and other	6.6	7,022	(6,932)	90	7,189	(7,148)	41
Total finite-life intangible assets	2.0	$37,682	$ (36,858)	$824	$52,125	$ (50,822)	$1,303

Amortization expense for intangible assets was $0.4 million and $0.8 million for the three and six months ended July 31, 2018 and $0.6 million and $1.2 million for the three and six months ended July 31, 2017.

As of July 31, 2018, the estimated future amortization expense for our finite-life intangible assets is as follows (amounts in thousands):

Estimated
Amortization

Fiscal Year Ended January 31,	Expense	
2019 (for the remaining six months)	$	440
2020		326
2021		8
2022		4
2023		4
2024 and thereafter		42
Total	$	824

6. Commitments and Contingencies

Indemnification and Warranties

We provide indemnification, to the extent permitted by law, to our officers, directors, employees and agents for liabilities arising from certain events or occurrences while the officer, director, employee or agent is, or was, serving at our request in such capacity. With respect to acquisitions, we provide indemnification to, or assume indemnification obligations for, the current and former directors, officers and employees of the acquired companies in accordance with the acquired companies' governing documents. As a matter of practice, we have maintained directors' and officers' liability insurance including coverage for directors and officers of acquired companies.

We enter into agreements in the ordinary course of business with customers, resellers, distributors, integrators and suppliers. Most of these agreements require us to defend and/or indemnify the other party against intellectual property infringement claims brought by a third party with respect to our products. From time to time, we also indemnify customers and business partners for damages, losses and liabilities they may suffer or incur relating to personal injury, personal property damage, product liability, and environmental claims relating to the use of our products and services or resulting from the acts or omissions of us, our employees, authorized agents or subcontractors. From time to time we have received requests from customers for indemnification of patent litigation claims. Management cannot reasonably estimate any potential losses, but these claims could result in material liability for us. There are no current pending legal proceedings, in the opinion of management, that would have a material adverse effect on our financial position, results from operations and cash flows. There is no assurance that future legal proceedings arising from ordinary course of business or otherwise, will not have a material adverse effect on our financial position, results from operations or cash flows.

We warrant that our products, including software products, will substantially perform in accordance with our standard published specifications in effect at the time of delivery. In addition, we provide maintenance support to our customers and therefore allocate a portion of the product purchase price to the initial warranty period and recognize revenue on a straight-line basis over that warranty period related to both the warranty obligation and the maintenance support agreement. When we enter into arrangements that include revenue for extended warranties beyond the standard duration, the revenue is deferred and recognized on a straight-line basis over the contract period. Related costs are expensed as incurred.

7. Severance and Other Restructuring Costs
Restructuring Costs

During the six months ended July 31, 2018, we incurred some immaterial restructuring charges, primarily for employee-related benefits for terminated employees offset by the reversal of certain accruals from fiscal 2018 for costs related to the restructuring.

The following table shows the activity in accrued restructuring reported as a component of other accrued expenses on the consolidated balance sheet as of July 31, 2018 (amounts in thousands):

	Employee-Related Benefits	Closure of Leased Facilities	Other Restructuring	Total
Accrual balance as of January 31, 2018	$ 61	$ 135	$ 29	$225
Restructuring charges incurred	22	(7)	(29)	(14)
Cash payments	(83)	(128)	—	(211)
Other charges	—	—	—	—
Accrual balance as of July 31, 2018	$ —	$ —	$ —	$—

During the third quarter of fiscal 2017, we implemented a restructuring program (“Restructuring Plan”) with the purpose of reducing costs and assisting in restoring SeaChange to profitability and positive cash flow. This program included measures intended to allow the Company to more efficiently operate in a leaner, more direct cost structure. These measures included reductions in workforce, consolidation of facilities, transfers of certain business processes to lower cost regions and reduction in third-party service costs. The Restructuring Plan was substantially complete as of January 31, 2018. However, we incurred a small charge for employee-related benefits during the first quarter of fiscal 2019 and reversed any remaining estimates to severance and other restructuring charges in our consolidated statements of operations and comprehensive loss in April 2018. Since its implementation, we recognized $7.1 million in restructuring charges related to the Restructuring Plan.

In September 2018, in order to return the Company to profitability by the end of fiscal 2019, we announced that we are implementing cost-savings actions during the third quarter of fiscal 2019 for our worldwide operations with the implementation of a restructuring program. The primary element of this program will be staff reductions across all of our functions and geographic areas and we expect the program to be completed by the end of the third quarter of fiscal 2019. Annualized cost savings will be approximately $6 million once completed and other restructuring and severance charges will be approximately $1 million.

Severance Costs

During the three and six months ended July 31, 2018, we incurred additional severance charges not related to a restructuring plan of $0.5 million and $0.7 million, respectively, primarily from the departure of 12 employees. Severance costs during each of the three and six months ended July 31, 2017 were $0.2 million.

8. Stockholders' Equity
2011 Compensation and Incentive Plan

In July 2011, our stockholders approved the adoption of our 2011 Compensation and Incentive Plan (the "2011 Plan"). The 2011 Plan provides for the grant of incentive stock options, nonqualified stock options, restricted stock, restricted stock units ("RSUs"), deferred stock units ("DSUs") and other equity based non-stock option awards as determined by the plan administrator to officers, employees, consultants, and directors of the Company.

On July 13, 2017, our stockholders approved an amendment to the 2011 Plan which increased the number of shares under the 2011 Plan by 4,000,000 shares and correspondingly, increased the number of incentive stock options that can be authorized for issuance under the 2011 Plan.

Effective February 1, 2014, SeaChange gave its non-employee members of the Board of Directors the option to receive DSUs in lieu of RSUs, beginning with the annual grant for fiscal 2015. The number of units subject to the DSUs is determined as of the grant date and shall fully vest one year from the grant date. The shares underlying the DSUs are not vested and issued until the earlier of the director ceasing to be a member of the Board of Directors (provided such time is subsequent to the first day of the succeeding fiscal year) or immediately prior to a change in control.

We may satisfy awards upon the exercise of stock options or the vesting of stock units with newly issued shares or treasury shares. The Board of Directors is responsible for the administration of the 2011 Plan and determining the terms of each award, award exercise price, the number of shares for which each award is granted and the rate at which each award vests. In certain instances, the Board of Directors may elect to modify the terms of an award. As of July 31, 2018, there were 2,437,215 shares available for future grant under the 2011 Plan.

Option awards may be granted to employees at an exercise price per share of not less than 100% of the fair market value per common share on the date of the grant. Stock units may be granted to any officer, employee, director, or consultant at a purchase price per share as determined by the Board of Directors. Option awards granted under the 2011 Plan generally vest over a period of one to four years and expire ten years from the date of the grant.

In fiscal 2016, the Board of Directors developed a Long-Term Incentive ("LTI") Program under which the named executive officers and other key employees of the Company will receive long-term equity-based incentive awards, which are intended to align the interests of our named executive officers and other key employees with the long-term interests of our stockholders and to emphasize and reinforce our focus on team success. Long-term equity-based incentive compensation awards are made in the form of stock options, RSUs and performance stock units ("PSUs") subject to vesting based in part on the extent to which employment continues for three years. In fiscal 2018, the Board of Directors changed the structure of prospective LTI performance-based awards, changing from awards based on total shareholder return to awards based on Company-specific financial performance metrics. Since these awards are performance-based awards and do not include market conditions, we record the fair value of these PSUs using the grant date share price rather than the Monte Carlo simulation model used for PSUs previously granted in fiscal 2016 and fiscal 2017, which included market conditions. We recognize stock compensation expense ratably over the required service period based on the estimate that it is probable that the measurement criteria will be achieved and the targeted number of shares will vest. If there is a change in estimate of the number of shares that are probable of vesting, we will cumulatively adjust stock compensation expense in the period that the change in estimate is made.

We have granted market-based options to certain officers in connection with their appointment. These stock options have an exercise price equal to our closing stock price on the date of grant and will vest in approximately equal increments based upon the closing price of SeaChange's common stock. We record the fair value of these stock options using the Monte Carlo simulation model, since the stock option vesting is variable depending on the closing price of our traded common stock. The model simulated the daily trading price of the market-based stock options expected terms to determine if the vesting conditions would be triggered during the term. Effective April 6, 2016, Ed Terino, who previously served as our Chief Operating Officer ("COO"), was appointed Chief Executive Officer ("CEO") of SeaChange and was granted 600,000 market-based options, bringing the total of his market-based options, when added to the 200,000 market-based options he received upon hire as COO in June 2015, to 800,000 market-based options. The fair value of these 800,000 stock options was estimated to be \$2.1 million. As of July 31, 2018, \$0.1 million remained unamortized on these market-based stock options, which will be expensed over the next 0.6 years, the remaining weighted average amortization period.

2015 Employee Stock Purchase Plan

In July 2015, we adopted the 2015 Employee Stock Purchase Plan (the "ESPP"). The purpose of the ESPP is to provide eligible employees, including executive officers of SeaChange, with the opportunity to purchase shares of our common stock at a discount through accumulated payroll deductions of up to 15%, but not less than one percent of their eligible compensation, subject to any plan limitations. Offering periods typically commence on October 1st and April 1st and end on March 31st and September 30th

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with the last trading day being the exercise date for the offering period. On each purchase date, eligible employees will purchase our stock at a price per share equal to 85% of the closing price of our common stock on the exercise date, but no less than par value. The maximum number of shares of our common stock which will be authorized for sale under the ESPP is 1,150,000 shares. Since its inception, a total of 50,240 shares have been purchased under the ESPP. Stock-based compensation expense related to the ESPP was not significant for the three and six months ended July 31, 2018 and 2017.

9. Accumulated Other Comprehensive Loss

The following shows the changes in the components of accumulated other comprehensive loss for the six months ended July 31, 2018:

	Foreign Currency Translation Adjustment	Changes in Fair Value of Available-for-Sale Investments	Total
	(Amounts in thousands)		
Balance at January 31, 2018	$(5,380)	$ (54)	$(5,434)
Other comprehensive income (loss)	1,431	(18)	1,413
Balance at July 31, 2018	$(3,949)	$ (72)	$(4,021)

Unrealized holding gains (losses) on securities available-for-sale are not material for the periods presented.

Comprehensive loss consists of our net loss and other comprehensive income (loss), which includes foreign currency translation adjustments and changes in unrealized gains and losses on marketable securities available-for-sale. For purposes of comprehensive loss disclosures, we do not record tax expense or benefits for the net changes in the foreign currency translation adjustments.

10. Revenue from Contracts with Customers

On February 1, 2018, the Company adopted ASC 606 using the modified retrospective method to achieve a consistent application of revenue recognition, resulting in a single revenue model to be applied by reporting companies under U.S. GAAP. Under the new model, recognition of revenue occurs when a customer obtains control of promised goods or services in an amount that reflects the consideration to which the providing entity expects to be entitled in exchange for those goods or services. Therefore, for arrangements that include customer-specified acceptance criteria, revenue is recognized when the Company can objectively determine that control has been transferred to the customer in accordance with the agreed-upon specifications in the contract, which may occur before formal customer acceptance. In addition, the new guidance requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The new guidance no longer requires the Company to have vendor specific object evidence (“VSOE”) to determine the fair value of undelivered elements in a multiple-element software transaction, resulting in revenue attributable to the sale of software being recognized earlier.

Our products and services facilitate the aggregation, licensing, management and distribution of video and advertising content to cable television system operators, telecommunication companies, satellite operators and media companies. Offerings include and revenue is generated from the sales of software, hardware, professional services, maintenance and support in order to deploy SeaChange systems and provide ongoing functionality.

These offerings can be sold on a standalone basis or as a component of a contract with multiple performance obligations. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative standalone selling price. The performance obligations include future credits, significant discounts and material rights in addition to the software, hardware, professional services, maintenance and support.

The revenue for perpetual licenses to software applications and hardware is recognized upon delivery or acceptance by the customer. Product maintenance and technical support is recognized ratably over the stated and implied maintenance periods.

The professional services are either fixed price or time and material contracts, and consist of installation and integration, customized development and customized software, training, and on-site managed services. The installation and integration is recognized over time based on an input measure of hours incurred to total estimated hours. The customized development and software is recognized at a point in time upon delivery and acceptance of the final software product. The training and the on-site managed services are recognized over the service period.

The cumulative effect of the changes made to our consolidated balance sheet as of February 1, 2018 for the adoption of the new guidance under the modified retrospective method is as follows (amounts in thousands):

	As of January 31, 2018 Under ASC 605	Adjustment	February 1, 2018 Under ASC 606
Assets			
Unbilled receivables	$3,101	$ 137	$3,238
Prepaid expenses and other current assets [1]	$3,557	$ 824	$4,381
Liabilities			
Deferred revenues	$14,433	$ (1,358)	$13,075
Equity			
Accumulated loss	$(148,620)	$ 2,319	$(146,301)

(1) Contract assets, short-term are included in prepaid expenses and other current assets in our consolidated balance sheet.

The following tables set forth the amount by which each financial statement line item is affected in the current reporting period by the application of ASC 606, as compared to the guidance that was in effect before its adoption. The impact of adoption on the consolidated financial statements as of and for the three and six months ended July 31, 2018 is as follows (amounts in thousands):

Consolidated Balance Sheets:

	As of July 31, 2018 Under ASC 605	Adjustment	July 31, 2018 Under ASC 606
Assets			
Unbilled receivables	$5,114	$ 216	$5,330
Prepaid expenses and other current assets [1]	$4,361	$ 635	$4,996
Liabilities			
Deferred revenues	$13,755	$ (5,251)	$8,504
Equity			
Accumulated loss	$(166,954)	$ 6,102	$(160,852)

(1)

Contract assets, short-term, are included in prepaid expenses and other current assets in our consolidated balance sheet.

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Consolidated Statements of Operations and Comprehensive Loss:

	For the Three Months Ended July 31, 2018		
	Under ASC 605	Adjustment	Under ASC 606
Revenues	$10,780	$ 1,121	$11,901
Cost of revenues	5,775	(160)	5,615
Operating expenses	14,665	(109)	14,556
Loss from operations	(9,660)	1,390	(8,270)
Loss before income taxes	(11,622)	1,390	(10,232)
Income tax (benefit) provision	(1,152)	—	(1,152)
Net loss	(10,470)	1,390	(9,080)
Net loss per share:			
Basic	$(0.30)	$ 0.04	$(0.26)
Diluted	$(0.30)	$ 0.04	$(0.26)

	For the Six Months Ended July 31, 2018		
	Under ASC 605	Adjustment	Under ASC 606
Revenues	$22,864	$ 3,972	$26,836
Cost of revenues	11,346	298	11,644
Operating expenses	28,687	(109)	28,578
Loss from operations	(17,169)	3,783	(13,386)
Loss before income taxes	(19,980)	3,783	(16,197)
Income tax (benefit) provision	(1,646)	—	(1,646)
Net loss	(18,334)	3,783	(14,551)
Net loss per share:			
Basic	$(0.52)	$ 0.11	$(0.41)
Diluted	$(0.52)	$ 0.11	$(0.41)

Consolidated Statement of Cash Flows:

	For the Six Months Ended July 31, 2018		
	Under ASC 605	Adjustment	Under ASC 606
Cash used in operating activities:			
Net loss	$(18,334)	$ 3,783	$(14,551)
Unbilled receivables	(2,119)	(216)	(2,335)
Prepaid expenses and other current assets	(949)	(635)	(1,584)
Deferred revenues	(478)	(5,251)	(5,729)
Other operating activities	111	2,319	2,430
Total cash used in operating activities	$(19,416)	$ —	$(19,416)

The following summarizes the significant changes under ASC 606 as compared to legacy U.S. GAAP:

- Under legacy U.S. GAAP, the Company allocated revenue to licenses under the residual method when it had VSOE for the remaining undelivered elements, which allocated any future credits or significant discounts entirely to the license. Under ASC 606, the Company allocates all future credits, significant discounts, and material rights to all performance obligations based upon their relative selling price. Additional license revenue from the reallocation of such arrangement consideration is recognized when control is transferred to the customer, which is generally upon delivery of the license.

- Under legacy U.S. GAAP, the Company did not have VSOE for professional services and maintenance in certain geographical areas, which resulted in revenue being deferred in such instances until such time as VSOE existed for all undelivered elements or recognized ratably over the longest service period. Under ASC 606, the requirement for VSOE is eliminated and replaced with the concept of a standalone selling price. Once the transaction price is allocated to each of the performance obligations, the Company recognizes revenue as the performance obligations are delivered, either at a point in time or over time. Under ASC 606, license revenue is recognized when control is transferred to the customer and professional services revenue is recognized over time based on an input measure of hours incurred to total estimated hours. This results in the acceleration of professional services revenue when compared to the historical practice of ratable recognition for professional services when there is a lack of VSOE.

- Under legacy U.S. GAAP, sales commissions and other third-party acquisition costs resulting directly from securing contracts with customers are expensed when incurred. Under ASC 340, “Other Assets and Deferred Costs,” because the sales commission paid on the maintenance renewals is not commensurate with the original arrangement, ASC 340 requires that these acquisition costs be expensed over the expected period of benefit, which we estimate as the customer life of five years.

- Under legacy U.S. GAAP, professional service costs associated with highly customized development efforts related directly to contracts with customers are expensed when incurred. Under ASC 340, these costs are recognized as an asset when incurred and are expensed along with professional service revenue at the time that customized software is delivered and/or accepted.

Disaggregated Revenue

The following table shows our revenue disaggregated by revenue stream for the three and six months ended July 31, 2018 (amounts in thousands):

	For the Three Months Ended July 31, 2018	For the Six Months Ended July 31, 2018
Revenue by revenue stream:		
Product	$1,462	$4,553
Professional services	3,426	8,063
Maintenance - first year	460	1,118
Maintenance - renewal	6,553	13,102
Total revenues	$11,901	$26,836

Transaction Price Allocated to Future Performance Obligations

The aggregate amount of transaction price that is allocated to performance obligations that have not yet been satisfied or are partially satisfied as of July 31, 2018 is $1.5 million. This amount consists of amounts billed for undelivered services that are included in deferred revenue. This total amount is expected to be recognized as revenue within the next 12 months.

Significant Judgments

Our contracts with customers often include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. Once we determine the performance obligations, the Company determines the transaction price, which includes estimating the amount of variable consideration to be included in the transaction price, if any. We then allocate the transaction price to each performance obligation in the contract based on a relative stand-alone selling price method. The corresponding revenue is recognized as the related performance obligations are satisfied as discussed in the revenue categories above.

Judgment is required to determine the standalone selling price for each distinct performance obligation. We determine standalone selling price based on the price at which the performance obligation is sold separately. If the standalone selling price is not observable through past transactions, we estimate the standalone selling price taking into account available information such as market conditions and internally approved pricing guidelines related to the performance obligations.

With the exception of travel and entertainment expenses, our contracts do not generally include a variable component to the transaction price. With certain statements of work, we explicitly state that we are to be reimbursed for reasonable travel and entertainment expenses incurred as part of the delivery of professional services. In the cases when we are entitled to collect all travel and entertainment expenses incurred, an estimate of the fulfillment costs is made at the onset of the contract in order to determine the transaction price. The revenue associated with travel and entertainment expenses is then recognized over time along with the professional services.

As discussed above, some of our contracts have payment terms that differ from the timing of revenue recognition which requires us to assess whether the transaction price for those contracts include a significant financing component. We have elected the practical expedient that permits an entity to not adjust for the effects of a significant financing component if we expect that at the contract inception, the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less. For those contracts in which the period exceeds the one-year threshold, this assessment, as well as the quantitative estimate of the financing component and its relative significance, requires judgment. We estimate the significant financing component provided to our customers with extended payment terms by determining the present value of the future payments by applying a discount rate that reflects the customer’s creditworthiness.

Contract Balances

Contract assets consist of unbilled revenue which arises when revenue is recognized in advance of billing for certain customer contracts. Contract liabilities consist of deferred revenue and customer deposits which arise when amounts are billed to or collected from customers in advance of revenue recognition.

Costs to Obtain and Fulfill a Contract

The Company recognizes an asset for the incremental costs of obtaining a contract with a customer if we expect the benefit of those costs to be longer than one year. We have determined that commissions and special incentive payments (“Spiffs”) for hardware and software maintenance and support and professional services paid under our sales incentive programs meet the requirements to be capitalized under ASC 340-40, which prior to the adoption of ASC 606, we had expensed as incurred. The amount capitalized for incremental costs to obtain contracts as of July 31, 2018 was $0.4 million, all of which was short-term and has been included in prepaid expenses and other current assets in our consolidated balance sheet. Costs to obtain a contract are amortized as sales and marketing expense over the expected period of benefit in a manner that is consistent with the transfer of the related goods or services to which the asset relates. The judgments made in determining the amount of costs incurred include whether the commissions are in fact incremental and would not have occurred absent the customer contract and the estimate of the amortization period. The commissions and Spiffs related to professional services are amortized over time, as work is completed. The commissions and Spiffs for hardware and software maintenance are amortized over the life of the customer, which is estimated to be five years. These costs are periodically reviewed for impairment; however, we determined that no impairment existed as of July 31, 2018. We have elected to apply the practical expedient and recognize the incremental costs of obtaining contracts as an expense when incurred if the amortization period of the assets that the Company otherwise would have recognized is one year or less.

We capitalize incremental costs incurred to fulfill our contracts that (i) relate directly to the contract, (ii) are expected to generate resources that will be used to satisfy the Company’s performance obligation under the contract, and (iii) are expected to be recovered through revenue generated under the contract. Contract fulfillment costs include direct labor for support services, software enhancements, reimbursable expenses, and professional services for customized software development costs. The revenue associated with the support services, software enhancements, and reimbursable expenses is recognized ratably over time therefore the costs associated are expensed as incurred. The professional services associated with the customized software are not recognized until completion. As such, the professional services costs are capitalized and recognized upon completion of the services.

11. Segment Information, Significant Customers and Geographic Information

Segment Information

Our operations are organized into one reportable segment. Operating segments are defined as components of an enterprise evaluated regularly by the Company’s chief operating decision maker in deciding how to allocate resources and assess performance. Our reportable segment was determined based upon the nature of the products offered to customers, the market characteristics of each operating segment and the Company’s management structure.

Significant Customers

One customer accounted for 10% or more of our total revenues for the three and six months ended July 31, 2018 and 2017 as follows:

	Three Months Ended July 31,		Six Months Ended July 31,	
	2018	2017	2018	2017
Customer A	19%	26%	19%	25%

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Geographic Information

The following table summarizes revenues by customers' geographic locations for the periods presented:

	Three Months Ended July 31,				Six Months Ended July 31,			
	2018		2017		2018		2017	
	Amount	%	Amount	%	Amount	%	Amount	%
	(Amounts in thousands, except percentages)							
Revenues by customers' geographic locations:								
North America [(1)]	$5,932	50%	$8,320	48%	$13,046	49%	$16,646	49%
Europe and Middle East	3,858	32%	6,478	38%	9,881	37%	13,643	40%
Latin America	1,575	13%	2,142	12%	3,071	11%	2,863	9 %
Asia Pacific	536	5 %	285	2 %	838	3 %	740	2 %
Total	$11,901		$17,225		$26,836		$33,892	

(1) Includes total revenues for the United States for the periods shown as follows (amounts in thousands, except percentage data):

	Three Months Ended July 31,		Six Months Ended July 31,	
	2018	2017	2018	2017
U.S. Revenue	$5,102	$7,047	$10,889	$14,075
% of total revenues	42.9 %	40.9 %	40.6 %	41.5 %

12. Income Taxes

We recorded income tax benefits of $1.2 million and $1.6 million in the three and six months ended July 31, 2018, respectively, and we recorded income tax provisions of approximately $35,000 and $0.3 million for the three and six months ended July 31, 2017. Our effective tax rate in fiscal 2019 and in future periods may fluctuate on a quarterly basis as a result of changes in our jurisdictional forecasts where losses cannot be benefitted due to the existence of valuation allowances on our deferred tax assets, changes in actual results versus our estimates, or changes in tax laws, regulations, accounting principles, or interpretations thereof.

The Company reviews all available evidence to evaluate the recovery of deferred tax assets, including the recent history of losses in all tax jurisdictions, as well as its ability to generate income in future periods. As of July 31, 2018, due to the uncertainty related to the ultimate use of certain deferred income tax assets, the Company has recorded a valuation allowance on certain of its deferred assets.

On December 22, 2017, the U.S. Tax Cuts and Jobs Act ("Tax Reform Act") was signed into law. The Tax Reform Act resulted in significant changes in the U.S. corporate income tax system effective January 1, 2018, including, but not limited to, the following:

- Reduction of the corporate federal income tax rate from 35% to 21%;
- Repeal of the corporate alternative minimum tax (“AMT”);
- A one-time transition tax on the deemed repatriation of accumulated previously untaxed foreign earnings (“Transition Tax”);
- A move to a territorial tax system;
- Additional limitations on the tax treatment of executive compensation; and
- Acceleration of business asset expensing.

On December 22, 2017, the SEC issued guidance under SAB 118, which allows us to record provisional amounts during a measurement period not to extend beyond one year of the enactment date. The measurement period is deemed to have ended when the registrant has obtained, prepared, and analyzed the information necessary to finalize its accounting.

SAB 118 summarizes a three-step process to be applied at each reporting period to account for and qualitatively disclose: (1) the effects of the change in tax law for which accounting is complete; (2) any provisional amounts (or adjustments to provisional amounts) for the effects of the tax law where accounting is not complete, but that a reasonable estimate has been determined; and (3) when a reasonable estimate cannot yet be made and therefore taxes are reflected in accordance with law prior to the enactment of the Tax Reform Act.

The Company is still evaluating the provisions of the Tax Reform Act and amounts reflected in the financial statements for the six months ended July 31, 2018 are provisional. The ultimate impact may differ from these provisional amounts, due to, among other things, additional analysis, changes in interpretations and assumptions the Company has made, additional regulatory guidance that may be issued, and actions the Company may take as a result of the Tax Reform Act. The accounting is expected to be completed within the one-year measurement period.

We are subject to additional requirements of the Tax Reform Act during the fiscal year ended January 31, 2019. Those provisions include a tax on global intangible low-taxed income ("GILTI") and a limitation on the tax treatment of certain executive compensation. We have elected to account for GILTI as a period cost, and therefore included GILTI expense in the effective tax rate calculation. Our fiscal 2019 effective tax rate includes estimates of these new provisions.

We file income tax returns in the U.S. federal jurisdiction, various state jurisdictions, and various foreign jurisdictions. We have closed out an audit with the Internal Revenue Service ("IRS") through fiscal 2013. We are no longer subject to U.S. federal examinations before fiscal 2015. However, the taxing authorities will still have the ability to review the propriety of certain tax attributes created in closed years if such tax attributes are utilized in an open tax year, such as our federal research and development credit carryovers.

13. Net Loss Per Share

Net loss per share is presented in accordance with authoritative guidance which requires the presentation of "basic" and "diluted" earnings per share. Basic earnings (loss) per share is computed by dividing earnings (loss) available to common shareholders by the weighted-average shares of common stock outstanding during the period. For the purposes of calculating diluted earnings per share, the denominator includes both the weighted average number of shares of common stock outstanding during the period and the weighted average number of shares of potential dilutive shares of common stock, such as stock awards, calculated using the treasury stock method. Basic and diluted net loss per share was the same for all the periods presented as the impact of potential dilutive shares outstanding was anti-dilutive.

The following table sets forth our computation of basic and diluted net loss per common share (amounts in thousands, except per share amounts):

	Three Months Ended July 31,		Six Months Ended July 31,	
	2018	2017	2018	2017
Net loss	$(9,080)	$(1,529)	$(14,551)	$(6,900)
Weighted average shares used in computing net loss per share - basic and diluted	35,649	35,351	35,628	35,331
Net loss per share:				
Basic	$(0.26)	$(0.05)	$(0.41)	$(0.20)
Diluted	$(0.26)	$(0.05)	$(0.41)	$(0.20)

The number of common shares used in the computation of diluted net income (loss) per share for the three and six months ended July 31, 2018 and 2017 does not include the effect of the following potentially outstanding common shares because the effect would have been anti-dilutive (amounts in thousands):

	Three Months Ended July 31,		Six Months Ended July 31,	
	2018	2017	2018	2017
Stock options	2,923	1,636	3,014	1,657
Restricted stock units	193	365	192	889
Deferred stock units	173	158	189	130
Performance stock units	352	473	291	128
Total	3,641	2,632	3,686	2,804

14. Recent Accounting Standard Updates

We consider the applicability and impact of all ASUs on our consolidated financial statements. Updates not listed below were assessed and determined to be either not applicable or are expected to have minimal impact on our consolidated financial position or results of operations. Recently issued ASUs which we feel may be applicable to us are as follows:

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Recently Issued Accounting Standard Updates – Not Yet Adopted

Stock-based Compensation

In June 2018, the FASB issued ASU 2018-07, "Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting." ASU 2018-07 expands the scope of Topic 718 to include all share-based payment transactions for acquiring goods and services from nonemployees. ASU 2018-07 is effective for us in the first quarter of fiscal 2020. Early adoption is permitted. We are currently evaluating what impact the adoption of this update will have on our consolidated financial statements.

Comprehensive Income

In February 2018, the FASB issued ASU 2018-02, "Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." On December 22, 2017, the U.S. federal government enacted a tax bill, H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 ("Tax Cuts and Jobs Act"), which requires deferred tax liabilities and assets to be adjusted for the effect of a change in tax laws. ASU 2018-02 allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Reform Act. ASU 2018-02 is effective for us in the first quarter of fiscal 2020. Early adoption is permitted. We are currently evaluating what impact the adoption of this update will have on our consolidated financial statements.

Leases

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)," which supersedes ASC 840, "Leases (Topic 840)." Subsequently, the FASB issued additional updates which clarify this guidance including ASU 2018-01, "Leases (Topic 842: Land Easement Practical Expedient for Transitioning to Topic 842,"in January 2018, which allows an entity to elect an optional transition practical expedient to not evaluate land easements that exist or expired before the entity's adoption of Topic 842, and ASU 2018-11, "Leases – Targeted Improvements (Topic 842)," which provides for an additional transition method that allows companies to apply the new lease standard at the adoption date, eliminating the requirement to apply the standard to the earliest period presented in the consolidated financial statements. ASU 2016-02 requires a lessee to recognize a right-of-use asset and a lease liability for operating leases with terms over twelve months, initially measured at the present value of the lease payments, in its balance sheet. The standard also requires a lessee to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, on a generally straight-line basis. It also requires lessees to classify leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase of the leased asset by the lessee. This classification will determine whether the lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. Early adoption of the new guidance is permitted. ASU 2016-02, ASU 2018-01 and ASU 2018-11 are effective for us beginning in the first quarter of fiscal 2020. We have begun evaluating and planning for adoption and implementation, including gathering, documenting and analyzing lease agreements subject to the new guidance. We anticipate material additions to the balance sheet (upon adoption) of right-of-use assets, offset by the associated liabilities.

Recently Issued Accounting Standard Updates – Adopted During the Period

Revenue from Contracts with Customers (Topic 606)

In May 2014, the FASB issued ASU. 2014-09, "Revenue from Contracts with Customers (Topic 606)." ASU 2014-09 provides enhancements to the quality and consistency of how revenue is reported while also improving comparability in the financial statements of companies using International Financial Reporting Standards and U.S. GAAP. The core principle requires entities to recognize revenue in a manner that depicts the transfer of goods or services to customers in amounts that reflect the consideration an entity expects to be entitled to in exchange for those goods or services. In July 2015, the FASB voted to approve a one-year deferral, making the standard effective for public entities for annual and interim periods beginning after December 15, 2017.

In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)." The purpose of ASU 2016-08 is to clarify the guidance on principal versus agent considerations. It includes indicators that help to determine whether an entity controls the specified good or service before it is transferred to the customer and to assist in determining when the entity satisfied the performance obligation and as such, whether to recognize a gross or a net amount of consideration in their consolidated statement of operations.

In April 2016, the FASB issued ASU 2016-10, "Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing." ASU 2016-10 clarifies that entities are not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract. ASU 2016-10 also addresses how to determine whether promised goods or services are separately identifiable and permits entities to make a policy election to treat shipping and handling costs as fulfillment activities. In addition, it clarifies key provisions in Topic 606 related to licensing.

In May 2016, the FASB issued ASU 2016-11, "Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815)." ASU 2016-11 rescinds previous SEC comments that were codified in Topic 605, Topic 932 and Topic 815. Upon adoption of Topic 606, certain SEC comments including guidance on accounting for shipping and handling fees and costs and consideration given by a vendor to a customer should not be relied upon.

In May 2016, the FASB also issued ASU 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow Scope Improvements and Practical Expedients." ASU 2016-12 provides clarity around collectability, presentation of sales taxes, non-cash consideration, contract modifications at transition and completed contracts at transition. ASU 2016-12 also includes a technical correction within Topic 606 related to required disclosures if the guidance is applied retrospectively upon adoption.

In December 2016, the FASB issued ASU 2016-20, "Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers." ASU 2016-20 allows entities not to make quantitative disclosures about remaining performance obligations in certain cases and requires entities that use any of the optional exemptions to expand their qualitative disclosures. ASU 2016-20 also clarifies other areas of the new revenue standard, including disclosure requirements for prior period performance obligations, impairment guidance for contract costs and the interaction of impairment guidance in ASC 340-40 with other guidance elsewhere in the Codification.

Effective February 1, 2018, the Company adopted ASC 606 using the modified retrospective adoption model. See Note 10, "Revenue from Contracts with Customers," to this Form 10-Q for additional information regarding how the Company is accounting for revenue under the new guidance.

ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This Form 10-Q contains or incorporates forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, and such statements involve risks and uncertainties. The following information should be read in conjunction with the unaudited consolidated financial information and the notes thereto included in this Form 10-Q. You should not place undue reliance on these forward-looking statements. Actual events or results may differ materially due to competitive factors and other factors referred to in Part I, Item 1A. “Risk Factors” in our Form 10-K for our fiscal year ended January 31, 2018 and elsewhere in this Form 10-Q. These factors may cause our actual results to differ materially from any forward-looking statement. These forward-looking statements are based on current expectations, estimates, forecasts and projections about the industry and markets in which we operate, and management’s beliefs and assumptions. We undertake no obligation to publicly update or revise the statements in light of future developments. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on our behalf. Words such as “expect,” “seek,” “anticipate,” “intend,” “plan,” “believe,” “could,” “estimate,” “m “project,” or variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties, and assumptions that are difficult to predict.

Business Overview

We are an industry leader in the delivery of multiscreen, advertising and premium over-the-top (“OTT”) video management solutions headquartered in Acton, Massachusetts. Our products and services facilitate the aggregation, licensing, management and distribution of video and advertising content for cable television system operators, telecommunications companies, satellite operators and media companies. We currently operate under one reporting segment.

We address what we see as the continuing rise of Internet Protocol Television (“IPTV”) and OTT services by such companies as Netflix, Hulu, Amazon, mlbam, Kaltura, Ooyala and Brightcove and by media companies such as HBO, CBS and BBC. This rise of IPTV and OTT video services globally has increased the demand for multiscreen capabilities on a range of consumer devices operating on cloud-based platforms. We have been increasing our strategic investments in research and development related to our cloud-based offerings, as well as in sales and marketing as we focus on our go-to-market efforts in this area.

We continue to invest in developing and commercializing next generation capabilities in our four main product offerings: video back office, advertising, content management and user experience. Our portfolio of products allows us to provide customers with end-to-end video delivery capabilities across multiple platforms, thus reducing cost and increasing speed and ease of use for end users. We believe that by delivering innovative solutions to both our existing customer base and to content owners that are looking to provide end-to-end solutions, we can meet their growing needs and help them get to market faster, which will help them drive new revenue growth. We have virtualized our solutions and products to make integrating with existing networks simple and this ease-of-use is a core competency of our platform. We have optimized our software solutions to serve a wide range of consumer devices.

We expect to increase software sales in North America and Europe, the Middle East and Africa (“EMEA”) through targeted sales efforts in those regions. In addition, we believe that we have the opportunity for revenue growth in other areas of the world by expanding our selling efforts in Asia Pacific and Latin America, primarily with partners. We also believe that our existing service operator customers will continue upgrading to new features that can increase average revenue per subscriber, reduce operating and capital expenses, and lower customer churn.

As evidenced by our financial results from the three month period ended July 31, 2018, we continue to experience fluctuations in our revenues from period to period due to the following factors:

- Changes to estimated times to complete long-term projects;
- The time required to deliver and install the product and for the customer to accept the product and services;
- Timing of customers in selecting programs to launch our services to their end users;
- The ability of our customers to process the purchase order within their organizations in a timely manner;
- The transition from perpetual license to subscription, cloud-based revenue and the associated deviation from our traditional professional services model;
- Budgetary approvals by our customers for capital purchases;
- Uncertainty caused by potential consolidation in the industry; and

• Changes in foreign exchange rates.

These, together with other factors, could result in reductions in sales of our products, longer sales cycles, difficulties in collection of accounts receivable, a longer period of time before we may recognize revenue attributable to a sale, changes in cost estimates on long-term contracts which could result in a loss provision, gross margin deterioration, slower adoption of new technologies, the transition to SaaS, and increased price competition.

On May 5, 2016, we acquired a 100% share of DCC Labs in exchange for an aggregate of $2.7 million in newly issued shares of SeaChange common stock and $5.2 million in cash, net of cash acquired, resulting in a total net purchase price of $7.9 million. The stock consideration was determined by dividing the total value of $2.7 million by the volume weighted average closing price of our common stock for the twenty trading days preceding the closing. DCC Labs is a developer of set-top and multiscreen device software. Of the total consideration, $0.5 million in cash and all the stock (681,278 shares) were initially held in escrow as security for the indemnification obligations of the former DCC Labs owners to SeaChange under the purchase agreement, with one-third of the stock in escrow to be released to the former DCC Labs owners annually on the anniversary date of the acquisition beginning on May 5, 2017 and ending May 5, 2019, and one-half of the cash in escrow to be released to the former DCC Labs owners on May 5, 2017 and May 5, 2018. As of May 5, 2018, all of the cash and 454,184 shares of our common stock initially deposited with an Escrow Agent have been disbursed to the sellers. The remaining stock held of 227,094 shares will be released on May 5, 2019.

The acquisition of DCC Labs in fiscal 2017 enabled us to optimize the operations of our In-Home business, which developed home video gateway software including SeaChange's Nucleus and NitroX products. In addition, the acquisition brought market-ready products, including an optimized television software stack for Europe's Digital Video Broadcasting community, and an HTML5 framework for building additional user experience client applications across a variety of CPE devices, including Android TV STBs, tablets, mobile and computer devices. During fiscal 2018, the In-Home business became the center of engineering and expanded to include product development for backoffice, advertising and legacy products. The Poland operation became the prime engineering location and as of the end of fiscal 2018, was the largest location by number of engineers. In addition, the engineering efforts were combined and the teams were re-organized into a single global team in fiscal 2018, which spans a reduced number of locations globally compared to fiscal 2017. As part of the engineering transition, organizational improvements were implemented in order to focus on software quality, reliability and pre-integration, in order to de-risk deployments and improve go-to-market time for new solutions and existing upgrades. The global engineering team introduced DevOps practices with a customer-centric view of technology improvements across all products within the SeaChange solution. Along with operational improvements, engineering introduced changes to process and workflow which enabled more accurate effort estimations and velocity tracking. With the introduction of common agile project methodology across all teams and products, the efficiency of software engineering increased, which allowed more engineering resources to focus on innovation and development of industry leading features and enhancements to existing products as well as new product releases that expand the SeaChange technology franchise. At the same time, improved efficiency and better allocation of software developers enabled a more lean and targeted approach to supporting existing deployments and delivering upon support commitments for legacy products using a cost-optimized workforce.

In conjunction with the DCC Labs acquisition and an additional company-wide cost savings program established in the second half of fiscal 2017, SeaChange commenced a restructuring program ("Restructuring Program"), which has allowed us to achieve approximately $38 million in annualized cost savings since its commencement. The Restructuring Program resulted in aggregate charges of $9.2 million as of January 31, 2018 in severance and other restructuring costs. These charges include costs for workforce reductions, facility closings and other costs to complete the restructuring, such as legal and consulting fees. As of January 31, 2018, the Restructuring Program has been completed and has helped us improve operations and optimize our cost structure. Any remaining costs related to the Restructuring Program will be expensed as incurred to severance and other restructuring costs in our consolidated statements of operations and comprehensive loss in future quarters.

Results of Operations

The following discussion summarizes the key factors our management believes are necessary for an understanding of our consolidated financial statements.

Revenues

The following table summarizes information about our revenues for the three and six months ended July 31, 2018 and 2017:

	Three Months Ended July 31,		Increase/ (Decrease) $	Increase/ (Decrease)	Six Months Ended July 31,		Increase/ (Decrease) $	Increase/ (Decrease)
	2018	2017	Amount	% Change	2018	2017	Amount	% Change
	(Amounts in thousands, except for percentage data)							
Product	$1,462	$5,039	$(3,577)	(71.0%)	$4,553	$7,788	$(3,235)	(41.5%)
Service	10,439	12,186	(1,747)	(14.3%)	22,283	26,104	(3,821)	(14.6%)
Total revenues	11,901	17,225	(5,324)	(30.9%)	26,836	33,892	(7,056)	(20.8%)
Cost of product revenues	490	1,363	(873)	(64.1%)	816	1,942	(1,126)	(58.0%)
Cost of service revenues	5,125	4,446	679	15.3%	10,828	10,657	171	1.6%
Total cost of revenues	5,615	5,809	(194)	(3.3%)	11,644	12,599	(955)	(7.6%)
Gross profit	$6,286	$11,416	$(5,130)	(44.9%)	$15,192	$21,293	$(6,101)	(28.7%)
Gross product profit margin	66.5%	73.0%		(6.5%)	82.1%	75.1%		7.0%
Gross service profit margin	50.9%	63.5%		(12.6%)	51.4%	59.2%		(7.8%)
Gross profit margin	52.8%	66.3%		(13.5%)	56.6%	62.8%		(6.2%)

Product Revenue. The decrease in product revenue for the three and six months ended July 31, 2018 of $3.6 million and $3.2 million, respectively, included a $4.2 million and a $3.8 million decrease in our video platform, user experience, hardware and third-party product revenues, as compared to the same periods of fiscal 2018. We had a number of customers delay their decision to invest in their video platforms during the quarter ended July 31, 2018. This resulted in less product revenue in the three and six months ended July 31, 2018, compared to the same periods in the prior fiscal year due to our inability to complete product upgrades for existing customers. In addition, as we have broadened our product offering, we are pursuing opportunities outside of our traditional service provider customers, including broadcast and content owners, as well as wireless carriers and internet service providers. In the quarter ended July 31, 2018, we expected several multimillion dollar transactions to close in these new market segments with new customers, many of which were dependent on new channel partnerships as well. We found that these opportunities required more time and effort to close and therefore were unable to generate revenue from these transactions during the quarter. The decrease was partially offset by a $0.6 million increase in advertising revenues in the three and six months ended July 31, 2018 as compared to the same periods of fiscal 2018.

Service Revenue. Service revenue decreased $1.7 million and $3.8 million for the three and six months ended July 31, 2018, as compared to the same periods of fiscal 2018, primarily due to less revenue recognized for our software-as-a-service managed services. Additionally, there was a decrease in maintenance and support revenue provided on post-warranty contracts for both periods as customers continue to provide their own solutions.

During each period shown in the table above, one customer accounted for more than 10% of our total revenue. See Note 11, “Segment Information, Significant Customers and Geographic Information,” to our consolidated financial statements for more information.

International revenues accounted for approximately 57% and 59% of total revenues in the three months ended July 31, 2018 and 2017, respectively. For the six months ended July 31, 2018 and 2017, international revenues accounted for 59% and 58% of total revenues, respectively. The decrease in the international sales as a percentage of total revenue for the three months ended July 31, 2018, as compared to the same prior period is primarily due to a decrease in revenue outside the United States at a higher rate than the decrease in domestic revenue.

Gross Profit and Margin. Cost of revenues consists primarily of the cost of resold third-party products and services, purchased components and subassemblies, labor and overhead relating to the assembly and testing of complete systems and costs related to customized software development contracts.

Our gross profit margin decreased 14 percentage points for the three months ended July 31, 2018, as compared to the same period of the prior fiscal year. Excluding the $0.8 million adjustment to the provision for loss contract recorded in the second quarter of fiscal 2018, gross profit margin decreased nine percentage points. This decrease is primarily due to the product mix during the quarter, as less, higher-margin software licenses were delivered. Product profit margin decreased seven percentage points for the three months ended July 31, 2018, as compared to the same period of fiscal 2018 as there was a higher hardware component in the second quarter of fiscal 2019, as compared to more pure software licenses in product deals, which have a higher margin, in the same period last fiscal year. Service profit margins decreased 13 percentage points for the three months ended July 31, 2018, as compared to the same period of fiscal 2018. However, excluding the adjustment to the provision for loss contract mentioned above, service profit margin decreased nine percentage points. The reason for this decrease is primarily due to lower service revenue to absorb our fixed costs from professional services during the current fiscal quarter compared to the same quarter last fiscal year. In addition, there was an increase in employee-related costs due to the hiring of new professional service employees since the second quarter of fiscal 2018.

Our gross profit margin decreased six percentage points for the six months ended July 31, 2018, as compared to the same period of the prior fiscal year. Excluding the $0.6 million adjustment to the provision for loss contract recorded in fiscal 2018, gross profit margin decreased five percentage points. This decrease is due to the same reasons discussed above. However, product profit margin increased by seven percentage points during the first half of fiscal 2019, as compared to the same period of fiscal 2018 as we delivered approximately $3 million of product revenue in the first quarter of fiscal 2019 that contributed high gross margins compared to the product revenue delivered in the first quarter of fiscal 2018. Service profit margins decreased eight percentage points for the six months ended July 31, 2018, as compared to the same period of fiscal 2018. Excluding the adjustment to the provision for loss contract recorded in the first half of fiscal 2018 mentioned above, service profit margin decreased five percentage points. This decrease is due to the lower service revenue generated during the first half of fiscal 2019 with higher fixed costs as described above.

Operating Expenses

Research and Development

The following table provides information regarding the change in research and development expenses during the periods presented:

	Three Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change
	(Amounts in thousands, except for percentage data)							
Research and development expenses	$5,157	$6,399	$ (1,242)	(19.4 %)	$10,641	$11,777	$ (1,136)	(9.6 %)
% of total revenues	43.3 %	37.1 %			39.7 %	34.7 %		

Research and development expenses consist primarily of employee costs, which include salaries, benefits and related payroll taxes, depreciation of development and test equipment and an allocation of related facility expenses. During the three and six months ended July 31, 2018, research and development costs decreased $1.2 million and $1.1 million, respectively, as compared to the same periods of fiscal 2018, primarily due to a decrease in labor costs associated with the lower headcount resulting from the cost-savings efforts implemented in the second half of fiscal 2017 and which was completed at the end of fiscal 2018.

Selling and Marketing

The following table provides information regarding the change in selling and marketing expenses during the periods presented:

	Three Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change
	(Amounts in thousands, except for percentage data)							
Selling and marketing expenses	$3,685	$2,439	$ 1,246	51.1 %	$7,071	$5,376	$ 1,695	31.5 %
% of total revenues	31.0 %	14.2 %			26.3 %	15.9 %		

Selling and marketing expenses consist primarily of payroll costs, which include salaries and related payroll taxes, benefits and commissions, travel expenses and certain promotional expenses. Selling and marketing expenses increased $1.2 million for the three months ended and $1.7 million for the six months ended July 31, 2018, as compared to the same periods of the prior fiscal year. The increase is due to $0.5 million and $1.2 million of less costs being reclassified during the three and six months ended July 31, 2018, respectively, from selling and marketing expenses to cost of sales for solutions architects contributing time to revenue generating products. In addition, contract labor costs increased $0.4 million for the three months ended July 31, 2018 and $0.5 million for the six months primarily from sales consulting and digital marketing costs and professional fees increased $0.1 million in the three-month period and $0.3 million in the six-month period ending July 31, 2018, when compared to the same periods of 2017. The increases were offset during the six months ended July 31, 2018 by a $0.6 million decrease in employee-related costs due to lower headcount year over year.

General and Administrative

The following table provides information regarding the change in general and administrative expenses during the periods presented:

	Three Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change
	(Amounts in thousands, except for percentage data)							
General and administrative expenses	$4,021	$3,084	$ 937	30.4 %	$8,015	$6,727	$ 1,288	19.1 %
% of total revenues	33.8 %	17.9 %			29.9 %	19.8 %		

General and administrative expenses consist primarily of employee costs, which include salaries and related payroll taxes and benefit-related costs, legal and accounting services and an allocation of related facilities expenses. General and administrative expenses increased $0.9 million in the three months ended and $1.3 million in the six months ended July 31, 2018, as compared to the same periods of fiscal 2018, primarily due to a $0.6 million and a $0.8 million increase, respectively, in bonus expense accrued during the quarter, a $0.2 million increase and $0.4 million increase in contract labor costs, respectively, due to the implementation of our new payroll system and a $0.1 million and a $0.4 million increase, respectively, in professional fees in fiscal 2019 from higher accounting and internal controls consulting services. This is partially offset by a $0.1 million decrease for the three months ended July 31, 2018 and a $0.2 million decrease for the six months ended July 31, 2018, as compared to the same periods of fiscal 2018 in depreciation expense due to fully depreciated assets.

Amortization of Intangible Assets

The following table provides information regarding the change in amortization of intangible assets expenses during the periods presented:

	Three Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change
	(Amounts in thousands, except for percentage data)							
Amortization of intangible assets	$411	$616	$ (205)	(33.3 %)	$815	$1,214	$ (399)	(32.9 %)
% of total revenues	3.5 %	3.6 %			3.0 %	3.6 %		

Amortization expense is primarily related to the costs of acquired intangible assets. Amortization expense on certain intangible assets is based on the future economic value of the related intangible assets, which is generally higher in the earlier years of the assets' lives. The decrease in amortization expense for the three and six months ended July 31, 2018, as compared to the same period of fiscal 2018, is primarily due to fully amortized intangible assets from prior acquisitions as well as the change in foreign exchange rates.

Stock-based Compensation Expense

The following table provides information regarding the change in stock-based compensation expense during the periods presented:

	Three Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change
	(Amounts in thousands, except for percentage data)							
Stock-based compensation expense	$923	$653	$ 270	41.3 %	$1,802	$1,530	$ 272	17.8 %
% of total revenues	7.8 %	3.8 %			6.7 %	4.5 %		

Stock-based compensation expense is related to the issuance of stock grants to our employees, executives and members of our Board of Directors. Stock-based compensation expense increased $0.3 million for the three and six months ended July 31, 2018, as compared to the same periods in fiscal 2018, primarily due to an increase in stock awards granted to key employees at the end of fiscal 2018 as part of the long-term incentive plan.

Severance and Other Restructuring Costs

The following table provides information regarding the change in severance and other restructuring costs during the periods presented:

	Three Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change
	(Amounts in thousands, except for percentage data)							
Severance and other restructuring costs	$536	$563	$ (27)	(4.8 %)	$590	$2,710	$ (2,120)	(78.2 %)
% of total revenues	4.5 %	3.3 %			2.2 %	8.0 %		

Severance and other restructuring costs decreased $2.1 million for the six months ended July 31, 2018, as compared to the same period of fiscal 2017. Charges in fiscal 2019 include severance paid to 12 employees terminated during fiscal 2019. Charges in fiscal 2018 include $2.4 million related to a cost reduction initiative implemented in the second half of fiscal 2017 and completed at the end of fiscal 2018, $0.1 million of charges related to the reduction in force in our In-Home engineering and services organization in conjunction with our acquisition of DCC Labs in May 2016 and to severance charges not related to a restructuring plan of $0.2 million.

In September 2018, in order to return the Company to profitability by the end of fiscal 2019, we announced that we are implementing cost-savings actions during the third quarter of fiscal 2019 for our worldwide operations with the implementation of a restructuring program. The primary element of this program will be staff reductions across all of our functions and geographic areas and we expect the program to be completed by the end of the third quarter of fiscal 2019. Annualized cost savings will be approximately $6 million once completed and other restructuring and severance charges will be approximately $1 million.

Other (Expenses) Income, Net

The table below provides detail regarding our other (expenses) income, net:

	Three Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change
	(Amounts in thousands, except for percentage data)							
Interest income, net	$102	$33	$ 69	>100%	143	60	83	>100%
Foreign exchange (loss) gain	(2,035)	604	(2,639)	>(100%)	(2,934)	845	(3,779)	>100%
Miscellaneous income	(29)	(48)	19	(39.6 %)	(20)	50	(70)	>(100%)

	$(1,962)	$589	$ (2,551)		$(2,811)	$955	$ (3,766)

For the three and six months ended July 31, 2018, foreign exchange gains decreased by $2.6 million and $3.8 million, respectively, as compared to the same periods of fiscal 2018, primarily due to the revaluation of a note receivable between our Netherlands and Ireland subsidiaries of $2.8 million in the second quarter of fiscal 2019 and $4.2 million for the first half of fiscal 2019.

Income Tax (Benefit) Provision

	Three Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount	Increase/ (Decrease) % Change
	(Amounts in thousands, except for percentage data)							
Income tax (benefit) provision	$(1,152)	$35	$ (1,187)	>(100%)	$(1,646)	$304	$ (1,950)	>(100%)
% of total revenues	(9.7 %)	0.2 %			(6.1 %)	0.9 %		

We recorded income tax benefits of $1.2 million and $1.6 million for the three and six months ended July 31, 2018, respectively, and we recorded income tax provisions of approximately $35,000 and $0.3 million for the three and six months ended July 31, 2017, respectively. Our effective tax rate in fiscal 2019 and in future periods may fluctuate on a quarterly basis, as a result of changes in our jurisdictional forecasts where losses cannot be benefitted due to the existence of valuation allowances on our deferred tax assets, changes in actual results versus our estimates, or changes in tax laws, regulations, accounting principles or interpretations thereof.

The U.S. Tax Cuts and Jobs Act ("Tax Reform Act") introduced significant changes to U.S. income tax law. Changes include, but are not limited to, a corporate tax rate decrease from 35% to 21% effective for tax years beginning after December 31, 2017, the transition of U.S. international taxation from a worldwide tax system to a territorial system and a one-time tax on the mandatory deemed repatriation of cumulative foreign earnings (the "Transition Tax") as of December 31, 2017.

On December 22, 2017, the SEC issued guidance under Staff Accounting Bulletin No. ("SAB") 118, which allows us to record provisional amounts during a measurement period not to extend beyond one year of the enactment date. The measurement period is deemed to have ended earlier when the registrant has obtained, prepared and analyzed the information necessary to finalize its accounting. During the measurement period, impacts of the law are expected to be recorded at the time a reasonable estimate for all or a portion of the effects can be made, and provisional amounts can be recognized and adjusted as information becomes available, prepared or analyzed.

The Company is still evaluating the provisions of the Tax Reform Act and amounts reflected in the financial statements for the three and six months ended July 31, 2018 are provisional. The ultimate impact may differ from these provisional amounts, due to, among other things, additional analysis, changes in interpretations and assumptions the Company has made, additional regulatory guidance that may be issued and actions the Company may take as a result of the Tax Reform Act. The accounting is expected to be completed within the one-year measurement period.

We are subject to additional requirements of the Tax Reform Act during the fiscal year ended January 31, 2019. Those provisions include a tax on global intangible low-taxed income ("GILTI") and a limitation on the tax treatment of certain executive compensation. We have elected to account for GILTI as a period cost, and therefore included GILTI expense in the effective tax rate calculation. Our fiscal 2019 effective tax rate includes our estimates of these new provisions.

The Company reviews all available evidence to evaluate the recovery of deferred tax assets, including the recent history of losses in all tax jurisdictions, as well as its ability to generate income in future periods. As of July 31, 2018, due to the uncertainty related to the ultimate use of certain deferred income tax assets, the Company has recorded a valuation allowance on certain of its deferred assets.

We file income tax returns in the U.S. federal jurisdiction, various state jurisdictions, and various foreign jurisdictions. We have closed out an audit with the Internal Revenue Service ("IRS") through fiscal 2013. We are no longer subject to U.S. federal examinations before fiscal 2015. However, the taxing authorities will still have the ability to review the propriety of certain tax attributes created in closed years if such tax attributes are utilized in an open tax year, such as our federal research and development credit carryovers.

Non-GAAP Measures.

We define non-GAAP loss from operations as U.S. GAAP operating loss plus stock-based compensation expenses, amortization of intangible assets, provision for loss contract, non-operating expense professional fees and severance and other restructuring costs. We discuss non-GAAP loss from operations in our quarterly earnings releases and certain other communications as we believe non-GAAP operating loss from operations is an important measure that is not calculated according to U.S. GAAP. We use non-GAAP loss from operations in internal forecasts and models when establishing internal operating budgets, supplementing the financial results and forecasts reported to our Board of Directors, determining a component of bonus compensation for executive officers and other key employees based on operating performance and evaluating short-term and long-term operating trends in our operations. We believe that the non-GAAP loss from operations financial measure assists in providing an enhanced understanding of our underlying operational measures to manage the business, to evaluate performance compared to prior periods and the marketplace, and to establish operational goals. We believe that the non-GAAP financial adjustments are useful to investors because they allow investors to evaluate the effectiveness of the methodology and information used by management in our financial and operational decision-making.

Non-GAAP loss from operations is a non-GAAP financial measure and should not be considered in isolation or as a substitute for financial information provided in accordance with U.S. GAAP. This non-GAAP financial measure may not be computed in the same manner as similarly titled measures used by other companies. We expect to continue to incur expenses similar to the financial adjustments described above in arriving at non-GAAP loss from operations and investors should not infer from our presentation of this non-GAAP financial measure that these costs are unusual, infrequent or non-recurring.

The following table includes the reconciliations of our U.S. GAAP loss from operations, the most directly comparable U.S. GAAP financial measure, to our non-GAAP loss from operations for the three and six months ended July 31, 2018 and 2017 (amounts in thousands, except per share and percentage data):

	Three Months Ended July 31, 2018			Three Months Ended July 31, 2017		
	GAAP As Reported	Adjustments	Non-GAAP	GAAP As Reported	Adjustments	Non-GAAP
Revenues:						
Products	$1,462	$ —	$ 1,462	$5,039	$ —	$ 5,039
Services	10,439	—	10,439	12,186	—	12,186
Total revenues	11,901	—	11,901	17,225	—	17,225
Cost of revenues:						
Products	483	—	483	1,336	—	1,336
Services	4,955	—	4,955	4,218	766	4,984
Amortization of intangible assets	178	(178)	—	255	(255)	—
Stock-based compensation	(1)	1	—	—	—	—
Total cost of revenues	5,615	(177)	5,438	5,809	511	6,320
Gross profit	6,286	177	6,463	11,416	(511)	10,905
Gross profit percentage	52.8 %	1.5 %	54.3 %	66.3 %	(3.0 %)	63.3 %
Operating expenses:						
Research and development	5,157	—	5,157	6,399	—	6,399
Selling and marketing	3,685	—	3,685	2,439	—	2,439
General and administrative	4,021	—	4,021	3,084	—	3,084
Amortization of intangible assets	233	(233)	—	361	(361)	—
Stock-based compensation expense	924	(924)	—	653	(653)	—
Severance and other restructuring costs	536	(536)	—	563	(563)	—
Total operating expenses	14,556	(1,693)	12,863	13,499	(1,577)	11,922
(Loss) income from operations	$(8,270)	$ 1,870	$ (6,400)	$(2,083)	$ 1,066	$ (1,017)
(Loss) income from operations percentage	(69.5 %)	15.7 %	(53.8 %)	(12.1 %)	6.2 %	(5.9 %)
Weighted average common shares outstanding:						
Basic	35,649	35,649	35,649	35,351	35,351	35,351
Diluted	35,649	36,299	35,649	35,351	35,565	35,351
Non-GAAP operating (loss)						

income per share:						
Basic	$(0.23)	$ 0.05	$ (0.18)	$(0.06)	$ 0.03	$ (0.03)
Diluted	$(0.23)	$ 0.05	$ (0.18)	$(0.06)	$ 0.03	$ (0.03)

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	Six Months Ended July 31, 2018 GAAP As Reported	Adjustments	Non-GAAP	Six Months Ended July 31, 2017 GAAP As Reported	Adjustments	Non-GAAP
Revenues:						
Products	$4,553	$ —	$ 4,553	$7,788	$ —	$ 7,788
Services	22,283	—	22,283	26,104	—	26,104
Total revenues	26,836	—	26,836	33,892	—	33,892
Cost of revenues:						
Products	802	—	802	1,890	—	1,890
Services	10,486	—	10,486	10,198	593	10,791
Amortization of intangible assets	356	(356)	—	509	(509)	—
Stock-based compensation	—	—	—	2	(2)	—
Total cost of revenues	11,644	(356)	11,288	12,599	82	12,681
Gross profit	15,192	356	15,548	21,293	(82)	21,211
Gross profit percentage	56.6 %	1.3 %	57.9 %	62.8 %	(0.2 %)	62.6 %
Operating expenses:						
Research and development	10,641	—	10,641	11,777	—	11,777
Selling and marketing	7,071	—	7,071	5,376	—	5,376
General and administrative	8,015	—	8,015	6,727	—	6,727
Amortization of intangible assets	459	(459)	—	705	(705)	—
Stock-based compensation expense	1,802	(1,802)	—	1,528	(1,528)	—
Professional fees: other	—	—	—	21	(21)	—
Severance and other restructuring costs	590	(590)	—	2,710	(2,710)	—
Total operating expenses	28,578	(2,851)	25,727	28,844	(4,964)	23,880
(Loss) income from operations	$(13,386)	$ 3,207	$ (10,179)	$(7,551)	$ 4,882	$ (2,669)
(Loss) income from operations percentage	(49.9 %)	12.0 %	(37.9 %)	(22.3 %)	14.4 %	(7.9 %)
Weighted average common shares outstanding:						
Basic	35,628	35,628	35,628	35,331	35,331	35,331
Diluted	35,628	36,187	35,628	35,331	35,485	35,331
Non-GAAP operating (loss) income per share:						
Basic	$(0.38)	$ 0.09	$ (0.29)	$(0.22)	$ 0.14	$ (0.08)
Diluted	$(0.38)	$ 0.09	$ (0.29)	$(0.22)	$ 0.14	$ (0.08)

The changes in the table above during the three and six months ended July 31, 2018, compared to the same periods of 2017, were a result of the factors described in connection with revenues and operating expenses under Item 2. "Management's Discussion and Analysis of Financial Conditions and Results of Operations – Results of Operations," of this Form 10-Q.

In managing and reviewing our business performance, we exclude a number of items required by U.S. GAAP. Management believes that excluding these items is useful in understanding the trends and managing our operations. We provide these supplemental non-GAAP measures in order to assist the investment community in seeing SeaChange through the "eyes of management," and therefore enhance the understanding of SeaChange's operating performance. Non-GAAP financial measures should be viewed in addition to, not as an alternative to, our reported results prepared in accordance with U.S. GAAP. Our non-GAAP financial measures reflect adjustments based on the following items:

Provision for Loss Contract. We entered a fixed-price customer contract on a multi-year arrangement, which included multiple vendors. As the system integrator on the project, we are subject to any cost overruns or increases with these vendors resulting in delays of acceptance by our customer. Delays of customer acceptance on this project result in incremental expenditures and require us to recognize a loss on this project in the period the determination is made. As a result, we recorded an estimated loss of $9.2 million in fiscal 2016. Subsequently, because of changes in the scope of the project and negotiations with the fixed-price customer, we recorded adjustments since fiscal 2016 totaling $4.7 million to reduce this estimated loss. We believe that the exclusion of this item, which is recorded in cost of revenues – services, allows a comparison of operating results that would otherwise impair comparability between periods.

Amortization of Intangible Assets. We incur amortization expense of intangible assets related to various acquisitions that have been made in recent years. These intangible assets are valued at the time of acquisition, are then amortized over a period of several years after the acquisition and generally cannot be changed or influenced by management after the acquisition. We believe that exclusion of these expenses allows comparisons of operating results that are consistent over time for the Company's newly-acquired and long-held businesses.

Stock-based Compensation Expense. We incur expenses related to stock-based compensation included in our U.S. GAAP presentation of cost of revenues and operating expenses. Although stock-based compensation is an expense we incur and is viewed as a form of compensation, the expense varies in amount from period to period, and is affected by market forces that are difficult to predict and are not within the control of management, such as the market price and volatility of our shares, risk-free interest rates and the expected term and forfeiture rates of the awards.

Professional Fees - Other. We have excluded the effect of legal and other professional costs associated with our acquisitions, divestitures, litigation and strategic alternatives because the amounts are considered significant non-operating expenses.

Severance and Other Restructuring Costs. We incur charges due to the restructuring of our business, including severance charges and facility reductions resulting from our restructuring and streamlining efforts and any changes due to revised estimates, which we generally would not have otherwise incurred in the periods presented as part of our continuing operations.

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Liquidity and Capital Resources

The following table includes key line items of our consolidated statements of cash flows:

	Six Months Ended July 31,		Increase/ (Decrease)
	2018	2017	$ Amount
	(Amounts in thousands)		
Total cash used in operating activities	$(19,416)	$(2,317)	$(17,099)
Total cash used in investing activities	(1,937)	(39)	(1,898)
Total cash provided by (used in) financing activities	39	(10)	49
Effect of exchange rate changes on cash	2,593	(742)	3,335
Net decrease in cash, cash equivalents and restricted cash	$(18,721)	$(3,108)	$(15,613)

Historically, we have financed our operations and capital expenditures primarily with cash on-hand. Cash, cash equivalents, restricted cash, and marketable securities decreased from $52.1 million at January 31, 2018 to $35.0 million at July 31, 2018.

In September 2018, in order to return the Company to profitability by the end of fiscal 2019, we announced that we are implementing cost-savings actions during the third quarter of fiscal 2019 for our worldwide operations with the implementation of a restructuring program. The primary element of this program will be staff reductions across all of our functions and geographic areas and we expect the program to be completed by the end of the third quarter of fiscal 2019. Annualized cost savings will be approximately $6 million once completed and other restructuring and severance charges will be approximately $1 million.

During fiscal 2018, we made significant reductions to our headcount as part of our restructuring efforts that concluded as of January 31, 2018. These measures are important steps in restoring SeaChange to profitability and positive cash flow. The Company believes that existing funds and cash expected to be provided by future operating activities, augmented by the plan highlighted above, are adequate to satisfy our working capital and capital expenditure requirements and other contractual obligations for the foreseeable future, including at least the next 12 months.

However, if our expectations are incorrect, we may need to raise additional funds to fund our operations, to take advantage of unanticipated strategic opportunities or to strengthen our financial position. In the future, we may enter into other arrangements for potential investments in, or acquisitions of, complementary businesses, services or technologies, which could require us to seek additional equity or debt financing. If adequate funds are not available or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to develop new products or to otherwise respond to competitive pressures.

Operating Activities

Below are key line items affecting cash from operating activities:

	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount
	(Amounts in thousands)		
Net loss	$(14,551)	$(6,900)	$(7,651)
Adjustments to reconcile net loss to cash used in operating activities	2,672	4,029	(1,357)
Net loss including adjustments	(11,879)	(2,871)	(9,008)
Decrease in receivables	7,780	6,916	864
(Increase) decrease in inventory	(165)	57	(222)
(Increase) decrease in prepaid expenses and other current assets	(1,584)	8	(1,592)
Increase (decrease) in accounts payable	371	(2,594)	2,965
Decrease in accrued expenses	(10,640)	(3,193)	(7,447)
Decrease in deferred revenues	(5,729)	(870)	(4,859)
All other - net	2,430	230	2,200
Net cash used in operating activities	$(19,416)	$(2,317)	$(17,099)

We used net cash in operating activities of $19.4 million for the six months ended July 31, 2018. This cash used in operating activities was primarily the result of our net loss including adjustments of $11.9 million and by changes in working capital, which include a decrease in accrued expenses of $10.6 million related to the payment of severance, bonuses and value-added tax and a decrease in deferred revenue of $5.7 million, offset by a decrease in receivables of $7.8 million due to the timing of customer payments.

Investing Activities

Cash flows from investing activities are as follows:

	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount
	(Amounts in thousands)		
Purchases of property and equipment	$(284)	$(274)	$(10)
Purchases of marketable securities	(4,354)	(4,501)	147
Proceeds from sale and maturity of marketable securities	2,761	4,449	(1,688)
Other investing activities	(60)	287	(347)
Net cash used in investing activities	$(1,937)	$(39)	$(1,898)

Cash used in investing activities includes $0.3 million for the purchase of capital assets during fiscal 2019 and the net purchase of marketable securities of $1.6 million.

Financing Activities

Cash flows from financing activities are as follows:

	Six Months Ended July 31, 2018	2017	Increase/ (Decrease) $ Amount
	(Amounts in thousands)		
Proceeds from issuance of common stock	$73	$26	$ 47
Payments of withholding tax on RSU vesting	(34)	(36)	2
Net cash provided by (used in) financing activities	$39	$(10)	$ 49

In the six months ended July 31, 2018, cash provided by financing activities reflects proceeds received from the issuance of common stock for the employee stock purchase plan.

The effect of exchange rate changes increased cash, cash equivalents and restricted cash by $2.6 million for the six months ended July 31, 2018, primarily due to the translation of European subsidiaries' cash balances, which use the Euro as their functional currency, to U.S. dollars.

Effects of Inflation

Management believes that financial results have not been significantly impacted by inflation and price changes in materials we use in manufacturing our products.

Contractual Obligations

There have been no significant changes outside the ordinary course of our business in our contractual obligations disclosed in our Form 10-K for the fiscal year ended January 31, 2018.

Critical Accounting Policies and Significant Judgment and Estimates

The accounting and financial reporting policies of SeaChange are in conformity with U.S. GAAP, which requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses and disclosure of contingent assets and liabilities. We evaluate our estimates on an on-going basis, including those related to revenue recognition, allowance for doubtful accounts, acquired intangible assets and goodwill, stock-based compensation, impairment of long-lived assets and accounting for income taxes. Our estimates are based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates. For a description of our critical accounting policies affecting revenue recognition and impairment of assets, see Note 2, "Significant Accounting Policies," to this Form 10-Q. For a description of other critical accounting policies that affect our more significant judgments and estimates used in the preparation of our consolidated financial statements, refer to our Form 10-K for the fiscal year ended January 31, 2018 filed with the SEC.

Recent Accounting Standard Updates

See Note 14, "Recent Accounting Standard Updates," to our consolidated financial statements included in Item 1 of this Form 10-Q for a summary of recent accounting standard updates.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Exchange Risk

We face exposure to financial market risks, including adverse movements in foreign currency exchange rates and changes in interest rates. These exposures may change over time as business practices evolve and could have a material adverse impact on our financial results. Our foreign currency exchange exposure is primarily associated with product sales arrangements or settlement of intercompany payables and receivables among subsidiaries and their parent company, and/or investment/equity contingency considerations denominated in the local currency where the functional currency of the foreign subsidiary is the U.S. dollar.

Our principal currency exposures relate primarily to the U.S. dollar and the Euro. All foreign currency gains and losses are included in other (expenses) income, net, in the accompanying consolidated statements of operations and comprehensive loss. For the six months ended July 31, 2018, we recorded $2.9 million in losses due to the international subsidiary translations and cash settlements of revenues and expenses.

A substantial portion of our earnings are generated by our foreign subsidiaries whose functional currency is other than the U.S. dollar. Therefore, our earnings could be materially impacted by movements in foreign currency exchange rates upon the translation of the subsidiary's earnings into the U.S. dollar. If the U.S. dollar had strengthened by 10% compared to the Euro, our total revenues would have decreased by $0.4 million and $0.9 million for the three and six months ended July 31, 2018, respectively, and it would have increased our loss from operations by $0.2 million and $0.4 million for the same periods.

Interest Rate Risk

Exposure to market risk for changes in interest rates relates primarily to our investment portfolio of marketable debt securities of various issuers, types and maturities. We do not use derivative instruments in our investment portfolio, and our investment portfolio only includes highly liquid instruments. Our cash and marketable securities include cash equivalents, which we consider to be investments purchased with original maturities of 90 days or less. There is risk that losses could be incurred if we were to sell any of our securities prior to stated maturity. Given the short maturities and investment grade quality of the portfolio holdings at July 31, 2018, a hypothetical 10% adverse change in interest rates should not have a material adverse impact on the fair value of our investment portfolio.

ITEM 4. Controls and Procedures

Evaluation of disclosure controls and procedures. We evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as of the end of the period covered by this Form 10-Q. Edward Terino, our Chief Executive Officer (“CEO”), and Peter R. Faubert, our Chief Financial Officer (“CFO”), reviewed and participated in this evaluation. The Company’s disclosure controls and procedures are designed to ensure that material information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and that such material information is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow timely decisions regarding required disclosures. Based upon that evaluation, Messrs. Terino and Faubert concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report and as of the date of the evaluation.

Changes in internal control over financial reporting. As a result of the evaluation completed by us, and in which Messrs. Terino and Faubert participated, we have concluded that there were no changes during the fiscal quarter ended July 31, 2018 in our internal control over financial reporting, which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

We enter into agreements in the ordinary course of business with customers, resellers, distributors, integrators and suppliers. Most of these agreements require us to defend and/or indemnify the other party against intellectual property infringement claims brought by a third party with respect to our products. From time to time, we also indemnify customers and business partners for damages, losses and liabilities they may suffer or incur relating to personal injury, personal property damage, product liability, and environmental claims relating to the use of our products and services or resulting from the acts or omissions of us, our employees, authorized agents or subcontractors. Management cannot reasonably estimate any potential losses, but these claims could result in material liability for us.

ITEM 1A. Risk Factors

In addition to other information set forth in this Form 10-Q, you should carefully consider the risk factors discussed in Part I, “Item 1A. Risk Factors” in our Form 10-K for the fiscal year ended January 31, 2018, which could materially affect our business, financial conditions, and results of operations. The risks described in our Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition or future results.

ITEM 6. Exhibits

(a) Exhibits

See the Exhibit Index following the signature page to this Form 10-Q.

Index to Exhibits

No.	Description
10.1	Employee Separation Agreement and Voluntary Release, dated July 18, 2018, by and between the Company and Jon Rider (filed herewith).
31.1	Certification Pursuant to Rule 13a-14(a) of the Exchange Act, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification Pursuant to Rule 13a-14(a) of the Exchange Act, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, SeaChange International, Inc. has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: September 10, 2018

SEACHANGE INTERNATIONAL, INC.

by: /s/ PETER R. FAUBERT
Peter R. Faubert
Chief Financial Officer, Senior Vice President,
and Treasurer

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