AVID TECHNOLOGY INC
Form 10-Q
August 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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# FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

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Commission File Number 0-21174

AVID TECHNOLOGY, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| DELAWARE | 04-2977748 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

AVID TECHNOLOGY PARK
ONE PARK WEST
TEWKSBURY, MA 01876
(Address of principal executive offices)

Registrant's telephone number, including area code: (978) 640-6789

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes [X]     No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer [X]   Accelerated Filer    Non-accelerated Filer

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

Yes       No [X]

The number of shares outstanding of the registrant's Common Stock as of July 24, 2006 was 42,327,550.

AVID TECHNOLOGY, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

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AVID TECHNOLOGY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net revenues: | | | | |
| Product | $197,960 | $141,636 | $392,323 | $289,178 |
| Services | 24,266 | 18,415 | 47,973 | 36,874 |
| Total net revenues | 222,226 | 160,051 | 440,296 | 326,052 |
| Cost of revenues: | | | | |
| Product | 93,819 | 61,244 | 185,180 | 122,141 |
| Services | 13,812 | 10,027 | 27,127 | 20,097 |
| Amortization of intangible assets | 5,016 | 282 | 10,096 | 563 |
| Total cost of revenues | 112,647 | 71,553 | 222,403 | 142,801 |
| Gross profit | 109,579 | 88,498 | 217,893 | 183,251 |
| Operating expenses: | | | | |
| Research and development | 35,617 | 24,910 | 71,113 | 49,589 |
| Marketing and selling | 52,583 | 38,452 | 102,495 | 76,294 |
| General and administrative | 15,853 | 10,471 | 30,990 | 20,773 |
| Restructuring costs | - | - | 1,066 | - |
| In-process research and development | - | - | 310 | - |
| Amortization of intangible assets | 3,977 | 1,593 | 7,642 | 3,185 |
| Total operating expenses | 108,030 | 75,426 | 213,616 | 149,841 |
| Operating income | 1,549 | 13,072 | 4,277 | 33,410 |
| Interest income | 2,144 | 1,052 | 4,213 | 1,860 |
| Interest expense | (89) | (95) | (187) | (189) |
| Other income (expense), net | (174) | 222 | (174) | 345 |
| Income before income taxes | 3,430 | 14,251 | 8,129 | 35,426 |
| Provision for income taxes | 731 | 685 | 2,084 | 2,114 |
| Net income | $2,699 | $13,566 | $6,045 | $33,312 |
| Net income per common share - basic | $0.06 | $0.39 | $0.14 | $0.95 |
| Net income per common share - diluted | $0.06 | $0.37 | $0.14 | $0.90 |
| Weighted-average common shares | 42,273 | 35,177 | 42,205 | 35,083 |

| | | | | |
|---|---|---|---|---|
| outstanding - basic | | | | |
| Weighted-average common shares outstanding - diluted | 43,057 | 37,024 | 43,126 | 37,154 |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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AVID TECHNOLOGY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)
(unaudited)

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $152,672 | $133,954 |
| Marketable securities | 85,475 | 104,476 |
| Accounts receivable, net of allowances of $22,212 and $22,233 at June 30, 2006 and December 31, 2005, respectively | 143,934 | 140,669 |
| Inventories | 121,979 | 96,845 |
| Current deferred tax assets, net | 566 | 528 |
| Prepaid expenses | 8,558 | 8,548 |
| Other current assets | 14,152 | 16,657 |
| Total current assets | 527,336 | 501,677 |
| Property and equipment, net | 38,096 | 38,563 |
| Intangible assets, net | 110,248 | 118,676 |
| Goodwill | 410,895 | 396,902 |
| Other assets | 6,410 | 6,228 |
| Total assets | $1,092,985 | $1,062,046 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $52,459 | $43,227 |
| Accrued compensation and benefits | 25,450 | 27,841 |
| Accrued expenses and other current liabilities | 51,426 | 55,443 |
| Income taxes payable | 15,625 | 13,027 |
| Deferred revenues | 66,913 | 62,863 |
| Total current liabilities | 211,873 | 202,401 |
| Long-term liabilities | 18,790 | 20,048 |
| Total liabilities | 230,663 | 222,449 |

Contingencies (Note 8)

| | | |
|---|---|---|
| Stockholders' equity: | | |
| Common stock | 423 | 421 |
| Additional paid-in capital | 939,907 | 928,703 |
| Accumulated deficit | (82,750) | (88,795) |
| Deferred compensation | - | (1,830) |
| Accumulated other comprehensive income | 4,742 | 1,098 |
| Total stockholders' equity | 862,322 | 839,597 |
| Total liabilities and stockholders' equity | $1,092,985 | $1,062,046 |

The accompanying notes are an integral part of the condensed consolidated financial statements.



AVID TECHNOLOGY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | Six Months Ended June 30 | |
|---|---|---|
| | 2006 | 2005 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $6,045 | $33,312 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 28,348 | 10,660 |
| Provision for (recoveries of) doubtful accounts | (1,107) | 625 |
| In-process research and development | 310 | - |
| Loss (gain) on disposal of fixed assets | 133 | (55 |
| Compensation expense from stock grants and options | 8,860 | 1,514 |
| Equity in loss (income) of non-consolidated company | 203 | (164 |
| Changes in deferred tax assets and liabilities, excluding initial effects of acquisitions | (974) | (345 |
| Changes in operating assets and liabilities, excluding initial effects of acquisitions: | | |
| Accounts receivable | 3,269 | (3,734 |
| Inventories | (22,746) | (10,169 |
| Prepaid expenses and other current assets | 3,663 | (3,763 |
| Accounts payable | 4,840 | 2,577 |
| Income taxes payable | 1,790 | 1,001 |
| Accrued expenses, compensation and benefits and other liabilities | (8,318) | (4,015 |
| Deferred revenues | (778) | 10,768 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 23,538 | 38,212 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (9,062) | (8,221 |
| Payments for other long-term assets | (569) | (311 |
| Payments for business acquisitions, including transaction costs, net of cash acquired | (20,490) | - |

| | | |
|---|---|---|
| Purchases of marketable securities | (31,439) | (27,255 |
| Proceeds from sales of marketable securities | 51,397 | 34,401 |
| NET CASH USED IN INVESTING ACTIVITIES | (10,163) | (1,386 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Payments on capital lease obligations | (37) | (30 |
| Proceeds from issuance of common stock under employee stock plans | 4,177 | 8,922 |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 4,140 | 8,892 |
| Effect of exchange rate changes on cash and cash equivalents | 1,203 | (1,137 |
| Net increase in cash and cash equivalents | 18,718 | 44,581 |
| Cash and cash equivalents at beginning of period | 133,954 | 79,058 |
| Cash and cash equivalents at end of period | $152,672 | $123,639 |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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PART I. FINANCIAL INFORMATION

ITEM 1D. NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. FINANCIAL INFORMATION

The accompanying condensed consolidated financial statements include the accounts of Avid Technology, Inc. and its wholly owned subsidiaries (collectively, "Avid" or the "Company"). These financial statements are unaudited. However, in the opinion of management, the condensed consolidated financial statements include all adjustments, consisting of only normal, recurring adjustments, necessary for their fair statement. Interim results are not necessarily indicative of results expected for a full year. The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a complete presentation of operations, financial position and cash flows of the Company in conformity with generally accepted accounting principles. The accompanying condensed consolidated balance sheet as of December 31, 2005 was derived from Avid's audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles. The Company filed audited consolidated financial statements for the year ended December 31, 2005 in its 2005 Annual Report on Form 10-K, which included all information and footnotes necessary for such presentation; the financial statements contained in this Form 10-Q should be read in conjunction with the audited consolidated financial statements in the Form 10-K. Certain amounts in the prior years' financial statements have been reclassified to conform to the current year presentation. As disclosed in the Company's 2005 Annual Report on Form 10-K, during 2005, the Company began reclassifying certain European administrative expenses as general and administrative expense rather than as marketing and selling expense. During 2006, the Company began reclassifying the long-term portion of certain liabilities from the captions 'deferred revenue' and 'accrued expenses and other current liabilities' to 'long-term liabilities' in the Condensed Consolidated

Balance Sheets. See Note 6 for the amounts included in long-term liabilities for each period presented.

The Company's preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reported periods. The most significant estimates reflected in these financial statements include accounts receivable and sales allowances, purchase accounting, stock-based compensation, inventory valuation and income tax asset valuation allowances. Actual results could differ from those estimates.

On April 13, 2006, the Company acquired Sundance Digital, Inc. ("Sundance"), a Texas-based developer of automation and device control software for broadcast video servers, tape transports, graphics systems and other broadcast station equipment. The results of operations of Sundance have been included in the Company's results of operations since the acquisition date (see Note 3).

On January 12, 2006, the Company acquired Medea Corporation ("Medea"), a California-based provider of low cost storage solutions for real-time media applications. The results of operations of Medea have been included in the Company's results of operations since the acquisition date (see Note 3).

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2. NET INCOME PER COMMON SHARE

Basic and diluted net income per share were as follows (in thousands, except per share data):

| | Three Months Ended June 30, | | Six Month June |
|---|---|---|---|
| | 2006 | 2005 | 2006 |
| Net income | $2,699 | $13,566 | $6,045 |
| Weighted-average common shares outstanding - basic | 42,273 | 35,177 | 42,205 |
| Weighted-average potential common stock: | | | |
| Options | 784 | 1,707 | 921 |
| Warrant | - | 140 | - |
| Weighted-average common shares outstanding - diluted | 43,057 | 37,024 | 43,126 |
| Net income per common share - basic | $0.06 | $0.39 | $0.14 |
| Net income per common share - diluted | $0.06 | $0.37 | $0.14 |

Common stock equivalents that were considered anti-dilutive securities and excluded from the diluted net income per share calculations, were as follows, on a weighted-average basis (in thousands):

Three Months Ended Six Months Ended

| | June 30, | | June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Options | 2,590 | 852 | 2,529 | 564 |
| Warrant | 1,155 | - | 1,155 | - |
| Restricted stock and restricted stock units | 230 | - | 151 | - |
| Total anti-dilutive common stock equivalents | 3,975 | 852 | 3,835 | 564 |

## 3. ACQUISITIONS

### Sundance

On April 13, 2006, Avid acquired all the outstanding shares of Sundance Digital, Inc., a Texas-based developer of automation and device control software for broadcast video servers, tape transports, graphics systems and other broadcast station equipment, for cash of $12.5 million plus transaction costs of $0.2 million. The Company performed a preliminary allocation of the total purchase price of $12.7 million to the net tangible and intangible assets of Sundance based on their fair values as of the consummation of the acquisition. The purchase price was allocated as follows: ($2.7) million to net liabilities assumed, $5.6 million to amortizable identifiable intangible assets and the remaining $9.8 million to goodwill. The goodwill, which reflects the value of the assembled workforce and the synergies the Company expects to realize by offering Sundance's broadcast automation products to its Professional Video segment customers, is reported within the Professional Video segment and is not deductible for tax purposes.

The Company used the cost approach to determine the value of the developed technology and used the income approach to determine the values of the other acquired intangible assets. The cost approach is based on the economic principles of substitution and price equilibrium and requires an estimation of the costs required to reproduce the intangible asset, which are then reduced for depreciation of the asset. The income approach presumes that the value of an asset can be estimated by the net economic benefit to be received over the life of the asset, generally cash flows discounted to present value. This approach typically uses a projection of revenues and expenses attributed to the intangible asset to calculate a potential income stream which is then discounted using a rate of return that is based on the weighted-average cost of capital factored for the risk, or uncertainty, associated with achieving the projected income stream. The weighted-average discount rate (or rate of return) used to determine the value of Sundance's intangible assets was 20% and the effective tax rate used was 35%.

The amortizable identifiable intangible assets include developed technology of $3.9 million, customer relationships of $1.0 million, non-compete agreements of $0.4 million and trademarks and trade name of $0.3 million. The values of the customer relationships, non-compete agreements and trademarks and trade name, which were determined using the income approach, are being amortized on a



straight-line basis over their estimated useful lives of six years, two years and six years, respectively. The value of the developed technology, which was determined using the cost approach, is being amortized over the greater of the amount calculated using the ratio of current quarter revenue to the total of current quarter and anticipated future revenues, or the straight-line method, over the estimated useful life of three years. The weighted-average amortization period for the amortizable identifiable intangible assets is approximately four years. Amortization expense for these intangibles totaled $0.4 million for both the three- and six-month periods ended June 30, 2006 and accumulated amortization was $0.4 million at June 30, 2006.

Medea

On January 12, 2006, Avid acquired all the outstanding shares of Medea Corporation, a California-based provider of local storage solutions for real-time media applications, for cash of $8.9 million plus transaction costs of $0.2 million. The Company performed a preliminary allocation of the total purchase price of $9.1 million to the net tangible and intangible assets of Medea based on their fair values as of the consummation of the acquisition. The purchase price was allocated as follows: ($2.1) million to net liabilities assumed, $3.8 million to amortizable identifiable intangible assets, $0.3 million to in-process research and development ("R&D") and the remaining $7.1 million to goodwill. During the second quarter of 2006, the Company continued its analysis of the fair values of certain assets and liabilities, primarily related to accruals for employee terminations. Accordingly, the Company recorded an additional liability of $0.3 million and a corresponding increase to goodwill. The total goodwill of $7.4 million, which reflects the value of the assembled workforce and the synergies the Company expects to realize by offering Medea's RAID (Redundant Array of Independent Disks) storage solutions to its Professional Video segment customers, is reported within the Professional Video segment and is not deductible for tax purposes.

The Company used the income approach to determine the value of the intangible assets, using a weighted-average discount rate (or rate of return) of 19% and an effective tax rate of 35%. The amortizable identifiable intangible assets include developed technology of $2.7 million, customer relationships of $0.7 million, order backlog of $0.3 million and non-compete agreements of $0.1 million. The customer relationships, order backlog and non-compete agreements are being amortized on a straight-line basis over their estimated useful lives of six years, one-half year and two years, respectively. Developed technology is being amortized over the greater of the amount calculated using the ratio of current quarter revenue to the total of current quarter and anticipated future revenues, or the straight-line method, over the estimated useful life of two and one-half years. The weighted-average amortization period for the amortizable identifiable intangible assets is approximately three years. Amortization expense for these intangibles totaled $0.5 million and $1.0 million, respectively, for the three- and six-month periods ended June 30, 2006 and accumulated amortization was $1.0 million at June 30, 2006. The allocation of $0.3 million to in-process R&D was expensed during the three months ended March 31, 2006.

Pinnacle

In August 2005, Avid completed the acquisition of California-based Pinnacle Systems, Inc. ("Pinnacle"), a supplier of digital video products to customers ranging from individuals to broadcasters. Avid paid $72.1 million in cash plus common stock consideration of approximately $362.9 million in exchange for all of the outstanding shares of Pinnacle. Avid also incurred $6.5 million of transaction costs. The Company has included Pinnacle's broadcast and professional offerings, including the Deko(R) on-air graphics system and the MediaStream(TM) playout server, into its Professional Video segment and has formed a new Consumer Video segment that offers Pinnacle's consumer products, including Pinnacle Studio(TM) and other products.

During 2005, the Company allocated the total purchase price of $441.4 million as follows: $91.8 million to net assets acquired, $123.1 million to identifiable intangible assets (including $32.3 million of in-process R&D) and the remaining $226.5 million to goodwill. During the first and second quarters of 2006, the Company continued its analysis of the fair values of certain assets and liabilities, in particular accruals for employee terminations, facilities closures and contract terminations; inventory reserves and certain other accruals. Accordingly, the Company recorded adjustments to these assets and liabilities, resulting in a $3.1 million increase in the value of the net assets acquired and a corresponding decrease to goodwill.

The identifiable intangible assets, with the exception of the in-process R&D, which was expensed at the time of acquisition, are being amortized over their estimated useful lives of six and one-half years for customer relationships, seven years for the trade names and two to three years for the developed technology. The weighted-average amortization period for these intangible assets in total is approximately five years. These intangible assets are being amortized using the straight-line method, with the exception of developed technology. Developed technology is being amortized on a product-by-product basis over the greater of: 1) the amount calculated using the ratio of current quarter revenues to the total of current quarter and anticipated future revenues over the estimated useful lives of two to three years; or 2) the straight-line method over each product's remaining respective useful life. Amortization



expense for these intangibles totaled $6.3 million and $12.6 million, respectively, for the three- and six-month periods ended June 30, 2006 and accumulated amortization was $25.2 million at June 30, 2006.

The goodwill of $223.4 million resulting from the purchase price allocation reflects the value of the underlying enterprise, as well as planned synergies that Avid expects to realize, including incremental sales of legacy Avid Professional Video products. Of the total $223.4 million of goodwill, $88.3 million has been assigned to the Company's Professional Video segment and $135.1 million has been assigned to the Consumer Video segment. This goodwill is not deductible for tax purposes and will not be amortized for financial reporting purposes, in accordance with the requirements of Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets".

Wizoo

In August 2005, Avid acquired all the outstanding shares of Wizoo Sound Design GmbH ("Wizoo"), a Germany-based provider of virtual instruments for music producers and sound designers. The total purchase price of $5.1 million was allocated as follows: ($0.6 million) to net liabilities assumed, $1.2 million to identifiable intangible assets, $0.1 million to in-process R&D and the remaining $4.4 million to goodwill. The identifiable intangible assets, which include developed technology of $0.6 million and license agreements of $0.6 million, are being amortized on a straight-line basis over their estimated useful lives of two to four years and three to four years, respectively. Amortization expense for these intangibles totaled $0.1 million and $0.2 million, respectively, for the three- and six-month periods ended June 30, 2006 and accumulated amortization was $0.4 million at June 30, 2006. The goodwill of $4.4 million, which reflects the value of the assembled workforce and the synergies the Company hopes to realize by integrating the Wizoo technology with its other products, is reported within the Company's Audio segment and is not deductible for tax purposes.

As part of the purchase agreement, Avid may be required to make additional payments to the former shareholders of Wizoo of up to 1.0 million euros ($1.2 million), contingent upon Wizoo achieving certain engineering milestones through January 2008. These payments, if required, will be recorded as additional purchase consideration, allocated to goodwill. As of June 30, 2006, two engineering milestones have been met and $0.2 million has been recorded as additional purchase price.

Pro Forma Financial Information for Acquisitions (Unaudited)

The results of operations of Sundance, Medea, Pinnacle and Wizoo have been included in the results of operations of the Company since the respective date of each acquisition. The following unaudited pro forma financial information presents the results of operations for the three- and six-month periods ended June 30, 2005 as if the acquisition of Pinnacle had occurred at the beginning of 2005. The Company's pro forma results of operations giving effect to the Sundance, Medea and Wizoo acquisitions as if each had occurred at the beginning of 2005 are not included as they would not differ materially from reported results. The pro forma financial information for the combined entities has been prepared for comparative purposes only and is not indicative of what actual results would have been if the acquisitions had taken place at the beginning of fiscal 2005, or of future results.

| | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|---|---|---|
| (In thousands, except per share data) | | |
| Net revenues | $214,519 | $445,724 |
| Net loss | ($4,651) | ($25,709) |
| Net loss per share: | | |
| Basic | ($0.11) | ($0.62) |
| Diluted | ($0.11) | ($0.62) |

Included in the pro forma net income reported above for the six-month period ended June 30, 2005 is a charge of $32.3 million for in-process R&D related to the Pinnacle acquisition.

Amortizing Identifiable Intangible Assets

As a result of the Company's acquisitions, amortizing identifiable intangible assets consist of the following (in thousands):



| | June 30, 2006 | | | December 31, 2005 | | |
|---|---|---|---|---|---|---|
| | Gross | Accumulated Amortization | Net | Gross | Accumulated Amortization | Net |
| Completed technologies | $59,328 | ($25,603) | $33,725 | $52,698 | ($14,606) | $38,0 |
| Customer relationships | 69,800 | (11,204) | 58,596 | 68,200 | (6,755) | 61,4 |
| Trade names | 20,516 | (3,509) | 17,007 | 20,245 | (1,993) | 18,2 |
| Non-compete covenants | 1,670 | (1,179) | 491 | 1,200 | (818) | 3 |
| License agreements | 560 | (131) | 429 | 560 | (55) | 5 |
| Order Backlog | 340 | (340) | - | - | - | |
| | $152,214 | ($41,966) | $110,248 | $142,903 | ($24,227) | $118,6 |

Amortization expense related to all intangible assets in the aggregate was $9.0

million and $1.9 million, respectively, for the three-month periods ended June 30, 2006 and 2005, and $17.7 million and $3.7 million, respectively, for the six-month periods ended June 30, 2006 and 2005. The Company expects amortization of these intangible assets to be approximately $17 million for the remainder of 2006, $27 million in 2007, $20 million in 2008, $13 million in 2009, $11 million in 2010, $10 million in 2011 and $12 million thereafter.

4. ACCOUNTS RECEIVABLE

Accounts receivable, net consist of the following (in thousands):

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Accounts receivable | $166,146 | $162,902 |
| Less: | | |
| Allowance for doubtful accounts | (2,969) | (4,847) |
| Allowance for sales returns and rebates | (19,243) | (17,386) |
| | $143,934 | $140,669 |

The allowance for doubtful accounts represents a reserve for estimated bad debt losses resulting from the inability of customers to make required payments for products or services. When evaluating the adequacy of this allowance, the Company analyzes accounts receivable balances, historical bad debt experience, customer concentrations, customer credit-worthiness and current economic trends. The allowance for sales returns and rebates, which includes allowances for estimated returns, exchanges and credits for price protection, are provided as a reduction of revenues in the same period that related revenues are recorded, based upon the Company's historical experience. To date, actual returns and other allowances have not differed materially from management's estimates.

The accounts receivable balances as of June 30, 2006 and December 31, 2005 are net of approximately $20 million and $17 million, respectively, which represent amounts for large solution and certain distributor sales that have been invoiced but for which revenue has not been earned and payment is not due.

5. INVENTORIES

Inventories, net of related reserves, consist of the following (in thousands):

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Raw materials | $43,281 | $26,878 |
| Work in process | 9,841 | 13,040 |
| Finished goods | 68,857 | 56,927 |
| | $121,979 | $96,845 |

As of June 30, 2006 and December 31, 2005, the finished goods inventory includes inventory at customer locations of $11.6 million and $11.5 million, respectively, associated with product shipped to customers for which revenue has not yet been recognized.



6. LONG-TERM LIABILITIES

Long-term liabilities consist of the following (in thousands):

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Long-term deferred tax liability | $7,871 | $9,372 |
| Long-term deferred revenue | 4,631 | 3,171 |
| Long-term deferred rent | 3,295 | 3,644 |
| Long-term accrued restructuring | 2,993 | 3,861 |
| | $18,790 | $20,048 |

## 7. ACCOUNTING FOR STOCK-BASED COMPENSATION

The Company has several stock-based compensation plans under which employees, officers, directors and consultants may be granted stock awards or options to purchase the Company's common stock, generally at the market price on the date of grant. Certain plans allow for options to be granted at below market price under certain circumstances, although this is typically not the Company's practice. The options become exercisable over various periods, typically four years for employees and one year for non-employee directors, and have a maximum term of ten years. As of June 30, 2006, 2,591,105 shares of common stock remain available to cover future stock option grants under the Company's stock-based compensation plans, including 2,227,063 shares that may alternatively be issued as awards of restricted stock, restricted stock units or other forms of stock-based compensation.

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123(R)"), which is a revision of SFAS No. 123, "Accounting for Stock Based Compensation". SFAS 123(R) requires employee stock-based compensation awards to be accounted for under the fair value method and eliminates the ability to account for these instruments under the intrinsic value method as prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. The Company adopted SFAS 123(R) on January 1, 2006 using the modified prospective application method as permitted under SFAS 123(R). Under this method, the Company is required to record compensation cost, based on the fair value estimated in accordance with SFAS 123(R), for stock-based awards granted after the date of adoption over the requisite service periods for the individual awards, which generally equals the vesting period. The Company is also required to record compensation cost for the unvested portion of previously granted stock-based awards outstanding at the date of adoption over the requisite service periods for the individual awards based on the fair value estimated in accordance with the original provisions of SFAS No. 123 adjusted for forfeitures as required by SFAS 123(R).

Prior to the adoption of SFAS 123(R), the Company accounted for stock-based compensation under the recognition and measurement principles of APB Opinion No. 25 and related interpretations. Accordingly, no compensation expense was recorded for options issued to employees and directors in fixed amounts and with fixed exercise prices at least equal to the market price of the Company's common stock at the date of grant. In connection with the acquisition of M-Audio in August 2004, the Company granted options to certain M-Audio employees at exercise prices that were less than the market price of the Company's common stock at the date of grant. The Company recorded the difference between the exercise prices and the fair values of the options at the date of completion of the acquisition, determined under the Black-Scholes method, multiplied by the number of shares underlying the options, as deferred compensation. The resulting deferred compensation is being expensed over the vesting period of the options. Additionally, deferred compensation was recorded for restricted stock granted to employees based on the market price of the Company's common stock at the date of grant, which is being expensed over the period in which the restrictions lapse. In connection with the adoption of SFAS 123(R) on January 1, 2006, the Company reversed the remaining deferred compensation of $1.8 million, with the offset to additional paid-in capital.

The following table illustrates the effect on net income and net income per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to all stock-based employee awards for the three- and six-month periods ended June 30, 2005 (in thousands, except per share data):



| | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|---|---|---|
| Net income as reported | $13,566 | $33,312 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 672 | 1,514 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects | (5,904) | (10,724) |
| Pro forma net income | $8,334 | $24,102 |
| Net income per share: | | |
| Basic-as reported | $0.39 | $0.95 |
| Basic-pro forma | $0.24 | $0.69 |
| Diluted-as reported | $0.37 | $0.90 |
| Diluted-pro forma | $0.23 | $0.66 |

Beginning with the adoption of SFAS 123(R) in the first quarter of 2006, the Company recorded stock-based compensation expense for the fair value of stock options. Stock-based compensation expense of $4.4 million and $8.9 million, resulting from the adoption of SFAS 123(R), the acquisition of M-Audio and the issuance of restricted stock and restricted stock units, was included in the following captions in the Company's condensed consolidated statement of operations for the three- and six-month periods ended June 30, 2006, respectively (in thousands):

| | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2006 |
|---|---|---|
| Product cost of revenues | $131 | $270 |
| Services cost of revenues | 208 | 427 |
| Research and development expense | 1,272 | 2,607 |
| Marketing and selling expense | 1,230 | 2,533 |
| General and administrative expense | 1,513 | 3,023 |

| | |
|---|---|
| $4,354 | $8,860 |

The fair values of restricted stock awards, including restricted stock and restricted stock units, are based on the intrinsic values of the awards at the date of grant. As permitted under SFAS No. 123 and SFAS 123(R), the Company uses the Black-Scholes option pricing model to estimate the fair value of stock option grants. The Black-Scholes model relies on a number of key assumptions to calculate estimated fair values. The following table sets forth the weighted-average key assumptions and fair value results for stock options granted during the three- and six-month periods ended June 30, 2006 and 2005:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Expected dividend yield | 0.00% | 0.00% | 0.00% | 0.00% |
| Risk-free interest rate | 5.01% | 3.63% | 4.86% | 3.82% |
| Expected volatility | 34.32% | 48.00% | 34.52% | 50.80% |
| Expected life (in years) | 4.63 | 4.17 | 4.48 | 4.09 |
| Weighted-average fair value of options granted | $14.17 | $22.81 | $15.11 | $28.17 |

The dividend yield of zero is based on the fact that the Company has never paid cash dividends and has no present intention to pay cash dividends. Since adoption of SFAS 123(R) on January 1, 2006, the expected stock-price volatility assumption used by the Company has been based on recent (six month trailing) implied volatility calculations. These calculations are performed on exchange-traded options of the Company's stock, based on the implied volatility of long-term (nine to thirty-nine month term) exchange traded options, which is

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consistent with the requirements of SFAS 123(R) and Securities and Exchange Commission Staff Accounting Bulletin No. 107. The Company believes that using a forward-looking, market-driven volatility assumption will result in the best estimate of expected volatility. Prior to adoption of SFAS 123(R), the expected volatility was based on historical volatilities of the underlying stock. The risk-free interest rate is the U.S. Treasury security rate with a term equal to the expected life of the option. The expected life is based on company-specific historical experience. With regard to the estimate of the expected life, the Company considers the exercise behavior of past grants and models the pattern of aggregate exercises.

Based on the Company's historical turnover rates, an annualized estimated forfeiture rate of 6.5% has been used in calculating the estimated compensation cost for both the three- and six-month periods ended June 30, 2006. Additional expense will be recorded if the actual forfeiture rates are lower than estimated and a recovery of prior expense will be recorded if the actual forfeitures are higher than estimated. Prior to the adoption of SFAS 123(R), forfeitures were not estimated at the time of award.

Information with respect to options granted under all stock option plans is as follows:

| | Six Months Ended June 30, 2006 | | | |
|---|---|---|---|---|
| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | A I t |
| Options outstanding at December 31, 2005 | 4,220,174 | $36.65 | | |
| Granted | 186,200 | $41.64 | | |
| Exercised | (211,021) | $16.33 | | |
| Forfeited | (114,873) | $40.00 | | |
| Canceled | (23,268) | $49.75 | | |
| Options outstanding at June 30, 2006 | 4,057,212 | $37.77 | 7.35 | |
| Options vested at June 30, 2006 and expected to vest | 3,917,650 | $37.48 | 7.30 | |
| Options exercisable at June 30, 2006 | 2,355,662 | $34.32 | 6.54 | |

The aggregate intrinsic value of stock options exercised during the six months ended June 30, 2006 was approximately $5.3 million. Cash received from the exercise of stock options for the six months ended June 30, 2006 was $3.4 million. The Company did not realize any actual tax benefit from the tax deductions for stock option exercises during the six months ended June 30, 2006, due to the full valuation allowance on the Company's U.S. deferred tax assets.

The following table summarizes the status of the Company's non-vested restricted stock units as of December 31, 2005 and changes during the six months ended June 30, 2006:

| | Non-Vested Restricted Stock Units | | | |
|---|---|---|---|---|
| | Shares | Weighted-Average Grant-Date Fair Value | Weighted-Average Remaining Recognition Period | Aggregate Intrinsic Value (in thousands) |
| Non-vested at December 31, 2005 | - | - | | |
| Granted | 207,757 | $47.01 | | |
| Vested | - | - | | |
| Forfeited | (2,950) | $47.01 | | |
| Non-vested at June 30, 2006 | 204,807 | $47.01 | 3.69 | $6,824 |

The following table summarizes the status of the Company's non-vested restricted stock as of December 31, 2005 and changes during the six months ended June 30, 2006:

| | Non-Vested Restricted Stock | | | |
|---|---|---|---|---|
| | Shares | Weighted-Average Grant-Date Fair Value | Weighted-Average Remaining Recognition Period | Aggregate Intrinsic Value (in thousands) |
| Non-vested at December 31, 2005 | 15,000 | $56.72 | | |
| Granted | 8,618 | $47.01 | | |
| Vested | - | - | | |
| Forfeited | - | - | | |
| Non-vested at June 30, 2006 | 23,618 | $53.18 | 2.85 | $787 |

As of June 30, 2006, there was $33.6 million of total unrecognized compensation cost, before forfeitures, related to non-vested stock-based compensation awards granted under the Company's stock-based compensation plans. This cost will be recognized over the next four years. The Company expects this amount to be amortized as follows: $8.8 million during the remainder of 2006, $12.7 million in 2007 and $12.1 million thereafter. The weighted-average recognition period of the total unrecognized compensation cost is 1.41 years.

The Company's 1996 Employee Stock Purchase Plan, as amended through May 25, 2003, authorizes the issuance of a maximum of 1,700,000 shares of common stock in quarterly offerings to employees at a price equal to 95% of the closing price on the applicable offering termination date. As of June 30, 2006, 310,261 shares remain available for issuance under this plan. Based on the plan design, the Company's 1996 Employee Stock Purchase Plan is considered noncompensatory under SFAS 123(R). Accordingly, the Company is not required to assign fair value to shares issued from this plan.

## 8. CONTINGENCIES

Avid receives inquiries from time to time with regard to possible patent infringement claims. If any infringement is determined to exist, the Company may seek licenses or settlements. In addition, as a normal incidence of the nature of the Company's business, various claims, charges and litigation have been asserted or commenced from time to time against the Company arising from or related to contractual or employee relations, intellectual property rights or product performance. Management does not believe these claims will have a material adverse effect on the financial position or results of operations of the Company.

In April 2005, Avid was notified by the Korean Federal Trade Commission ("KFTC") that a former reseller, Neat Information Telecommunication, Inc. ("Neat"), had filed a petition against a subsidiary, Avid Technology Worldwide, Inc., alleging unfair trade practices. On August 11, 2005, the KFTC issued a decision in favor of Avid regarding the complaint filed by Neat. However, Neat filed a second petition with the KFTC on October 17, 2005 alleging the same unfair trade practices as those set forth in the former KFTC petition. On January 13, 2006, Avid filed its response to the second KFTC petition denying Neat's allegations. On February 16, 2006, the KFTC reaffirmed its earlier decision in favor of Avid and concluded its review of the case. In addition, on October 14, 2005, Neat filed a civil lawsuit in Seoul Central District Court against Avid Technology Worldwide, Inc. alleging unfair trade practices. In the civil action, Neat is seeking approximately $1.7 million in damages, plus interest and attorneys fees. The Company has filed answers to the complaint denying Neat's allegations. Avid believes that Neat's claims are without merit and intends to vigorously defend the claim in these actions. Avid cannot predict the outcome of these actions at this time and, accordingly, no costs have been accrued for any possible loss contingency.

From time to time, the Company provides indemnification provisions in agreements with customers covering potential claims by third parties of intellectual property infringement. These agreements generally provide that the Company will indemnify customers for losses incurred in connection with an infringement claim brought by a third party with respect to the Company's products. These indemnification provisions generally offer perpetual coverage for infringement claims based upon the products covered by the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification provisions is theoretically unlimited; however, to date, the Company has not incurred material costs related to these indemnification provisions. As a result, the Company believes the estimated fair value of these indemnification provisions is minimal.



As permitted under Delaware law, Avid has agreed to indemnify its officers and directors for certain events that occur while the officer or director is serving in such capacity. The term of the indemnification period is for each respective officer's or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, Avid has mitigated the exposure through the purchase of directors and officers insurance, which is intended to limit the risk and, in most cases, enable the Company to recover all or a portion of any future amounts paid. As a result of this insurance policy coverage and Avid's related payment experience to date, the Company believes the estimated fair value of these indemnification agreements is minimal.

The Company has a standby letter of credit at a bank that is used as a security deposit in connection with the Company's Daly City, California office space lease. In the event of default on this lease, the landlord would be eligible to draw against this letter of credit to a maximum, as of June 30, 2006, of $3.5 million, subject to an annual reduction of approximately $0.8 million, but not below $2.0 million. The letter of credit will remain in effect at $2.0 million throughout the remaining lease period, which extends to September 2009. As of June 30, 2006, the Company was not in default of this lease.

The Company, through a third party, provides lease financing options to its customers, including end-users and, on a limited basis, resellers. During the terms of these leases, which are generally three years, the Company remains liable for any unpaid principal balance upon default by the end-user, but such liability is limited in the aggregate based on a percentage of initial amounts funded or, in certain cases, amounts of unpaid balances. At June 30, 2006 and December 31, 2005, Avid's maximum recourse exposure totaled approximately $12.8 million and $13.0 million, respectively. The Company records revenue from these transactions upon the shipment of products, provided that all other revenue recognition criteria, including collectibility being reasonably assured, are met. Because the Company has been providing these financing options to its customers for many years, the Company has a substantial history of collecting under these arrangements without providing significant refunds or concessions to the end user, reseller or financing party. To date, the payment default rate has consistently been between 2% and 4% per year of the original funded amount. This low default rate results from the diligence of the third party leasing company in screening applicants and in collecting amounts due, and because Avid actively monitors its exposures under the financing program and participates in the approval process for any lessees outside of agreed-upon credit-worthiness metrics. The Company maintains a reserve for estimated losses under this recourse lease program based on these historical default rates applied to the funded amount outstanding at period end. At June 30, 2006 and December 31, 2005, the Company's accrual for estimated losses was $1.9 million and $1.8 million, respectively.

Avid provides warranties on externally sourced and internally developed hardware. For internally developed hardware and in cases where the warranty granted to customers for externally sourced hardware is greater than that provided by the manufacturer, the Company records an accrual for the related liability based on historical trends and actual material and labor costs. The warranty period for all of the Company's products is generally 90 days to one year, but can extend up to five years depending on the manufacturer's warranty or local law.

The following table sets forth the activity in the product warranty accrual account (in thousands):

| | Six Months Ended June 30, | |
|---|---|---|
| | 2006 | 2005 |
| Accrual balance at beginning of period | $6,190 | $2,261 |
| Acquired product warranty | 67 | - |
| Accruals for product warranties | 3,313 | 2,244 |
| Cost of warranty claims | (3,365) | (1,727) |
| Accrual balance at end of period | $6,205 | $2,778 |

The $3.4 million product warranty accrual increase from June 30, 2005 to June 30, 2006 is primarily the result of $3.1 million of acquired Pinnacle warranty accruals.

9. COMPREHENSIVE INCOME

Total comprehensive income net of taxes consists of net income and the net changes in foreign currency translation adjustment and net unrealized gains and losses on available-for-sale securities. The following is a summary of the Company's comprehensive income (in thousands):



| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |

| | | | | |
|---|---|---|---|---|
| Net income | $2,699 | $13,566 | $6,045 | $33,312 |
| Net changes in: | | | | |
| Foreign currency translation adjustment | 2,416 | (1,923) | 3,746 | (3,186) |
| Unrealized gains (losses) on securities | (18) | 74 | (102) | 135 |
| Total comprehensive income | $5,097 | $11,717 | $9,689 | $30,261 |

10. SEGMENT INFORMATION

The Company's organizational structure is based on strategic business units, each of which offers various products to the principal markets in which the Company's products are sold. These business units equate to three reportable segments: Professional Video, Audio and Consumer Video. The following is a summary of the Company's operations by reportable segment (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Professional Video: | | | | |
| Net revenues | $118,864 | $94,984 | $235,064 | $199,469 |
| Operating income | 6,251 | 7,083 | 16,363 | 22,198 |
| Audio: | | | | |
| Net revenues | $74,262 | $65,067 | $147,009 | $126,583 |
| Operating income | 10,199 | 8,465 | 19,791 | 16,332 |
| Consumer Video: | | | | |
| Net revenues | $29,100 | - | $58,223 | - |
| Operating loss | (1,625) | - | (4,045) | - |
| Combined Segments: | | | | |
| Net revenues | $222,226 | $160,051 | $440,296 | $326,052 |
| Operating income | 14,825 | 15,548 | 32,109 | 38,530 |

Certain expenses are not included in the operating results of the reportable segments because management does not consider them in evaluating operating results of the segments. The following table reconciles operating income (loss) for reportable segments to the total consolidated amounts for the three- and six-month periods ended June 30, 2006 and 2005 (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Total operating income for reportable segments | $14,825 | $15,548 | $32,109 | $38,530 |
| Unallocated amounts: | | | | |
| Restructuring costs | - | - | (1,066) | - |
| In-process research and development | - | - | (310) | - |
| Stock-based compensation | (4,283) | (601) | (8,718) | (1,372) |
| Amortization of acquisition-related intangible assets | (8,993) | (1,875) | (17,738) | (3,748) |

| | | | | |
|---|---|---|---|---|
| Consolidated operating income | $1,549 | $13,072 | $4,277 | $33,410 |



## 11. RESTRUCTURING COSTS AND ACCRUALS

In March 2006, the Company implemented a restructuring program within the Consumer Video segment under which 23 employees worldwide, primarily in the marketing and selling function and the research and development function, were notified that their employment would be terminated. The purpose of the program was to maximize the efficiency of the Company's organizational structure. In connection with this action, the Company recorded a charge of $1.1 million. Payments to the employees are expected to be completed during 2006.

In December 2005, the Company implemented a restructuring program under which the employment of 20 employees worldwide was terminated and a portion of a leased facility in Montreal, Canada was vacated. In connection with these actions, the Company recorded charges of $0.8 million for employee terminations and $0.5 million for continuing rent obligations on excess space vacated, net of potential sublease income.

Also during 2005, the Company recorded a charge of $1.8 million in connection with a revised estimate of the lease obligation associated with a facility that was vacated as part of a restructuring plan in 1999. The revision was necessary due to one of the subtenants in the facility giving notice of their intention to discontinue their sublease. The lease extends through September 2010.

The Company recorded these charges in accordance with the guidance of SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities". These restructuring charges and accruals require significant estimates and assumptions, including sub-lease income assumptions. These estimates and assumptions are monitored on at least a quarterly basis for changes in circumstances and any corresponding adjustments to the accrual are recorded in the Company's statement of operations in the period when such changes are known.

In connection with the August 2005 Pinnacle acquisition and the January 2006 Medea acquisition, the Company recorded accruals of $14.4 million for Pinnacle in 2005 and $0.3 million for Medea in 2006 related to severance agreements and lease or other contract terminations in accordance with EITF 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination". Such amounts recorded in connection with the Pinnacle and Medea acquisitions are reflected in the purchase price allocations for the acquisitions and any adjustments to the accruals are recorded as adjustments to goodwill (see Note 3) and are not recorded in the Company's statement of operations.

The following table sets forth the activity in the restructuring and other costs accruals for the six months ended June 30, 2006 (in thousands):

| | Non-Acquisition Related Restructuring Liabilities | | Acquisition Related Restructuring Liabilities | | |
|---|---|---|---|---|---|
| | Employee Related | Facilities Related | Employee Related | Facilities Related | Total |

| | | | | | |
|---|---|---|---|---|---|
| Accrual balance at December 31, 2005 | $129 | $4,467 | $2,976 | $2,785 | $10,357 |
| New restructuring activities | 1,134 | - | 257 | - | 1,391 |
| Revisions of estimated liabilities | (68) | - | (1,414) | (646) | (2,128 |
| Cash payments for employee-related charges | (517) | - | (853) | - | (1,370 |
| Cash payments for facilities, net of sublease income | - | (817) | - | (862) | (1,679 |
| Foreign exchange impact on ending balance | 68 | 180 | 140 | 125 | 513 |
| Accrual balance at June 30, 2006 | $746 | $3,830 | $1,106 | $1,402 | $7,084 |

The employee-related accruals at June 30, 2006 represent severance and outplacement costs to former employees that will be paid out within 2006.

The facilities-related accruals at June 30, 2006 represent estimated losses on subleases of space vacated as part of the Company's restructuring actions. The leases, and payments against the amounts accrued, extend through 2011 unless the Company is able to negotiate earlier terminations.

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12. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the FASB issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109", which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 will be effective for fiscal years beginning after December 15, 2006, or January 1, 2007 for Avid. The Company has not yet completed its evaluation of the impact of adoption on the Company's financial position or results of operations.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets", an amendment to FASB Statement No. 140. SFAS No. 156 requires recognition of a servicing asset or servicing liability whenever an entity enters into certain service agreements which result in an obligation to service a financial asset, and requires that servicing assets and servicing liabilities be recognized at fair value, if practicable. SFAS No. 156 will be effective for fiscal years beginning after September 15, 2006, or January 1, 2007 for Avid. Adoption of SFAS No. 156 is not expected to have a material impact on the Company's financial position or results of operations.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments", an amendment to FASB Statements No. 133 and 140. SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. SFAS No. 155 will be effective for fiscal years beginning after September 15, 2006, or January 1, 2007 for Avid. As of June 30, 2006, the Company did not have any hybrid financial instruments subject to the fair value election of SFAS No. 155.

In November 2005, the FASB issued FASB Staff Position No. FAS 123(R)-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards". The Company is considering whether to adopt the alternative transition method provided in the FASB Staff Position ("FSP") for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool ("APIC Pool") related to the excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123(R). The Company is currently evaluating which transition method it will use for calculating its APIC Pool. An entity may take up to one year from the later of its initial adoption of SFAS 123(R) or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election. Until and unless the Company elects the transition method described in the FSP, the transition method provided in SFAS 123(R) is being followed. The Company expects to complete its evaluation by December 31, 2006.

In June 2005, the FASB issued FSP No. FAS 143-1, "Accounting for Electronic Equipment Waste Obligations", or FSP 143-1, which provides guidance on the accounting for obligations associated with the European Union, or EU, Directive on Waste Electrical and Electronic Equipment, or the WEEE Directive. FSP 143-1 provides guidance on how to account for the effects of the WEEE Directive with respect to historical waste associated with products in the market on or before August 13, 2005. FSP 143-1 is required to be applied to the later of the first reporting period ending after June 8, 2005 or the date of the adoption of the WEEE Directive into law by the applicable EU member country. The Company is in the process of registering with the member countries, as appropriate, and is still awaiting guidance from these countries with respect to the compliance costs and obligations for historical waste. Avid will continue to work with each country to obtain guidance and will accrue for compliance costs when they are probable and reasonably estimable. The accruals for these compliance costs may have a material impact on the Company's financial position or results of operations when guidance is issued by each member country.

13. SUBSEQUENT EVENTS

A stock repurchase program was approved by the Company's board of directors effective July 21, 2006. Under this program, the Company was authorized to repurchase up to $50 million of the Company's common stock through transactions on the open market, in block trades or otherwise. The program was completed on August 7, 2006 with 1,432,327 shares of the Company's common stock repurchased from July 25, 2006 through the completion date. The stock repurchase program was funded using the Company's working capital.

On July 28, 2006, the Company acquired Sibelius Software Limited ("Sibelius"), a UK-based music applications software company and a leading provider of music notation software in the education and professional markets, for cash consideration of approximately (pound)12.4 million ($23 million). The acquisition of Sibelius will allow the Company to broaden its Audio product offerings and accelerate its expansion into the educational market.

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PART I. FINANCIAL INFORMATION

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

EXECUTIVE OVERVIEW

We develop, market, sell and support a wide range of software and hardware products for digital media production, management and distribution. Digital media are video, audio or graphic elements in which an image or sound is recorded and stored in digital values, as opposed to analog, or tape-based, signals. Our diverse range of product and service offerings enables customers to "Make, Manage and Move Media(TM)".

Make Media. Our products help every class of user create and use video and audio assets, from the home user to the feature film professional. Our Professional Video segment offers innovative video and film editing systems, as well as 3D and special-effects software. These products enable professionals, and aspiring professionals, in the post-production and broadcast markets to manipulate moving pictures and sound in fast, easy, creative and cost-effective ways. Our Audio segment offers consumer and professional digital audio software applications and hardware systems for music, film, television, video, broadcast, streaming media and web development. These systems are based upon proprietary audio hardware, software and control surfaces, and allow users to record, edit, mix, process and master audio in an integrated manner. Our Consumer Video segment offers products for home video editing and TV viewing. Our home video editing products allow users to create, edit and share video content more easily and effectively, while our TV viewing products allow consumers to view, record and time shift television programming on their computers.

Manage Media. The ability to manage digital media assets effectively is a critical component of success for all content creators. Our technology enables users to simultaneously share and manage media assets throughout a project or organization. As a result, professionals can collaborate in real time on all production elements and streamline the process for cost-effective management and delivery of media. In addition, our tools allow customers to easily repurpose digital assets to take advantage of a variety of market opportunities. For consumer applications, we also offer products that allow users to manage their media projects, such as home movies or recorded music.

Move Media. Our products allow our customers to distribute media over multiple platforms - including air, cable or satellite, or on the Internet. In addition, we provide technology for playback directly to air for broadcast television applications. Many of our products also support the broadcast of streaming Internet video. For professionals as well as consumers, our laptop-based editing systems, storage products and DVD authoring tools enable easy portability of media.

Our products are used worldwide in production and post-production facilities; film studios; network, affiliate, independent and cable television stations; recording studios; performance venues; advertising agencies; government and educational institutions; corporate communication departments; and by game developers and Internet professionals, as well as by amateurs, aspiring professionals and home hobbyists. Projects produced by customers using our products have been honored with Oscar(R), Emmy(R) and Grammy(R) awards, in addition to a host of other international awards. We have also received numerous awards for technical innovations, including two Oscar awards, 12 Emmy awards and a Grammy award. Oscar is a registered trademark and service mark of the Academy of Motion Picture Arts and Sciences. Emmy is a registered trademark of ATAS/NATAS. Grammy is a registered trademark of The National Academy of Recording Arts and Sciences, Inc.

Our strategy consists of four key elements: deliver best of breed stand-alone products, deliver integrated workflow for customers with multiple systems, support open standards for media and deliver excellent customer service. We continue to focus on enhancing our existing products and broadening our product offerings to satisfy customer demand for new technology across the spectrum of educational to consumer to professional markets. We continue to position ourself and deliver new products and services to benefit from a number of important industry trends, including the move to high-definition, or HD, in television production, the switch to all-digital production in broadcast, the growth of home audio studios, the move to digital audio mixing and the growth of consumer video editing and consumption. Our products may be developed internally or through acquisitions. As part of this strategy, we made the following acquisitions in 2006.

- On July 28, 2006, we acquired Sibelius Software Limited, or Sibelius, a UK-based music applications software company and a leading provider of music notation software in the education and professional markets. Our acquisition of Sibelius will allow us to broaden our Audio product offerings and accelerate our expansion into the educational market.



- On April 13, 2006, we acquired Sundance Digital, Inc., a Texas-based developer of automation and device control software for broadcast video servers, tape transports, graphics systems and other broadcast station equipment. The acquisition of Sundance will allow us to offer more open and streamlined broadcast production workflows across the entire spectrum of media acquisition, production and transmission.

- On January 12, 2006, we acquired Medea Corporation, a California-based provider of local storage solutions for real-time media applications. The acquisition of Medea will allow us to provide high performance, low cost RAID (Redundant Array of Independent Disks) storage solutions to our Professional Video customers.

Total net revenues for the first six months of 2006 were $440.3 million, an increase of $114.2 million, or 35%, compared to the first six months of last year. Approximately 82% of this increase represents net revenues in 2006 from Pinnacle, which was acquired in the third quarter of 2005. Net income for the first six months of 2006 was $6.0 million, a decrease of $27.3 million, or 82%, from the same period last year. However, $8.2 million of this decrease was the direct result of the adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment", or SFAS 123(R), on January 1, 2006, which requires the recognition of fair value expense for all stock-based compensation awards. Net income for the first six months of 2006 also included $17.7 million of acquisition-related amortization expense and $1.1 million of restructuring costs, compared to $3.7 million of amortization expense and no restructuring expense for the same period last year. Our operating activities continue to generate positive cash flow with cash of $23.5 million provided by operating activities in the first six months of 2006, compared to $38.2 million for the same period last year.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements and related disclosures in conformity with U.S. generally accepted accounting principles and our discussion and analysis of our financial condition and results of operations requires us to make judgments, assumptions and estimates that affect the amounts reported in our consolidated financial statements and accompanying notes. Note B of the Notes to Consolidated Financial Statements in our 2005 Annual Report on Form 10-K describes the significant accounting policies and methods used in the preparation of our consolidated financial statements. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates.

We believe that our critical accounting policies are those related to revenue recognition and allowances for product returns and exchanges, allowance for bad debts and reserves for recourse under financing transactions, inventories, business combinations, goodwill and intangible assets, stock-based compensation and income tax assets. We believe these policies are critical because they are important to the portrayal of our financial condition and results of operations, and they require us to make judgments and estimates about matters that are inherently uncertain. Additional information about our critical accounting policies, except stock-based compensation, may by found in our 2005 Annual Report on Form 10-K in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations", under the heading "Critical Accounting Policies and Estimates". The critical accounting policy for stock-based compensation, which follows, was added to our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, as a result of the adoption of SFAS 123(R) on January 1, 2006.

Stock-Based Compensation

During the first quarter of 2006, we adopted the provisions of and accounted for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment", which is a revision of SFAS No. 123, "Accounting for Stock Based Compensation". SFAS 123(R) requires employee stock-based compensation awards to be accounted for under the fair value method and eliminates the ability to account for these instruments under the intrinsic value method as prescribed by Accounting Principles Board, or APB, Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. We adopted SFAS 123(R) on January 1, 2006 using the modified prospective application method as permitted under SFAS 123(R). Under this method, we are required to record compensation cost, based on the fair value estimated in accordance with SFAS 123(R), for stock-based awards granted after the date of adoption over the requisite service periods for the individual awards, which generally equals the vesting period. We are also required to record compensation cost for the unvested portion of previously granted stock-based awards outstanding at the date of adoption over the requisite service periods for the individual awards based on the fair value estimated in accordance with the original provisions of SFAS No. 123 adjusted for forfeitures as required by SFAS 123(R).

Prior to the adoption of SFAS 123(R), we accounted for stock-based compensation under the recognition and measurement principles of APB Opinion No. 25 and related interpretations. Accordingly, no compensation expense was recorded for options issued to employees and non-employee directors in fixed amounts and with fixed exercise prices at least equal to the market price of our



common stock at the date of grant. In connection with our acquisition of M-Audio in August 2004, we granted options to certain M-Audio employees at exercise prices that were less than the market price of our common stock at the date of grant. We recorded the difference between the exercise prices and the fair value of the options at the date of completion of the acquisition, determined under the Black-Scholes method, multiplied by the number of shares underlying the options, as deferred compensation. The resulting deferred compensation is being expensed over the vesting period of the options. Additionally, deferred compensation was recorded for restricted stock granted to employees based on the market price of our common stock at the date of grant, which is being expensed over the period in which the restrictions lapse. In connection with the adoption of SFAS 123(R) on January 1, 2006, we reversed the remaining deferred compensation of $1.8 million, with the offset to additional paid-in capital.

In anticipation of the adoption of SFAS 123(R), on October 26, 2005, our board of directors approved a partial acceleration of the vesting of all outstanding options to purchase our common stock that were granted on February 17, 2005. Vesting was accelerated for options to purchase 371,587 shares of our common stock with an exercise price of $65.81 per share, including options to purchase 157,624 shares of our common stock held by our executive officers. The decision to accelerate vesting of these options was made to avoid recognizing compensation cost related to these out-of-the money options in our future statements of operations upon the adoption of SFAS 123(R). It is estimated that the maximum future compensation expense that would have been recorded in our statements of operations had the vesting of these options not been accelerated is approximately $4.4 million.

The fair values of restricted stock awards, including restricted stock and restricted stock units, are based on the intrinsic values of the awards at the date of grant. As permitted under SFAS No. 123 and SFAS 123(R), we use the Black-Scholes option pricing model to estimate the fair value of stock option grants. The Black-Scholes model relies on a number of key assumptions to calculate estimated fair values. Our assumed dividend yield of zero is based on the fact that we have never paid cash dividends and have no present intention to pay cash dividends. Since adoption of SFAS 123(R) on January 1, 2006, the expected stock-price volatility assumption used by us has been based on recent (six month trailing) implied volatility calculations. These calculations are performed on exchange traded options of our stock. We believe that using a forward-looking market driven volatility assumption will result in the best estimate of expected volatility. Prior to adoption of SFAS 123(R), the expected volatility was based on the historical volatility of the underlying stock. The assumed risk-free interest rate is the U.S. Treasury security rate with a term equal to the expected life of the option. The assumed expected life is based on company-specific historical experience. With regard to the estimate of the expected life, we consider the exercise behavior of past grants and model the pattern of aggregate exercises. Based on our historical turnover rates, an annualized estimated forfeiture rate of 6.5% has been used in calculating the estimated compensation cost for the three- and six-month periods ending June 30, 2006. Additional expense will be recorded if the actual forfeiture rates are lower than estimated, and a recovery of prior expense will be recorded if the actual forfeitures are higher than estimated. Prior to the adoption of SFAS 123(R), forfeitures were not estimated at the time of award.

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods, or if we decide to use a different valuation model, the stock-based compensation expense we recognize in future periods may differ significantly from what we have recorded in the current period and could materially affect our operating income, net income and earnings per share. It may also result in a lack of comparability with other companies that use different models, methods and assumptions. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. These characteristics are not present in our option grants. Existing valuation models, including the Black-Scholes model, may not provide reliable measures of the fair values of our stock-based compensation. Consequently, there is a risk that our estimates of the fair values of our stock-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination or forfeiture of those stock-based payments in the future. Certain stock-based payments, such as employee stock options, may expire with little or no intrinsic value compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, the value realized from these instruments may be significantly higher than the fair values originally estimated on the grant date and reported in our financial statements. The guidance in SFAS 123(R) is relatively new and the application of these principles may be subject to further interpretation and refinement over time. See Note 7 of the Condensed Consolidated Financial Statements in Item 1 for further information regarding our adoption of SFAS 123(R).

During the first quarter of 2006, we granted restricted stock units, rather than stock options, as part of our annual stock-based compensation program. During the first and second quarters of 2006, we also granted restricted stock and stock options to new hires and for other purposes. In the future, we may grant either stock awards, options, or other equity-based instruments allowed by our stock-based compensation plans, or a combination thereof, as part of our overall compensation strategy.



RESULTS OF OPERATIONS

Net Revenues

We develop, market, sell and support a wide range of software and hardware for digital media production, management and distribution. Our net revenues are derived mainly from the sales of computer-based digital, nonlinear media editing and finishing systems and related peripherals including shared storage systems, licensing of software and sales of related software maintenance contracts. We are organized into strategic business units that reflect the principal markets in which our products are sold: Professional Video, Audio and Consumer Video. Discrete financial information is available for each business unit and the operating results of these business units are evaluated regularly to make decisions regarding the allocation of resources and to assess performance. As such, these business units represent our reportable segments under Statement of Financial Accounting Standards, or SFAS, No. 131, "Disclosures about Segments of an Enterprise and Related Information".

Our Professional Video segment produces tools for digital non-linear editing and finishing, data storage, digital asset management and on-air graphics to improve the productivity of video and film editors and broadcasters by enabling them to manipulate moving pictures and sound in a faster, easier, more creative and cost-effective manner than by use of traditional analog tape-based systems. The products in this operating segment are designed to provide capabilities for editing and finishing feature films, television shows, broadcast news programs, commercials, music videos and corporate and consumer videos. Net revenues in this segment grew 18% to $235 million for the six months ended June 30, 2006 as compared to the same period in 2005, while segment operating income decreased 26% to $16.4 million. Segment operating income excludes stock-based compensation and amortization of intangible assets, as these costs are not considered when evaluating the operating results of our segments. The revenue increase relates largely to our August 2005 acquisition of Pinnacle, specifically the broadcast video portion of Pinnacle's business, and to a lesser extent, our January 2006 acquisition of Medea, both of which were incorporated into our Professional Video segment. The decrease in operating income reflects lower gross margins due primarily to higher overhead costs and an unfavorable impact from foreign currency fluctuations on revenue.

Our Audio segment produces digital audio systems for the audio market. This operating segment includes products developed to provide audio recording, editing, signal processing and mixing. Net revenues in this segment grew 16% to $147 million for the six months ended June 30, 2006 as compared to the same period in 2005, while segment operating income increased 21% to $19.8 million. We continue to see strong demand for our products in both the professional and home user markets of our Audio business with increased revenues from the Digidesign(R) mixing consoles and M-Audio(R) product lines.

Our Consumer Video segment develops and markets products that allow consumer users to create, edit, view and distribute rich media content including video, photographs and audio. The Consumer Video segment was formed as part of our August 2005 acquisition of Pinnacle, so a comparison of revenues and segment operating results for the six months ended June 30, 2006 and the same period in 2005 is not meaningful. For the six months ended June 30, 2006, this segment had an operating loss of $4.0 million on net revenues of $58.2 million. We have made operational changes in this segment to address product reliability issues and ensure that the business runs as efficiently as possible. We also have marketing efforts planned for the third quarter in anticipation of the upcoming holiday buying season.



The following is a summary of our net revenues by segment for the three- and six-month periods ended June 30, 2006 and 2005, respectively:

Three Months Ended June 30, (dollars in thousands)

| | 2006 Net Revenues | % of Consolidated Net Revenues | 2005 Net Revenues | % of Consolidated Net Revenues | Change | % Chan in Reve |
|---|---|---|---|---|---|---|
| Professional Video: | | | | | | |
| Product revenues | $94,972 | 42.7% | $76,727 | 47.9% | $18,245 | 23 |
| Services revenues | 23,892 | 10.8% | 18,257 | 11.4% | 5,635 | 30 |
| Total | 118,864 | 53.5% | 94,984 | 59.3% | 23,880 | 25 |
| Audio: | | | | | | |
| Product revenues | 73,888 | 33.2% | 64,909 | 40.6% | 8,979 | 13 |
| Services revenues | 374 | 0.2% | 158 | 0.1% | 216 | 136 |
| Total | 74,262 | 33.4% | 65,067 | 40.7% | 9,195 | 14 |
| Consumer Video: | | | | | | |
| Product revenues | 29,100 | 13.1% | - | - | 29,100 | 100 |
| Total | 29,100 | 13.1% | - | - | 29,100 | 100 |
| Total net revenues: | $222,226 | 100.0% | $160,051 | 100.0% | $62,175 | 38 |

Six Months Ended June 30, (dollars in thousands)

| | 2006 Net Revenues | % of Consolidated Net Revenues | 2005 Net Revenues | % of Consolidated Net Revenues | Change | % Chan in Reve |
|---|---|---|---|---|---|---|
| Professional Video: | | | | | | |
| Product revenues | $187,713 | 42.6% | $162,867 | 50.0% | 24,846 | 15 |
| Services revenues | 47,351 | 10.8% | 36,602 | 11.2% | 10,749 | 29 |
| Total | 235,064 | 53.4% | 199,469 | 61.2% | 35,595 | 17 |
| Audio: | | | | | | |
| Product revenues | 146,387 | 33.2% | 126,311 | 38.7% | 20,076 | 15 |
| Services revenues | 622 | 0.2% | 272 | 0.1% | 350 | 128 |
| Total | 147,009 | 33.4% | 126,583 | 38.8% | 20,426 | 16 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Consumer Video: | | | | | | |
| Product revenues | 58,223 | 13.2% | - | - | 58,223 | 100 |
| Total | 58,223 | 13.2% | - | - | 58,223 | 100 |
| Total net revenues: | $440,296 | 100.0% | $326,052 | 100.0% | $114,244 | 35 |

We began selling Pinnacle products in the third quarter of 2005. Therefore, there is no comparable data included in our Professional Video revenues for the first two quarters of 2005. For the three- and six-month periods ended June 30, 2006, Pinnacle products accounted for $13.4 million and $28.8 million of Professional Video product revenues, respectively. The remaining $4.8 million increase in Professional Video product revenues for the three-month period ended June 30, 2006 was primarily due to increased revenues from our shared-storage systems and high-end editing systems, including new product introductions of Avid Unity ISIS(TM) and Symphony(TM) Nitriscc in the third and fourth quarters of 2005, respectively. These increased revenues also include a seasonality impact as HD post production product sales are typically strong during the second quarter in preparation for the fall television production season. These increases were partially offset by a decrease in Avid Xpress Pro(R) unit sales, as expected, with the introduction of Media Composer(R) software. We also experienced a strong increase in sales of our Avid Mojo(R) family of products. Total revenues from our Media Composer family of editing and finishing products remained relatively flat from the second quarter of 2005 to 2006; however, these revenues represented increased unit sales of our Adrenaline(TM) HD at a reduced average selling price, as well as revenues from our software-only version of Media Composer, which was introduced in the second quarter of 2006. For the six months ended June 30, 2006 compared to the same



period in 2005, the decrease of product revenues, excluding revenues from Pinnacle products, was primarily due to decreased revenues for editing and finishing products, which were mainly the result of lower average selling prices in 2006 compared to strong results in the first quarter of 2005. Average selling prices reflect the impact of price changes, mix of products sold and changes in foreign currency exchange rates.

Services revenues consist primarily of maintenance contracts, installation services and training. Professional Video services revenues resulting from the Pinnacle acquisition were $3.1 million and $6.3 million for the three- and six-month periods ended June 30, 2006, respectively. The remaining increases were primarily due to increases in maintenance contracts sold in connection with our products, as well as increased revenue generated from professional services, such as installation services provided in connection with large broadcast news deals.

The increase in revenue for our Audio segment for both the three- and six-month periods was the result of increased revenues from Digidesign's live sound mixing console, Venue, which began shipping in March 2005, as well as increased revenues from their ICON mixing consoles, D-Control(TM) and D-Command(TM), which began shipping in May 2005. We also saw an increase in our core Digidesign Pro Tools(R) products for the professional and home markets. The remaining increase was primarily due to increased revenues from M-Audio products, in particular from increases in the control surface, guitar product, keyboard and USB I/O product lines.

The Consumer Video segment was formed in the third quarter of 2005 with our acquisition of Pinnacle; therefore, there is no comparable data for the first two quarters of 2005. All of the revenues for the three- and six-month periods ended June 30, 2006 represent revenue from the Pinnacle consumer business acquired in August 2005. Net revenues for the Consumer Video segment for the first quarter of 2006 was $29.1 million. Net revenues remained flat from the first to second quarter of 2006, as a result of decreased revenues from the home editing product line, offset by increased revenues from the TV viewing product line. The decreased revenues from the home editing product line are due to the lingering impact of quality issues surrounding our introduction of Pinnacle Studio version 10 in the third quarter of 2005. During the first and second quarters of 2006, we made improvements to the Pinnacle Studio product. We are beginning to see improved user satisfaction ratings following our recently introduced Pinnacle Studio Titanium edition software, but these improvements have not yet materialized into increased revenues. The increase in revenues from the TV viewing products was primarily due to the release of new PCTV products across Europe, increased consumer demand during the 2006 World Cup tournament and a focused introduction of our PCTV products into the U.S. during the three months ended June 30, 2006.

Net revenues derived through indirect channels were 73% for both the three- and six-month periods ended June 30, 2006 compared to 69% and 68%, respectively, for the same periods in 2005. The increase in indirect selling is due primarily to the acquisition of Pinnacle, whose consumer products are sold almost exclusively through indirect channels.

For the three- and six-month periods ended June 30, 2006, international sales accounted for 55% and 56% of our net revenues, respectively, compared to 54% and 55% of our net revenues, respectively, for the same periods in 2005. International sales increased by $36.6 million, or 42%, and $67.3 million, or 37% for the three- and six-month periods ended June 30, 2006, respectively, compared to the corresponding 2005 periods. The increase in international sales occurred in Europe, Asia and Canada, and is primarily due to the acquisition of Pinnacle, which has a significant portion of its sales in Europe and Asia.

## Gross Profit

Cost of revenues consists primarily of costs associated with the procurement of components; the assembly, testing and distribution of finished products; warehousing; post-sales customer support costs related to maintenance contract revenue and other services; and royalties for third-party software and hardware included in our products. The resulting gross margin fluctuates based on factors such as the mix of products sold, the cost and proportion of third-party hardware and software included in the systems sold, the offering of product upgrades, price discounts and other sales promotion programs, the distribution channels through which products are sold, the timing of new product introductions, sales of aftermarket hardware products such as disk drives and currency exchange rate fluctuations.



The following is a summary of our cost of revenues and gross margin percentages for the three and six-month periods ended June 30, 2006 and 2005:

| | Three Months Ended June 30, (dollars in thousands) | | | | |
|---|---|---|---|---|---|
| | 2006 | Gross Margin % | 2005 | Gross Margin % | Gross Margin % Change |
| Product cost of revenues | $93,819 | 52.6% | $61,244 | 56.8% | (4.2%) |
| Services cost of revenues | 13,812 | 43.1% | 10,027 | 45.5% | (2.4%) |

| | | | | | |
|---|---|---|---|---|---|
| Amortization of technology | 5,016 | - | 282 | - | - |
| Total | $112,647 | 49.3% | $71,553 | 55.3% | (6.0%) |

| | Six Months Ended June 30, (dollars in thousands) | | | | |
|---|---|---|---|---|---|
| | 2006 | Gross Margin % | 2005 | Gross Margin % | Gross Margin % Change |
| Product cost of revenues | $185,180 | 52.8% | $122,141 | 57.8% | (5.0%) |
| Services cost of revenues | 27,127 | 43.5% | 20,097 | 45.5% | (2.0%) |
| Amortization of technology | 10,096 | - | 563 | - | - |
| Total | $222,403 | 49.5% | $142,801 | 56.2% | (6.7%) |

The decrease in the product gross margin percentage for the three- and six-month periods ended June 30, 2006, as compared to the same periods in 2005, primarily reflects changes in product mix largely due to the acquisition of the Pinnacle consumer business, as well as reduced product pricing due to competitive pressures. Product gross margins were also negatively impacted by an increased number of sales promotions, which were partially offset by increased volumes.

The decrease in the services gross margin for the three and six-month periods ended June 30, 2006, as compared to the same periods in 2005, primarily reflects the impact of the Pinnacle acquisition which has lower services gross margins. Amortization of technology included in the cost of sales primarily represents the amortization of developed technology assets resulting from the August 2005 Pinnacle acquisition.

Costs and Expenses

Beginning in the first quarter of 2006, with the adoption of SFAS 123(R), we recorded stock-based compensation expense for the fair value of stock options. Stock-based compensation expense of $4.4 million and $8.9 million resulting from the adoption of SFAS 123(R), the acquisition of M-Audio and the issuance of restricted stock and restricted stock units, was included in the following captions in our condensed consolidated statement of operations for the three- and six-month periods ended June 30, 2006, respectively (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Product cost of revenues | $ 131 | $ - | $ 270 | $ - |
| Services cost of revenues | 208 | - | 427 | - |
| Research and development expense | 1,272 | 67 | 2,607 | 150 |
| Marketing and selling expense | 1,230 | 205 | 2,533 | 440 |
| General and administrative expense | 1,513 | 400 | 3,023 | 924 |
| | $ 4,354 | $ 672 | $ 8,860 | $ 1,514 |

As of June 30, 2006, there was $33.6 million of total unrecognized compensation cost, before forfeitures, related to non-vested stock-based compensation awards granted under our stock-based compensation plans. This cost will be recognized over the next four years. We expect this amount to be amortized as follows: $8.8 million during the remainder of 2006, $12.7 million in 2007 and $12.1 million thereafter. See Note 7 of the Condensed Consolidated Financial Statements in Item 1 for further information regarding our stock-based compensation assumptions and expenses, including pro forma disclosures for the three- and six-month periods ended June 30, 2005.

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Research and Development

| | Three Months Ended June 30, (dollars in thousands) | | | |
|---|---|---|---|---|
| | 2006 Expenses | 2005 Expenses | Change | % Change |
| Research and development | $35,617 | $24,910 | $10,707 | 43.0% |
| As a percentage of net revenues | 16.0% | 15.6% | 0.4% | |

| | Six Months Ended June 30, (dollars in thousands) | | | |
|---|---|---|---|---|
| | 2006 Expenses | 2005 Expenses | Change | % Change |
| Research and development | $71,113 | $49,589 | $21,524 | 43.4% |
| As a percentage of net revenues | 16.2% | 15.2% | 1.0% | |

Research and development expenses include costs associated with the development of new products and enhancement of existing products, and consist primarily of employee salaries and benefits, facilities costs, depreciation, consulting and temporary help, and prototype and development expenses. For the three- and six-month periods ended June 30, 2006, the increase in research and development expenditures was primarily due to an increase in personnel-related and facilities costs, primarily resulting from the acquisition of Pinnacle in August 2005. We also incurred increased stock-based compensation expense of $1.2 million and $2.5 million for the three- and six-month periods ended June 30, 2006, respectively, as a result of the adoption of SFAS 123(R) on January 1, 2006. The increase in research and development expense as a percentage of revenues relates to the increase in stock-based compensation in 2006, as well as to the other spending increases noted above.

Marketing and Selling

| | Three Months Ended June 30, (dollars in thousands) | | | |
|---|---|---|---|---|
| | 2006 Expenses | 2005 Expenses | Change | % Change |
| Marketing and selling | $52,583 | $38,452 | $14,131 | 36.7% |

| | | | | |
|---|---|---|---|---|
| As a percentage of net revenues | 23.7% | 24.0% | (0.3%) | |

| | Six Months Ended June 30, (dollars in thousands) | | | |
|---|---|---|---|---|
| | 2006 Expenses | 2005 Expenses | Change | % Change |
| Marketing and selling | $102,495 | $76,294 | $26,201 | 34.3% |
| As a percentage of net revenues | 23.3% | 23.4% | (0.1%) | |

Marketing and selling expenses consist primarily of employee salaries and benefits for sales, marketing and pre-sales customer support personnel, commissions, travel expenses, advertising and promotional expenses, and facilities costs. For the three- and six-month periods ended June 30, 2006, the increase in marketing and selling expenses, as compared to the same periods last year, was primarily due to higher spending for advertising, trade shows and other marketing programs, as well as higher personnel-related costs, including salaries and related taxes, benefits and commissions, in large part due to the acquisition of Pinnacle in August 2005. We also spent more on consulting and other outside services during the three- and six-month periods ended June 30, 2006 as compared to the corresponding periods in 2005. In addition, we incurred increased stock-based compensation expense of $1.0 million and $2.1 million for the three- and six-month periods ended June 30, 2006, respectively, as a result of the adoption of SFAS 123(R) on January 1, 2006.

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General and Administrative

| | Three Months Ended June 30, (dollars in thousands) | | | |
|---|---|---|---|---|
| | 2006 Expenses | 2005 Expenses | Change | % Change |
| General and administrative | $15,853 | $10,471 | $5,382 | 51.4% |
| As a percentage of net revenues | 7.1% | 6.5% | 0.6% | |

| | Six Months Ended June 30, (dollars in thousands) | | | |
|---|---|---|---|---|
| | 2006 Expenses | 2005 Expenses | Change | % Change |
| General and administrative | $30,990 | $20,773 | $10,217 | 49.2% |
| As a percentage of net revenues | 7.0% | 6.4% | 0.6% | |

General and administrative expenses consist primarily of employee salaries and benefits for administrative, executive, finance and legal personnel, audit and legal fees, insurance and facilities costs. For the three- and six-month periods ended June 30, 2006, the increase in general and administrative expenditures was due in large part to higher personnel-related costs, as well as higher facilities-related costs and depreciation, all primarily resulting from our acquisition of Pinnacle in August 2005. We also incurred increased stock-based compensation expense of $1.1 million and $2.1 million for the three- and six-month periods ended June 30, 2006, respectively, as a result of the adoption of SFAS 123(R) on January 1, 2006.

Restructuring and Other Costs

In March 2006, we implemented a restructuring program within our Consumer Video segment under which 23 employees worldwide, primarily in the marketing and selling function and the research and development function, were notified that their employment would be terminated. The purpose of the program was to maximize the efficiency of our organizational structure. In connection with this action, we recorded a charge of $1.1 million in the statement of operations. The estimated annual cost savings expected to result from this restructuring action is approximately $2.9 million.

In-process Research and Development

During the six months ended June 30, 2006, we recorded in-process research and development, or R&D, charges of $0.3 million related to the acquisition of Medea. This in-process R&D charge represents product development efforts that were underway at Medea at the time of the acquisition for which technological feasibility had not yet been established. Technological feasibility is established when either of the following criteria is met: 1) detailed program design has been completed, documented and traced to product specifications and its high-risk development issues have been resolved; or 2) a working model of the product has been finished and determined to be complete and consistent with the product design. Upon completion of the acquisition, Medea did not have a completed product design or working model for this in-process technology, and we determined that there was no future alternative use for the technology beyond the stated purpose of the specific R&D project. Therefore, we expensed the Medea in-process R&D during the three months ended March 31, 2006.

The key assumptions used in the Medea valuation consisted of the expected completion dates for the in-process projects, estimated costs to complete the projects, revenue and expense projections assuming future release and a risk-adjusted discount rate. The discount rate considers risks such as delays bringing the products to market and competitive pressures. For purposes of valuing the in-process R&D of Medea, we used a discount rate of 20%.



Amortization of Acquisition-Related Intangible Assets

| | Three Months Ended June 30, (dollars in thousands) | | |
|---|---|---|---|
| | 2006 | 2005 | Change |
| Amortization of intangible assets | $8,993 | $1,875 | $7,118 |
| As a percentage of net revenues | 4.0% | 1.2% | 2.8% |

| | Six Months Ended June 30, (dollars in thousands) | | |
|---|---|---|---|
| | 2006 | 2005 | Change |

| | | | |
|---|---|---|---|
| Amortization of intangible assets | $17,738 | $3,748 | $13,990 |
| As a percentage of net revenues | 4.0% | 1.1% | 2.9% |

Included in amortization of intangible assets is $5.0 million and $10.1 million, respectively, for the three- and six-month periods ended June 30, 2006, and $0.3 million and $0.6 million, respectively, for the three- and six-month periods ended June 30, 2005, for amortization of developed technology which is recorded within cost of revenues. Acquisition-related intangible assets result from acquisitions accounted for under the purchase method of accounting and include customer-related intangibles, developed technology, trade names and other identifiable intangible assets with finite lives. These intangible assets are amortized using the straight-line method, with the exception of developed technology. Developed technology is being amortized over the greater of: 1) the amount calculated using the ratio of current quarter revenues to the total of current quarter and anticipated future revenues over the estimated useful lives of two to three years; or 2) the straight-line method over each product's remaining respective useful lives. The increase in amortization expense for the three- and six-month periods ended June 30, 2006 reflects acquisitions that occurred during 2005 and 2006 as discussed below.

For our Sundance acquisition, we allocated the $12.7 million purchase price to the acquired net tangible and intangible assets based on their fair values as of the consummation of the acquisition. As part of the purchase accounting allocation, we recorded $5.6 million of amortizable identifiable intangible assets, consisting of completed technology, customer relationships, trademarks and trade names, and a non-compete covenant.

For our Medea acquisition, we allocated the $9.1 million purchase price to the acquired net tangible and intangible assets based on their fair values as of the consummation of the acquisition. As part of the purchase accounting allocation, we recorded $3.8 million of amortizable identifiable intangible assets, consisting of completed technology, customer relationships, non-compete covenants and order backlog.

For our Pinnacle acquisition, we allocated the total Pinnacle purchase price of $441.4 million to the acquired net tangible and intangible assets based on their fair values as of the consummation of the acquisition. The determination of these fair values included management's consideration of a valuation of Pinnacle's intangible assets prepared by an independent valuation specialist. As part of the purchase accounting allocation, we recorded $90.8 million of amortizable identifiable intangible assets, consisting of completed technologies, customer relationships and trade names.



Other Income (Expense), Net

| | Three Months Ended June 30, (dollars in thousands) | | |
|---|---|---|---|
| | 2006 | 2005 | Change |
| Other income (expense), net | $1,881 | $1,179 | $702 |
| As a percentage of net revenues | 0.8% | 0.7% | 0.1% |

| | Six Months Ended June 30, (dollars in thousands) 2006 | 2005 | Change |
|---|---|---|---|
| Other income (expense), net | $3,852 | $2,016 | $1,836 |
| As a percentage of net revenues | 0.9% | 0.6% | 0.3% |

Other income (expense), net, generally consists of interest income, interest expense and equity in income of a non-consolidated company.

The increase in other income and expense for the three- and six-month periods ended June 30, 2006 was primarily due to increased interest income earned on higher average cash and marketable securities balances.

Provision for Income Taxes, Net

| | Three Months Ended June 30, (dollars in thousands) 2006 | 2005 | Change |
|---|---|---|---|
| Provision for income taxes, net | $731 | $685 | $46 |
| As a percentage of net revenues | 0.3% | 0.4% | (0.1%) |

| | Six Months Ended June 30, (dollars in thousands) 2006 | 2005 | Change |
|---|---|---|---|
| Provision for income taxes, net | $2,084 | $2,114 | ($30) |
| As a percentage of net revenues | 0.5% | 0.6% | (0.1%) |

Our effective tax rate was 21% and 5%, respectively, for the three-month periods ended June 30, 2006 and 2005 and 26% and 6%, respectively, for the six-month periods ended June 30, 2006 and 2005. The tax provisions for the six-month periods ended June 30, 2006 and 2005 were substantially comprised of taxes payable by our foreign subsidiaries and generally non-cash tax provisions for Federal and state tax on anticipated U.S taxable profits. The increase in the effective tax rate for the six months ended June 30, 2006, as compared to the same period of 2005, results from: (1) an increased foreign effective tax rate, (2) an increase in the Federal and state provisions caused by the absence of net operating loss carry-forwards available to offset current year profits as a result of the utilization of such carry-forwards and the related valuation allowance recognized in prior years' tax provisions and (3) the impact of lower profit before tax caused by increased acquisition related amortization and the implementation of SFAS 123(R) requiring the expensing of stock-based compensation as we generally recognize no significant U.S. tax benefit from these expenses due to the full valuation allowance on our U.S deferred tax assets. Except for a minimal amount of state tax payments, the Federal and state tax provisions are non-cash provisions due to the tax impact of net operating loss carry-forwards available from additional paid-in capital related stock option deductions and acquisition related net operating loss carry-forwards.

The tax rate in each year is affected by net changes in the valuation allowance against our deferred tax assets. We regularly review our deferred tax assets for recoverability taking into consideration such factors as historical losses after deductions for stock compensation, projected future taxable income and the expected timing of the reversals of existing temporary differences. SFAS No. 109, "Accounting for Income Taxes", requires us to record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. Based on the level of deferred tax assets as of June 30, 2006, the level of historical U.S. losses after deductions for stock compensation and the level of outstanding stock options which we anticipate will generate significant U.S. tax deductions in the future, we have determined that the uncertainty regarding the realization of these assets is sufficient to warrant the continued establishment of a full valuation allowance against the U.S. net deferred tax assets.

Our assessment of the valuation allowance on the U.S. deferred tax assets could change in the future based upon our levels of pre-tax income and other tax-related adjustments. Removal of the valuation allowance in whole or in part would result in a non-cash reduction in income tax expense during the period of removal. In addition, because a portion of the valuation allowance was established to reserve certain deferred tax assets resulting from the exercise of employee stock options, in accordance with SFAS No. 109 and SFAS 123(R), removal of the valuation allowance related to these assets would occur upon utilization of these deferred tax assets to reduce taxes payable and would result in a credit to additional paid in capital within stockholders equity rather than the provision for income taxes. To the extent no valuation allowance is established for our deferred tax assets in future periods, future financial statements would reflect an increase in income tax expense which would be on a non-cash basis until such time as our deferred tax assets are all used to reduce current taxes payable.

Excluding the impact of the valuation allowance, our effective tax rate would have been 25% and 32%, respectively, for the three-month periods ended June 30, 2006 and 2005 and 29% and 30%, respectively, for the six-month periods ended June 30, 2006 and 2005. These rates differ from the Federal statutory rate of 35% primarily due to income in foreign jurisdictions which have lower tax rates.

## LIQUIDITY AND CAPITAL RESOURCES

We have funded our operations in recent years through cash flows from operations as well as from stock option exercises. As of June 30, 2006, our principal sources of liquidity included cash, cash equivalents and marketable securities totaling $238.1 million.

With respect to cash flow, net cash provided by operating activities was $23.5 million for the six months ended June 30, 2006, compared to $38.2 million for the same period in 2005. During the six months ended June 30, 2006, net cash provided by operating activities primarily reflects net income adjusted for depreciation and amortization and stock-award compensation, partially offset by an increase in inventories and a decrease in accrued expenses. During the six months ended June 30, 2005, net cash provided by operating activities primarily reflects net income adjusted for depreciation and amortization, as well as an increase in deferred revenue, partially offset by an increase in inventories and a decrease in accrued expenses.

Accounts receivable increased by $3.2 million to $143.9 million at June 30, 2006 from $140.7 million at December 31, 2005. These balances are net of allowances for sales returns, bad debts and customer rebates, all of which we estimate and record based primarily on historical experience. Days sales outstanding in accounts receivable increased from 52 days at December 31, 2005 to 58 days at June 30, 2006. The increase in days sales outstanding was primarily attributable to the relative proportion of solution sales in each period, which was higher in the quarter ended December 31, 2005 than in the quarter ended June 30, 2006. These sales are typically paid prior to recognition and therefore lower our days sales outstanding in the period when revenue is recognized. The increase in days sales outstanding is also due to higher concentration of revenue in the last two weeks of the quarter ended June 30, 2006 compared to the quarter ended December 31, 2005.

At June 30, 2006 and December 31, 2005, we held inventory in the amounts of $122.0 million and $96.8 million, respectively. These balances include stockroom, spares and demonstration equipment inventories at various locations and inventory at customer sites related to shipments for which we have not yet recognized revenue. The increase from December 31, 2005 of approximately $25 million was attributable to several operating initiatives. For the past year, we have transitioned our products to comply with the European Union's Directive on the Restriction of Hazardous Substances, or RoHS Directive. Due to concern about possible slippage with key suppliers upon the RoHS effective date of July 1, 2006, we transferred additional pre-RoHS compliant inventory to Europe during the three months ended June 30, 2006. We also had a higher inventory balance due to inventory build-up for new product introductions expected in the third quarter of 2006, in-transit inventory related to a new outsourced manufacturing program in Asia and inventory related to the Sundance and Medea acquisitions. We expect the net inventory balance to decline by year-end. We review all inventory balances regularly for excess

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quantities or potential obsolescence and make appropriate adjustments as needed to reserve or write-down the inventories to reflect their estimated realizable value. We source inventory products and components pursuant to purchase orders placed from time to time.

Net cash flow used in investing activities was $10.2 million for the six months ended June 30, 2006 compared to $1.4 million for the same period in 2005. The increase in net cash flow used in investing activities for the six months ended June 30, 2006 was primarily the result of our acquisition of Sundance for $12.7 million in cash and our acquisition of Medea for $9.1 million in cash, partially offset by net proceeds resulting from the sale and purchase of marketable securities. In July 2006, we acquired Sibelius for cash consideration of approximately 12.4 million pounds sterling ($23 million).

We purchased $9.1 million of property and equipment during the six months ended June 30, 2006 compared to $8.2 million in the same period of 2005. Purchases of property and equipment in both quarters consisted primarily of computer hardware and software to support our research and development activities and information systems.

During the six months ended June 30, 2006 and 2005, we generated cash of $4.1 million and $8.9 million, respectively, from financing activities, primarily from the issuance of common stock related to the exercise of stock options and our employee stock purchase plan.

In connection with non-acquisition related restructuring activities during 2005 and prior periods, as of June 30, 2006, we have future cash obligations of approximately $12.9 million under leases for which we have vacated the underlying facilities. We have an associated restructuring accrual of $3.8 million at June 30, 2006 representing the excess of our lease commitments on space no longer used by us over expected payments to be received on subleases of such facilities. Additionally, we have restructuring-related severance obligations of $0.7 million in connection with restructuring activities in the first quarter of 2006. The severance payments will be made during 2006 while the lease payments will be made over the remaining terms of the leases, which have varying expiration dates through 2011, unless we are able to negotiate earlier terminations.

In connection with the Pinnacle acquisition in 2005, we recorded restructuring accruals totaling $14.4 million related to severance ($10.0 million) and lease or other contract terminations ($4.4 million). In connection with the January 2006 Medea acquisition, we recorded severance obligations of $0.3 million. As of June 30, 2006, we have future cash obligations of approximately $2.3 million under leases for which we have vacated the underlying facilities, and restructuring accruals of $1.1 million and $1.4 million related to acquisition-related severance and lease obligations, respectively. The severance payments will be made during 2006. The lease payments will be made over the remaining terms of the leases, which have varying expiration dates through 2010. All payments related to restructuring actions are expected to be funded through working capital. See Note 11 of the Condensed Consolidated Financial Statements in Item 1 for the activity in the restructuring and other costs accrual for the six months ended June 30, 2006.

A stock repurchase program was approved by our board of directors effective July 21, 2006. Under this program, we were authorized to repurchase up to $50 million of our common stock through transactions on the open market, in block trades or otherwise. The program was completed on August 7, 2006 with 1,432,327 shares of our common stock repurchased from July 25, 2006 through the completion date. The stock repurchase program was funded through working capital.

Our cash requirements vary depending upon factors such as our planned growth, capital expenditures, acquisitions of businesses or technologies and obligations under past restructuring programs. We believe that our existing cash, cash equivalents, marketable securities and funds generated from operations will be sufficient to meet our operating cash requirements for at least the next twelve months. In the event that we require additional financing, we believe that we will be able to obtain such financing; however, there can be no assurance that we would be successful in doing so, or that we could do so on favorable terms.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the Financial Standards Accounting Board, or FASB, issued FASB Interpretation No. 48, or FIN 48, "Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109", which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 will be effective for fiscal years beginning after December 15, 2006, or January 1, 2007 for Avid. We have not yet completed our evaluation of the impact of adoption on our financial position or results of operations.



In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets", an amendment to FASB Statement No. 140. SFAS No. 156 requires recognition of a servicing asset or servicing liability whenever an entity enters into certain service agreements which result in an obligation to service a financial asset, and requires that servicing assets and servicing liabilities be recognized at fair value, if practicable. SFAS No. 156 will be effective for fiscal years beginning after September 15, 2006, or January 1, 2007 for Avid. Adoption of SFAS No. 156 is not expected to have a material impact on our financial position or results of operations.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments", an amendment to FASB Statements No. 133 and 140. SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. SFAS No. 155 will be effective for fiscal years beginning after September 15, 2006, or January 1, 2007 for Avid. As of June 30, 2006, we did not have any hybrid financial instruments subject to the fair value election of SFAS No. 155.

In November 2005, the FASB issued FASB Staff Position No. FAS 123(R)-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards". We are considering whether to adopt the alternative transition method provided in the FASB Staff Position, or FSP, for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool, or APIC Pool, related to the excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS 123(R). We are currently evaluating which transition method it will use for calculating its APIC Pool. An entity may take up to one year from the later of its initial adoption of SFAS 123(R) or the effective date of this FSP to evaluate its available transition alternatives and make its one-time election. Until and unless we elect the transition method described in the FSP, the transition method provided in SFAS 123(R) is being followed. We expect to complete our evaluation by December 31, 2006.

In June 2005, the FASB issued Staff Position No. FAS 143-1, "Accounting for Electronic Equipment Waste Obligations", or FSP 143-1, which provides guidance on the accounting for obligations associated with the European Union, or EU, Directive on Waste Electrical and Electronic Equipment, or the WEEE Directive. FSP 143-1 provides guidance on how to account for the effects of the WEEE Directive with respect to historical waste associated with products in the market on or before August 13, 2005. FSP 143-1 is required to be applied to the later of the first reporting period ending after June 8, 2005 or the date of the adoption of the WEEE Directive into law by the applicable EU member country. We are in the process of registering with the member countries, as appropriate, and are still awaiting guidance from these countries with respect to the compliance costs and obligations for historical waste. We will continue to work with each country to obtain guidance and will accrue for compliance costs when they are probable and reasonably estimable. The accruals for these compliance costs may have a material impact on our financial position or results of operations when guidance is issued by each member country.

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## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

### Foreign Currency Exchange Risk

We have significant international operations and, therefore, our revenues, earnings, cash flows and financial position are exposed to foreign currency risk from foreign currency denominated receivables, payables, sales transactions, as well as net investments in foreign operations.

We derive more than half of our revenues from customers outside the United States. This business is, for the most part, transacted through international subsidiaries and generally in the currency of the end-user customers. Therefore, we are exposed to the risks that changes in foreign currency could adversely impact our revenues, net income and cash flow. To hedge against the foreign exchange exposure of certain forecasted receivables, payables and cash balances of our foreign subsidiaries, we enter into short-term foreign currency forward-exchange contracts. There are two objectives of our foreign currency forward-exchange contract program: (1) to offset any foreign exchange currency risk associated with cash receipts expected to be received from our customers over the next 30 day period and (2) to offset the impact of foreign currency exchange on our net monetary assets denominated in currencies other than the U.S. dollar. These forward-exchange contracts typically mature within 30 days of purchase. We record gains and losses associated with currency rate changes on these contracts in results of operations, offsetting gains and losses on the related assets and liabilities. The success of this hedging program depends on forecasts of transaction activity in the various currencies and contract rates versus financial statement rates. To the extent that these forecasts are overstated or understated during the periods of currency volatility, we could experience unanticipated currency gains or losses.

At June 30, 2006, we had foreign-exchange forward contracts outstanding with an aggregate notional value of $58.3 million, denominated in the euro, British pound, Swedish krona, Norwegian krone, Danish kroner, Canadian dollar, Japanese Yen, Australian Dollar, Singapore dollar and Korean won, as a hedge against forecasted foreign currency-denominated receivables, payables and cash balances. For the six months ended June 30, 2006, net losses of $4.1 million resulting from forward-exchange contracts were included in results of operations, offset by net transaction and remeasurement gains on the related assets and liabilities of $3.8 million. As of June 30, 2006, we also had a foreign-exchange forward contract with a notional value of $23 million to hedge our net investment in our Canadian subsidiary. At June 30, 2006, the fair value of this forward contract was ($0.5) million. The currency effect of the net investment hedge is deemed effective and is, therefore, reflected as a component of foreign currency translation in accumulated other comprehensive income. Interest effects of this hedge are reported in interest income.

A hypothetical 10% change in foreign currency rates would not have a material impact on our results of operations, assuming the above-mentioned forecast of foreign currency exposure is accurate, because the impact on the forward contracts as a result of a 10% change would at least partially offset the impact on the asset and liability positions of our foreign subsidiaries.

Interest Rate Risk

At June 30, 2006, we held $238.1 million in cash, cash equivalents and marketable securities, including short-term corporate obligations, asset-backed securities, commercial paper and U.S. government and government agency obligations. Marketable securities are classified as "available for sale" and are recorded on the balance sheet at market value, with any unrealized gain or loss recorded in other comprehensive income (loss). A hypothetical 10% increase or decrease in interest rates would not have a material impact on the fair market value of these instruments due to their short maturity.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2006. The term "disclosure controls and procedures", as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2006, our chief executive officer and chief financial officer concluded that, as of such date, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

Our management considers the acquisition of Pinnacle Systems, Inc. on August 9, 2005 to be material to the results of operations, financial position and cash flows of the Company from the date of acquisition through June 30, 2006 and considers the internal controls and procedures of Pinnacle to have a material effect on our internal control over financial reporting. The Company has executed an extension of our Sarbanes-Oxley Act Section 404 compliance program to include Pinnacle's operations in fiscal 2006. We do not consider our acquisitions of Sundance and Medea, each completed during the six months ended June 30, 2006, to have a material effect on our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In April 2005, we were notified by the Korean Federal Trade Commission ("KFTC") that a former reseller, Neat Information Telecommunication, Inc. ("Neat"), had filed a petition against our subsidiary, Avid Technology Worldwide, Inc., alleging unfair trade practices. On August 11, 2005, the KFTC issued a decision in favor of Avid regarding the complaint filed by Neat. However, Neat filed a second petition with the KFTC on October 17, 2005 alleging the same unfair trade practices as those set forth in the former KFTC petition. On January 13, 2006, we filed our response to the second KFTC petition denying Neat's allegations. On February 16, 2006, the KFTC reaffirmed its earlier decision in favor of Avid and concluded its review of the case. In addition, on October 14, 2005, Neat filed a civil lawsuit in Seoul Central District Court against Avid Technology Worldwide, Inc. alleging unfair trade practices. In the civil action, Neat is seeking approximately $1.7 million in damages, plus interest and attorneys' fees. We have filed answers to the complaint denying Neat's allegations. We believe that Neat's claims are without merit and we intend to defend ourselves vigorously in these actions. Because we cannot predict the outcome of these actions at this time, no costs have been accrued for any possible loss contingency.

We receive inquiries from time to time with regard to possible patent infringement claims. If any infringement is determined to exist, we may seek licenses or settlements. In addition, as a normal incidence of the nature of our business, various claims, charges and litigation have been asserted or commenced against the Company arising from or related to contractual or employee relations, intellectual property rights or product performance. We do not believe these claims will have a material adverse effect on our financial position or results of operations.

ITEM 1A. RISK FACTORS

Some of the statements in this Form 10-Q relating to our future performance constitute forward-looking statements. Such forward-looking statements are based upon management's current expectations and involve known and unknown risks. Realization of any of these risks may cause actual results to differ materially from the results described in the forward-looking statements. Certain of these risks are as follows:

We may not be able to realize the expected benefits of our acquisition of Pinnacle Systems. As a result of our acquisition of Pinnacle Systems, Inc. in 2005, we face challenges in several areas that could have an adverse effect on our business. For example, some of the assumptions that we relied upon, such as the achievement of operating synergies and revenue growth, may not be realized. We have encountered and may continue to encounter difficulties, unforeseen costs and delays involved in integrating the Pinnacle business, including:

- failure to successfully manage relationships with customers and with important third parties;
- failure of customers to continue using the products and services of the combined company; and
- potential impairment charges to write-down the carrying amount of goodwill and other intangible assets.

We also face challenges inherent in efficiently managing an increased number of employees over large geographic distances, including the need to develop appropriate systems, policies, benefits and compliance programs. The inability to manage the organization of the combined company effectively could have a material adverse effect on our business.

We will face challenges associated with sales of video and audio products to the consumer market.

As a result of our acquisition of Pinnacle in 2005, a material portion of our future revenue will come from sales to consumers of home video editing and viewing products. In addition, M-Audio has expanded its sales channel to include sales of its audio products through the consumer channel. The market for these consumer video and audio products is highly competitive and we expect to face price-based competition from competitors selling similar products. Although we acquired experienced personnel through our acquisitions of M-Audio and Pinnacle, Avid's prior experience in the consumer market is limited. If we are not successful marketing to consumers, our operating results could suffer. Furthermore, sales of consumer electronics and software typically increase in the second half of the year, reaching their peak during the year-end holiday season. As a result, to the extent we increase sales of our video and audio products through consumer channels, we expect to experience greater seasonality in our revenues.

Another challenge that is particularly acute with respect to the sale of consumer software is software piracy. The unauthorized use of our proprietary technology is costly and efforts to restrict such unauthorized use are time-consuming. We are unable to accurately measure the extent to which piracy of our software exists, but we expect it to be a persistent problem.



Our performance will depend in part on continued customer acceptance of our products.

We regularly introduce new products, as well as upgrades and enhancements to existing products. We will need to continue to focus marketing and sales efforts on educating potential customers, as well as our resellers and distributors, about the uses and benefits of these products. The future success of certain of our video products, such as Symphony(TM) Nitris(R), Media Composer(R) Adrenaline(TM) HD and Avid DS Nitris, which enable high-definition production, will also depend on demand for high definition content and appliances, such as television sets and monitors that utilize the high definition standard. Other risks involved with offering new products in general include, without limitation, the possibility of defects or errors, failure to meet customer expectations, delays in shipping new products and the introduction of similar products by our competitors. For example, we experienced initial quality issues with the introduction of Pinnacle Studio version 10. There can be no assurance that the improvements we have implemented will adequately address these issues or that customers will accept the improvements. In addition, we occasionally introduce products in new markets, where we have little experience and may not overcome any barriers to entry. The introduction and transition to new products could also have a negative impact on the market for our existing products, which could adversely affect our revenues and business.

The digital broadcast business is large, geographically dispersed and highly competitive, and we may not be successful in growing our customer base or predicting customer demand in this business.

We continue to enhance our status in the digital broadcast business. In this business, in addition to or in lieu of discrete point products, customers often seek complex solutions involving highly integrated components, including the configuration of unique workflows, from a single or multiple vendors. Success in this business will require, among other things, creating and implementing compelling solutions and developing a strong, loyal customer base.

In addition, large, complex broadcast orders often require us to devote significant sales, engineering, manufacturing, installation and support resources to ensure their successful and timely fulfillment. As the broadcast business converts from analog to digital, our strategy has been to build our broadcast solutions team in response to customer demand. To the extent that customer demand for our broadcast solutions exceeds our expectations, we may encounter difficulties in the short term meeting our customers' needs. Meanwhile, our competitors may devote greater resources to the broadcast business than we do, or may be able to leverage their presence more effectively. If we are unsuccessful in our continued expansion within the digital broadcast business or in predicting and satisfying customer demand, our business and revenues could be adversely affected.

We have a significant presence in the audio business, and therefore, the growth of our audio business will depend in part on our ability to successfully introduce new products.

Our Digidesign division has a significant presence in the audio business, due in large part to a series of successful product introductions. Our future success will depend in part upon our ability to offer, on a timely and cost-effective basis, new audio products and enhancements of our existing audio products. This can be a complex and uncertain process, and we could experience design, manufacturing, marketing, or other difficulties that delay or prevent the introduction of new or enhanced products, or the integration of acquired products, which, in turn, could harm our business.

A portion of our revenue is dependent on sales of large, complex solutions.

We expect sales of large, complex solutions to continue to constitute a material portion of our net revenue, particularly as news stations convert from analog, or tape-based, processes to digital formats. Our quarterly and annual revenues could fluctuate if:

- sales to one or more of our customers are delayed or are not completed within a given quarter;
- the contract terms preclude us from recognizing revenues relating to one or more significant contracts during a particular quarter;
- news stations' migrations to networked digital infrastructure slows down;
- we are unable to complete complex customer installations on schedule;
- our customers reduce their capital investments in our products in response to slowing economic growth; or
- any of our large customers terminates its relationship with us or significantly reduces the amount of business it does with us.



We compete with many other enterprises and we expect competition to intensify in the future.

The business segments in which we operate are highly competitive, with limited barriers to entry, and are characterized by pressure to reduce prices, incorporate new features and accelerate the release of new products. Some of our current and potential competitors have substantially greater financial, technical, distribution, support and marketing resources than we do. Such competitors may use these resources to lower their product costs, allowing them to reduce prices to levels at which we could not operate profitably. In addition to competing based on price, our products must also compete favorably with our competitors' products in terms of reliability, performance, ease of use, range of features, product enhancements, reputation and training. Delays or difficulties in product development and introduction may also harm our business. If we are unable to compete for our target customers effectively, our business and results of operations could suffer.

New product announcements by our competitors and by us also could have the effect of reducing customer demand for our existing products. New product introductions require us to devote time and resources to training our sales channels in product features and target customers, with the temporary result that the sales channels may have less time to devote to selling our products. In addition, our introduction of new products and expansion of existing product offerings can put us into competition with companies with whom we formerly collaborated. In the event such companies discontinue their alliances with us, we could experience a negative impact on our business.

Recent and potential future acquisitions could be difficult to integrate, divert the attention of key personnel, disrupt our business, dilute stockholder value and impair our financial results.

As part of our business strategy, we periodically acquire companies, technologies and products that we believe can improve our ability to compete in our core markets or allow us to enter new markets. For example, in 2005, we acquired Pinnacle and in 2006, we acquired Sundance and Medea. The risks associated with such acquisitions include, among others:

- difficulty in assimilating the operations, policies and personnel of the target companies;
- failure to realize anticipated returns on investment, cost savings and synergies;
- diversion of management's time and attention;
- potential dilution to existing stockholders, if we issue common stock or

other equity rights in the acquisition;
- potential loss of key employees of the target company;
- difficulty in complying with a variety of foreign laws and regulations, if so required;
- impairment of relationships with customers or suppliers;
- risks associated with contingent payments and earn-outs;
- possibility of incurring debt and amortization expenses, as well as impairment charges, related to goodwill and other intangible assets; and
- unidentified issues not discovered in due diligence, which may include product quality issues and legal contingencies.

Such acquisitions often involve significant transaction-related costs and could cause disruption to normal operations. In the future, we may also make debt or equity investments. If so, we may fail to realize anticipated returns on such investments. If we are unable to overcome or mitigate these risks, they could adversely affect our business and lower revenues.

Our products are complex and may contain errors or defects resulting from such complexity.

As we continue to enhance and expand our product offerings, our products have grown increasingly complex and, despite extensive testing and quality control, may contain errors or defects. Such errors or defects could cause us to issue corrective releases and could result in loss of revenues, delay of revenue recognition, increased product returns, lack of market acceptance and damage to our reputation.

Poor global economic conditions could adversely affect demand for our products and the financial condition of our suppliers, distributors and resellers.

The revenue growth and profitability of our business depends primarily on the overall demand for our products. If global economic conditions worsen, demand for our products may weaken, as could the financial health of our suppliers, distributors and resellers, which could adversely affect our revenues and business.



Our use of independent firms and contractors to perform some of our product development and manufacturing activities could expose us to risks that could adversely impact our revenues.

Independent firms and contractors, some of whom are located in other countries, perform some of our product development activities. We generally own the software developed by these contractors. We also rely on subcontractors for most of our manufacturing activities. Our strategy to rely on independent firms and contractors involves a number of significant risks, including loss of control over the manufacturing process, potential absence of adequate manufacturing capacity, potential delays in lead times and reduced control over delivery schedules, manufacturing yields, quality and cost. Furthermore, the use of independent firms and contractors, especially those located abroad, could expose us to risks related to governmental regulation, foreign taxation, intellectual property ownership and rights, exchange rate fluctuation, political instability and unrest, natural disasters and other risks, which could adversely impact our revenues.

An interruption of our supply of certain products or key components from our sole source suppliers, or a price increase in such products or components, could hurt our business.

We are dependent on a number of specific suppliers for certain products and key components of our products. We purchase these sole source products and components pursuant to purchase orders placed from time to time. We generally do not carry significant inventories of these sole source products and components and have no guaranteed supply arrangements. If any of our sole source vendors should fail to produce these products or components, our supply and our ability to continue selling and servicing products that use these components could be imperiled. Similarly, if any of our sole source vendors should encounter technical, operating or financial difficulties, our supply of these products or components would be threatened. While we believe that alternative sources for these products and components could be developed, or our products could be redesigned to permit the use of alternative components, an interruption of our supply could damage our business and negatively affect our operating results.

Our gross profit margin varies from product to product depending primarily on the proportion and cost of third-party hardware and software included in each product. From time to time, we add functionality and features to our products. If we effect such additions through the use of more, or more costly, third-party hardware or software and are not able to increase the price of our products to offset the increased costs, our gross profit margin on these products could decrease and our operating results could be adversely affected.

We rely on third party software for some of our products and if we are unable to use or integrate such software, our product and service development may be delayed.

We rely on certain software that we license from third parties, including software that is bundled with our products and sold to end users and software that is integrated with internally developed software and used in our products to perform key functions. These third-party software licenses may not continue to be available on commercially reasonable terms and the software may not be appropriately supported, maintained or enhanced by the licensors. The loss of licenses to, or inability to support, maintain and enhance, any such software, could result in increased costs, or in delays or reductions in product shipments until equivalent software could be developed, identified, licensed and integrated, which could adversely affect our business.

Qualifying and supporting our products on multiple computer platforms is time consuming and expensive.

Our software engineers devote significant time and effort to qualify and support our products on various computer platforms, including Microsoft and Apple platforms. Computer platform modifications and upgrades require additional time to be spent to ensure that our products function properly. To the extent that the current configuration of qualified and supported platforms changes, or we need to qualify and support new platforms, we could be required to expend valuable engineering resources, which could adversely affect our operating results.

Our revenues and gross profit are dependent on several unpredictable factors.

The revenue and gross profit from our products depend on many factors, including:

- mix of products sold;
- cost and proportion of third-party hardware and software included in such products;
- product distribution channels;
- acceptance of our new product introductions;
- product offers and platform upgrades;

- price discounts and sales promotion programs;
- volume of sales of aftermarket hardware products;
- costs of swapping or fixing products released to the market with defects;
- provisions for inventory obsolescence;
- competitive pressure on product prices;
- costs incurred in connection with our broadcast and some of our audio solution sales, which typically have longer selling and implementation cycles;
- timing of delivery of solutions to customers; and
- foreign currency exchange impact on our revenues.

Changes in any of these factors could adversely affect our operating results.

Our international operations expose us to significant exchange rate fluctuations and regulatory, intellectual property and other risks which could harm our operating results.

We generally derive approximately half of our revenues from customers outside of the United States. This business is, for the most part, transacted through international subsidiaries and generally in the currency of the end-user customers. Therefore, we are exposed to the risks that changes in foreign currency could adversely impact our revenues, net income (loss) and cash flow. To hedge against the foreign exchange exposure of certain forecasted receivables, payables and cash balances of our foreign subsidiaries, we enter into foreign currency forward-exchange contracts. The success of our hedging program depends on forecasts of transaction activity in the various currencies. To the extent that these forecasts are over- or under-stated during periods of currency volatility, we could experience currency gains or losses.

Other risks inherent in our international operations include changes in regulatory practices, environmental laws, tax laws, trade restrictions and tariffs, longer collection cycles for accounts receivable and greater difficulties in protecting our intellectual property.

We are subject to risks associated with compliance with environmental regulations.

Many of our products are subject to various international, federal and state laws governing the presence of chemical substances in these products and the proper recycling of such products. We could incur substantial costs, including penalties and fines, or our products could be enjoined from entering certain jurisdictions, if we fail to comply with these environmental laws.

Our product design and procurement operations are becoming increasingly complex as we adjust to new and future requirements relating to the composition of our products, including the restrictions on lead, mercury, cadmium and certain other substances under the Directive on the Restriction of Hazardous Substances, or the RoHS Directive, which applies to products put on the market in the European Union, or EU, as of July 1, 2006, and similar legislation currently proposed in other jurisdictions, such as China, South Korea and Australia, and certain states within the United States. The ultimate costs of complying with the RoHS Directive and similar environmental laws and the timing of these costs are difficult to predict.

We could also face significant costs and liabilities in connection with product labeling and recycling legislation. The EU has enacted the Waste Electrical and Electronic Equipment Directive, or the WEEE Directive, which requires producers of certain electrical goods, including some of our products, to label and be financially responsible for the collection, recycling, treatment and disposal of these goods. The WEEE Directive became effective on August 13, 2005, although to date not all EU countries have adopted rules implementing the WEEE Directive. Our potential liability resulting from the WEEE Directive and similar environmental legislation in other jurisdictions, including the United States, China and Japan, could be substantial and could have a material adverse effect on our results of operations.

Our operating costs are tied to projections of future revenues, which may differ from actual results.

Our operating expense levels are based, in part, on our expectations of future revenues. Such future revenues are difficult to predict. A significant portion of our business occurs near the end of each quarter, which can impact our ability to forecast revenues on a quarterly basis. Further, we are generally unable to reduce quarterly operating expense levels rapidly in the event that quarterly revenue levels fail to meet internal expectations. Therefore, if quarterly revenue levels fail to meet internal expectations upon which expense levels are based, our results of operations could be adversely affected.



Terrorism, acts of war and other catastrophic events may seriously harm our business.

Terrorism, acts of war, or other catastrophic events may disrupt our business and harm our employees, facilities, suppliers, distributors, resellers or customers, which could significantly impact our revenue and operating results. The increasing presence of these threats has created many economic and political uncertainties that could adversely affect our business and stock price in ways that cannot be predicted. We are predominantly uninsured for losses and interruptions caused by terrorism, acts of war and other catastrophic events.

If we fail to maintain strong relationships with our resellers, distributors and suppliers, our ability to successfully deploy and sell our products may be harmed.

We sell many of our Professional Video products and services and substantially all of our Audio and Consumer Video products and services, indirectly through resellers and distributors. In our Audio and Consumer Video segments, a few distributors account for a significant portion of the revenue in that segment. The loss of one or more key distributors could reduce our revenues. The resellers and distributors of our Professional Video segment products typically purchase Avid software and Avid-specific hardware from us and third-party components from various other vendors, in order to produce complete systems for resale. Any disruption to our resellers and distributors, or their third-party suppliers, could reduce our revenues. Increasingly, we are distributing our broadcast products directly, which could put us in competition with our resellers and distributors and could adversely affect our revenues. In addition, our resellers could diversify the manufacturers from whom they purchase products to sell to end-users, which could lead to a weakening of our relationships with our resellers and could adversely affect our revenues.

Most of the resellers and distributors of our Professional Video products are not granted rights to return products after purchase and actual product returns from such resellers and distributors have been insignificant to date. Our revenue from sales of Audio and Consumer Video products is generally derived, however, from transactions with distributors and authorized resellers that typically allow limited rights of return, inventory stock rotation and price protection. Accordingly, reserves for estimated returns, exchanges and credits for price protection are recorded as a reduction of revenues upon shipment of the related products to such distributors and resellers, based upon our historical experience. To date, actual returns have not differed materially from management's estimates. However, if returns of our Audio or Consumer Video segment products were to exceed estimated levels, our revenues and operating results could be adversely impacted.

With respect to our Consumer Video segment, we have expanded our distribution network to include several consumer channels, including large distributors of products to computer software and hardware retailers, which in turn sell products to end users. We also sell our Consumer Video products directly to certain retailers. Our Consumer Video product distribution network exposes us to the following risks, some of which are out of our control:

- we are obligated to provide price protection to our retailers and distributors and, while the agreements limit the conditions under which products can be returned to us, we may be faced with product returns or price protection obligations;
- retailers or distributors may not continue to stock and sell our consumer products; and
- retailers and distributors often carry competing products.

Changes in accounting rules could adversely affect our future operating results.

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. These principles are subject to interpretation by various governing bodies, including the Financial Accounting Standards Board and the Securities and Exchange Commission, which promulgate and interpret appropriate accounting regulations. Changes from current accounting regulations, as well as the judgments and methods we use to implement them, may have a significant effect on our reported financial results. Furthermore, changes in the rules regarding accounting for stock-based compensation, which took effect on January 1, 2006, have resulted in higher operating expenses and lower earnings per share compared to prior periods.

Our future growth could be harmed if we lose the services of certain employees.

Our success depends upon the services of a talented and dedicated workforce, including members of our executive team and employees in technical positions. The loss of the services of one or more key employees could harm our business. Our success also depends upon our ability to attract and retain highly skilled new employees. Competition for such employees is intense in the industries and geographic areas in which we operate. In the past, we have relied on our ability to grant stock options as one mechanism for recruiting and retaining highly skilled talent. However, changes in the accounting rules that



will require us to expense stock options will impair our ability to provide these incentives without incurring compensation costs. If we are unable to compete successfully for talented employees, our business could suffer.

If we fail to manage our growth effectively, our business could be harmed.

Our success depends on our ability to manage the growth of our operations effectively. As a result of our acquisitions and increasing demand for our products and services, the scope of our operations has grown both domestically and internationally. Our management team will face challenges inherent in efficiently managing an increased number of employees over larger geographic distances. These challenges include implementing effective operational systems, procedures and controls, as well as training new personnel. Inability to successfully respond to these challenges could have a material adverse effect on the growth of our business.

Our websites could subject us to legal claims that could harm our business.

Some of our websites provide interactive information and services to our customers. To the extent that materials may be posted on or downloaded from these websites and distributed to others, we may be subject to claims for defamation, negligence, copyright or trademark infringement, personal injury, or other theories of liability based on the nature, content, publication or distribution of such materials. In addition, although we have attempted to limit our exposure by contract, we may also be subject to claims for indemnification by end users in the event that the security of our websites is compromised. As these websites are available on a worldwide basis, they could potentially be subject to a wide variety of international laws.

We could incur substantial costs protecting our intellectual property or defending against a claim of infringement.

Our ability to compete successfully and achieve future revenue growth depends, in part, on our ability to protect our proprietary technology and operate without infringing upon the intellectual property rights of others. We rely upon a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and contractual provisions, as well as required hardware components and security keys, to protect our proprietary technology. However, our means of protecting our proprietary rights may not be adequate. In addition, the laws of certain countries do not protect our proprietary technology to the same extent as do the laws of the United States. From time to time unauthorized parties have obtained, copied and used information that we consider proprietary. Policing the unauthorized use of our proprietary technology is costly and time-consuming and we are unable to measure the extent to which such unauthorized use, including piracy, of our software exists. We expect software piracy to continue to be a persistent problem.

We occasionally receive communications suggesting that our products may infringe the intellectual property rights of others. It is our practice to investigate the factual basis of such communications and negotiate licenses where appropriate. While it may be necessary or desirable in the future to obtain licenses relating to one or more products or relating to current or future technologies, we may be unable to do so on commercially reasonable terms. If we are unable to protect our proprietary technology or unable to negotiate licenses for the use of others' intellectual property, our business could be impaired.

We also may be liable to some of our customers for damages that they may incur in connection with intellectual property claims. Although we attempt to limit our exposure to liability arising from infringement of third-party intellectual property rights in our agreements with customers, we may not always be successful. If we are required to pay damages to our customers, or indemnify our customers for damages they incur, our business could be harmed. Moreover, even if a particular claim falls outside of our indemnity or warranty obligations to our customers, our customers may be entitled to additional contractual remedies against us.

Regulations could be enacted that restrict our Internet initiatives.

Federal, state and international authorities may adopt new laws or regulations governing the Internet, including laws or regulations covering issues such as privacy, distribution and content. For example, the EU has issued several directives regarding privacy and data protection, including the Directive on Data Protection and the Directive on Privacy and Electronic Communications. The enactment of legislation implementing such directives by EU member countries is ongoing. The enactment of this and similar legislation or regulations could curb our Internet sales and other initiatives, require changes in our sales and marketing practices and place additional financial burdens on our business.

Our association with industry organizations could subject us to litigation.

We are members of several industry organizations, trade associations and standards consortia. Membership in these and similar groups could subject us to litigation as a result of the activities of such groups. For example, in



connection with our anti-piracy program, designed to enforce copyright protection of our software, we are a member of the Business Software Alliance, or BSA. From time to time the BSA undertakes litigation against suspected copyright infringers. These lawsuits could lead to counterclaims alleging improper use of litigation or a violation of other local laws. To date, none of these lawsuits or counterclaims have adversely affected our results of operations, but, should we become involved in material litigation, our cash flows or financial position could be adversely affected.

Compliance with rules and regulations concerning corporate governance has caused our operating expenses to increase and has put additional demands on our management.

The Sarbanes-Oxley Act of 2002 and various rules and regulations promulgated by the SEC and the National Association of Securities Dealers in recent years have increased the scope, complexity and cost of our corporate governance, reporting and disclosure practices. These laws, rules and regulations also divert attention from business operations, increase the cost of obtaining director and officer liability insurance and may make it more difficult for us to attract and retain qualified executive officers, key personnel and members of our board of directors.

If we experience problems with our third-party leasing program, our revenues could be adversely impacted.

We have an established leasing program with a third party that allows certain of our customers to finance their purchases of our products. If this program ended abruptly or unexpectedly, some of our customers might be unable to purchase our products unless or until they were able to arrange for alternative financing, which could adversely impact our revenues.

Our stock price may continue to be volatile.

The market price of our common stock has experienced volatility in the past and could continue to fluctuate substantially in the future based upon a number of factors, many of which are beyond our control. These factors include:

- changes in our quarterly operating results;
- shortfalls in our revenues or earnings compared to securities analysts' expectations;
- changes in analysts' recommendations or projections;
- fluctuations in investors' perceptions of us or our competitors;
- shifts in the markets for our products;
- development and marketing of products by our competitors;
- changes in our relationships with suppliers, distributors, resellers, system integrators or customers;
- announcements of major acquisitions;
- a shift in financial markets; and
- global macroeconomic conditions.

Furthermore, the market prices of equity securities of high technology companies have generally demonstrated volatility in recent years and this volatility has, at times, appeared to be unrelated to or disproportionate to any of the factors above.



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

We held our annual meeting of stockholders on May 24, 2006. At the meeting, George H. Billings and Nancy Hawthorne were reelected as Class I Directors. The vote with respect to each nominee is set forth below:

| | Total Vote For Each Director | Total Vote Withheld From Each Director |
|---|---|---|
| Mr. Billings | 40,225,989 | 139,809 |
| Ms. Hawthorne | 38,448,012 | 1,917,786 |

The additional directors whose term of office continued after the meeting are David A. Krall, Pamela F. Lenehan, Elizabeth M. Daley, John V. Guttag and Youngme E. Moon.

In addition, the stockholders ratified the selection of Ernst & Young LLP as the Company's independent auditors by a vote of 40,286,013 shares for, 64,887 shares against and 14,898 shares abstaining.

ITEM 6. EXHIBITS

#10.1 Form of Nonstatutory Stock Option Grant Terms and Conditions (Form for Non-Employee Directors) (incorporated by reference to our Current Report on Form 8-K as filed with the Commission on May 31, 2006)

*31.1 Certification of Principal Executive Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

*31.2 Certification of Principal Financial Officer pursuant to Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

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

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* Documents filed herewith

\# Management contract or compensatory plan



SIGNATURES

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

AVID TECHNOLOGY, INC.

Date: August 9, 2006 By: /s/ Paul J. Milbury

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Paul J. Milbury
Vice President and Chief Financial Officer
(Principal Financial Officer)

Date: August 9, 2006 By: /s/ Joel E. Legon
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Joel E. Legon
Vice President and Corporate Controller
(Principal Accounting Officer)



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