

SONIC FOUNDRY INC  
Form 10-K  
November 16, 2006  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-K**

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(Mark One)

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

For the fiscal period ended September 30, 2006

OR

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

Commission File Number 1-14007

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**SONIC FOUNDRY, INC.**

(Exact name of registrant as specified in its charter)

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**MARYLAND**  
(State or other jurisdiction of  
incorporation or organization)

**39-1783372**  
(I.R.S. Employer  
Identification No.)

**222 W. Washington Ave, Suite 775, Madison, WI 53703**  
(Address of principal executive offices)

**(608) 443-1600**  
(Issuer's telephone number)

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

None

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

Common stock par value \$0.01 per share

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

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

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

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

Accelerated filer

Non-accelerated filer

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

The aggregate market value of the registrant's common stock held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the Registrant's most recently completed second fiscal quarter was approximately \$63,200,000.

The number of shares outstanding of the registrant's common equity was 32,208,966 as of November 7, 2006.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the 2006 Annual Meeting of Stockholders are incorporated by reference into Part III. A definitive Proxy Statement pursuant to Regulation 14A will be filed with the Commission no later than January 28, 2007.

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**Table of Contents****TABLE OF CONTENTS**

|   | <b>PAGE NO.</b> |
|---|-----------------|
| <b><u>PART I</u></b>  |                 |
| Item 1. <u>Business</u>   | 1               |
| Item 1A. <u>Risk Factors</u>  | 10              |
| Item 1B. <u>Unresolved Staff Comments</u>   | 16              |
| Item 2. <u>Properties</u>   | 17              |
| Item 3. <u>Legal Proceedings</u>  | 17              |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u>  | 17              |
| <b><u>PART II</u></b>   |                 |
| Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> | 17              |
| Item 6. <u>Selected Financial Data</u>  | 19              |
| Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                        | 20              |
| Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>  | 28              |
| Item 8. <u>Consolidated Financial Statements and Supplementary Data:</u>  | 28              |
| <u>Report of Grant Thornton LLP, Independent Registered Public Accounting Firm</u>  | 29              |
| <u>Consolidated Balance Sheets</u>  | 30              |
| <u>Consolidated Statements of Operations</u>  | 31              |
| <u>Consolidated Statements of Stockholders' Equity</u>  | 32              |
| <u>Consolidated Statements of Cash Flows</u>  | 33              |
| <u>Notes to Consolidated Financial Statements</u>   | 34              |
| Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>                         | 45              |
| Item 9A. <u>Controls and Procedures</u>   | 45              |
| Item 9B. <u>Other Information</u>   | 46              |
| <b><u>PART III</u></b>  |                 |
| Item 10. <u>Directors and Executive Officers of the Registrant</u>  | 46              |
| Item 11. <u>Executive Compensation</u>  | 46              |
| Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>              | 46              |
| Item 13. <u>Certain Relationships and Related Transactions</u>  | 46              |
| Item 14. <u>Principal Accountant Fees and Services</u>  | 47              |
| Item 15. <u>Exhibits, Financial Statement Schedules</u>   | 47              |

---

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

*When used in this Report, the words anticipate , expect , plan , believe , seek , estimate and similar expressions are intended to identify forward-looking statements. These are statements that relate to future periods and include, but are not limited to, statements about the features, benefits and performance of our Rich Media products, our ability to introduce new product offerings and increase revenue from existing products, expected expenses including those related to sales and marketing, research and development and general and administrative, our beliefs regarding the health and growth of the market for Rich Media products, anticipated increase in our customer base, expansion of our products functionalities, expected revenue levels and sources of revenue, expected impact, if any, of legal proceedings, the adequacy of liquidity and capital resources, and expected growth in business. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, market acceptance for our products, our ability to attract and retain customers and distribution partners for existing and new products, our ability to control our expenses, our ability to recruit and retain employees, the ability of distribution partners to successfully sell our products, legislation and government regulation, shifts in technology, global and local business conditions, our ability to effectively maintain and update our products and service portfolio, the strength of competitive offerings, the prices being charged by those competitors, and the risks discussed elsewhere herein. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.*

**PART I**

**ITEM 1. BUSINESS**

**Who We Are**

Sonic Foundry, Inc. is a technology leader in the emerging web communications marketplace, providing enterprise solutions and services that link an information-driven world. Our principal product line, Mediasite , is a web communication and content management system that automatically and cost-effectively webcasts lectures and presentations. Trusted by Fortune 500 companies, top education institutions and Federal, state and local government agencies for a variety of critical communication needs, we believe Mediasite is the leading one-to-many multimedia communication solution for capturing knowledge and sharing it online.

Our core product is the Mediasite web communication and content management system. In the short time since we first introduced Mediasite, the system has set the standard as a transformational communications medium, changing the way organizations communicate via the web and how people around the globe receive vital information needed for work, professional advancement, safety and education.

The Mediasite solution family includes Mediasite Recorders to capture multimedia presentations; Mediasite Server Software to stream, archive and manage online presentation content; Mediasite Hosting Services to provide a user-friendly, pay-as-you go content hosting alternative; and SmartServe Services to provide annual software maintenance and technical support. Related products and services include installation, training, event capture and custom development services.

Mediasite lets organizations create affordable multimedia webcasts and gives them the tools to manage and secure their presentations. At the push of one button, **Mediasite Recorders** automate the capture and delivery of multimedia presentations and lectures (combining audio, video and accompanying graphics) for either live or on-demand viewing via the Internet. The process is unobtrusive and instantaneous, requiring no time-consuming or costly production. Viewers access the information live or on-demand anytime, anywhere using nothing more than a standard web browser. **Mediasite Server Software** provides a unified web communications platform to webcast presentations over the Internet for live or on-demand access and archive presentations in online catalogs. Mediasite Server centrally stores, secures, manages and monitors these media assets so they can be leveraged across large enterprises. **Mediasite Hosting Services** are available in Quick Start and Turnkey offerings to provide hosting, delivery and management of online multimedia content using our hosting data center and infrastructure, enabling organizations to take advantage of Mediasite without having to wade through the IT or network complexities



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

associated with their own technology environment. **SmartServe Services** provide Mediasite customers annually renewable maintenance and support plans on their Mediasite solutions giving them access to our technical skills and Mediasite software updates.

Currently, we have over one thousand media recorders installed within presentation venues around the world. We believe that these growing repositories drive further interest in deploying advanced search technology. Work on search technology began in the early 1990s through the initial efforts of Carnegie Mellon University and its Informedia project. Since that time, we have continued to advance and commercialize the technology to its present state. In December 2005, we launched Mediasite.com to showcase the public lectures, briefings and conference sessions of many education, government and corporate entities. Mediasite.com is the first search portal which aggregates publicly-available presentations of audio, video and graphical content, currently indexing over 11,000 public presentations or almost 9,000 hours of content. Mediasite.com also serves as a beta testing environment for new search technology initiatives involving speech recognition, phonetic speech, optical character recognition, language processing and contextual analysis to identify key words that are found within the graphics, audio and video of multimedia communications online.

Sonic Foundry, Inc., the parent company of Sonic Foundry Media Systems, Inc., our web communications business, was founded in 1991, incorporated in Wisconsin in March 1994 and merged into a Maryland corporation of the same name in October 1996. Our executive offices are located at 222 West Washington Ave., Madison, Wisconsin, 53703 and our telephone number is (608) 443-1600. Our corporate website is <http://www.sonicfoundry.com>. We make available, free of charge, at the Investor Information section of our website, our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to reports required to be filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after the filing of such reports with the Securities and Exchange Commission.

**Industry Background**

**Market need:** Every organization faces a fundamental need to communicate information efficiently to individuals who need it. Universities and colleges need to connect lecturers with students for advanced learning. Corporations strive for successful collaboration between colleagues to provide value to customers. Government agencies must keep partners, stakeholders and constituents informed to operate effectively.

And yet, significant communication challenges remain, including:

Connecting with a geographically-dispersed audience

Simultaneously addressing people in multiple locations

Holding meetings where it is not feasible for everyone to attend

Transmitting timely information that is crucial for all employees to receive

Requiring employees regardless of time zone or schedule to attend company training sessions  
Improving productivity and corporate logistics

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Reducing corporate travel expenses

Repeating the same presentation to different audiences

Making participants leave their desks to go to a meeting space

Diminishing employee productivity while in training

Lack of retention due to distractions, interruptions or absence

Incurring repeated costs for printing, mailing and meeting expenses  
Coordinating multiple project teams

Keeping everyone on the same page at the same time

Requiring time off task to get new hires trained

Failure to document and review past meeting content

Watering down of organizational initiatives, leading to false starts and forgotten directives

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

Operating time-consuming, cumbersome and restrictive technologies

Requiring technological expertise to manage existing systems

Inability to create learning content in real-time

Additional preparation and training for presenters, including pre-loading and pre-production of content

Needing costly and time-intensive post-production

**The Mediasite solution:** Sonic Foundry's technology is changing the way organizations share and use information because Mediasite is different from other web communication solutions. Our differentiating features include:

**Ease-of-use:** One-button recording simplifies what has previously been a highly technical and complex workflow. As a result, presenters do not need to make any changes to the way they normally present, which enables non-technical, line of business and subject matter experts to feel comfortable communicating via Mediasite.

**Transparency:** We believe the presenter of information and the information seeker should not be required to know anything about the technology that is facilitating their communication online. We mitigate the need for both presenters and viewers to have to interact with any software, hardware or proprietary downloads. Because no technical training is required to communicate via Mediasite, we are building a strong foundation for broader adoption and use.

**Content management focus:** Other market solutions place their emphasis on the technology of capture, focusing on the custom formats, bitrates and compression standards of streaming information over the web. We believe enterprises are more interested in ease-of-use for presenters and viewers, which leads to webcasting becoming a mode of everyday business communication. As their number of webcasts expands, enterprises must find ways to manage that content. Mediasite automatically creates online content catalogs that enable users to organize, secure, search, customize and report on viewers, access and use.

**Scalability:** The Mediasite system makes it possible for organizations to start small and grow as needed, scaling to meet rising demand and confidently supporting hundreds to thousands of simultaneous presentations while maximizing their enterprise infrastructures.

**Accessibility:** For hearing and visually-impaired viewers, Mediasite supports video closed captioning and allows presentations to be enabled for screen reader applications so organizations can begin addressing Section 508 technology accessibility requirements.



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Extensibility: Customers can extend the reach of Mediasite content with integration into other applications like course management, learning management and content management systems or custom portals.

Hosted offering: To minimize IT challenges, network infrastructure issues and technology expertise required to install, configure and maintain Mediasite within the enterprise, we offer a pay-as-you-go option that provides organizations a low-risk method of using Mediasite.

**Customers and applications:** The Mediasite system is rapidly emerging as the standard for capturing, archiving and delivering one-to-many multimedia presentations online. Popular applications in our primary vertical markets include:

### Corporate

Executive communications: state of the enterprise speeches, all-hands meetings

Workforce development: training, HR briefings, policy documentation

Program management: technical training, research collaboration

Sales and marketing: sales demonstrations, webinars, channel relations

Customer support: product tutorials, self-guided troubleshooting

Investor relations: earnings calls, analyst briefings, annual reports  
Higher education

Online lectures: students review content outside of in-class instruction

Distance learning: off-campus students learn remotely online

Continuing education: professionals learn online or supplement classroom experiences

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

Research and collaboration: present findings, facility training

Recruitment and orientation: campus tours, financial aid instructions

University business: leadership meetings, alumnae relations  
Government

Program management: relief work, military coordination, emergency preparedness

Community outreach: committee meetings, public safety announcements

Training, workshops and events: just-in-time, on-demand and remote learning

Executive and legislative communications: constituent relations, public speeches, debates

**Results:** In many cases, our customers have deployed our Mediasite technology to easily and cost-effectively build large-scale knowledge libraries of presentations. Through interviews, many customers report the following benefits of Mediasite:

Cuts costs and boosts productivity

Reduces the need for travel and meeting accommodations

Eliminates the need to choose between meetings by allowing executives to time-shift

Decreases work interruption and downtime while increasing the reach, retention and availability of important information

Recaptures time that would have been spent repeating company information to multiple audiences

Keeps sales people informed while in the field interacting with customers  
Enhances collaboration and morale

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Creates opportunities for executive face time and interaction between management and employees

Fosters a level of direct communication not possible before as presenters convey the significance of their message first hand

Enables non-technical people to create their own webcasts through highly-automated equipment

Improves employee morale through efficient, more inclusive communication so audiences at home and abroad feel more a part of the team  
Increases accuracy and comprehension

Staff and students can access presentations at their convenience, when they are less distracted, which leads to better retention

Allows managers to train employees consistently regardless of other day-to-day demands

Improves the reliability and frequency of internal and external communication

Enables quick and efficient briefing of employees with time-sensitive information, regardless of geographic location

Makes it possible to reuse and repurpose knowledge that could not otherwise be revisited

### **Market Demand**

Web communication is coming of age, now regarded by business, education and government as an essential communication tool for the enterprise. We believe the recent surge in adoption is fueled by the lower cost of bandwidth and storage, as well as growing consumer awareness of internet video with the proliferation of online multimedia advertising and websites like YouTube and Google Video. In its 2004 Market Forecast, Wainhouse Research predicted the market for on-demand media production would approach \$1 billion by 2007. We believe the market for this new medium will build at an increasing rate as more Mediasite systems are installed, more users begin webcasting and additional viewers come online.

**Mediasite in the enterprise:** Less than a decade ago, the only people in the enterprise talking openly about online multimedia were technical specialists in AV, IT or media services units, and even these technical people were skeptical about what benefits streaming would hold for the enterprise. Now, knowledge workers and line of business managers, people in executive communications, training, sales, HR and R&D, are pushing for online multimedia communications because they have a business need to be seen and heard by their colleagues.

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

*The Corporate Learning Factbook: Benchmarks and Analysis of U.S. Corporate Learning & Development*, published by Bersin and Associates in May 2006, estimates this year US organizations will spend a total of \$46.6 billion on training (including staff salaries), with \$14.8 billion budgeted for external products and services. According to the publication, nearly 60% of training groups report using virtual classroom technologies, and approximately 40% report using application simulation and rapid e-learning tools.

In December 2005, Sonic Foundry sponsored the Rich Media at Work Survey, an in-depth segment of Interactive Media Strategies' Enterprise Web Communications Survey, and found enterprise investments in web communications continue to grow as streaming goes mainstream. Almost half of the 689 companies surveyed were spending more than \$100,000 annually on online multimedia technology. That investment is paying off with significant tangible and intangible returns, the survey indicates. Webcasting the all-hands meeting or latest product training means people do not have to get on an airplane, struggle with room logistics or schedule time away from their desks to attend.

While many enterprises begin their web communications with live events, the majority move to live and on-demand, or on-demand only, as their webcasting experience grows. With that move, they report a spike in comprehension, productivity, strategic alignment around business goals, even morale. We believe the feeling that the presenter is talking directly to the listener helps people feel more a part of the team and fosters more intimate communication between management and employees.

**Mediasite in education:** We believe that adoption of web communications in educational enterprises is outpacing that in corporate enterprises. Given the technology pedigree of today's college students, this move to online learning makes perfect sense; as most of these students have never known a world without personal computers and the web. The delivery options for a modern education are akin to the electronic delivery of music that emerged approximately five years ago. Students want to get their courses as they get their music: go online, download what is needed and consume it on the go. They demand immediate access to their coursework regardless of time or place. Tomorrow's students may never actually miss a class because they will be able to watch it later on-demand with the added bonus of replaying the highlights if they need a refresher. To remain relevant, colleges and universities are striving to differentiate themselves through technical leadership as a means to attract students, while balancing their campus technology improvements with systems that faculty will embrace and adopt.

As a result, the education market is beginning to restructure around online learning, and we believe integration and bundling are two healthy indicators for the widespread adoption of online lectures on campus. To date, Sonic Foundry has installed Mediasite systems in the larger lecture halls and classrooms of campuses nationwide. Now, we are working on integration at the campus-wide level. Course management systems (CMS) like Blackboard®, WebCT and Desire2Learn® are ubiquitous in the education enterprise. As the foundation for e-learning, these CMS implementations are rapidly moving beyond simply aggregating related documents (handouts, assignments, course syllabus) to incorporating multimedia content like online lectures. We recently introduced software integration with Blackboard, the leading course management system used in higher education, which addresses the need for CMS integration at the campus CIO level.

In addition, Mediasite is now a featured technology in the Dell Intelligent Classroom™, the foundation of Dell's academic computing solution, kicking off our sales relationship with the Dell Education Reseller channel. Mediasite is part of Dell's suite of software, hardware and interactive technologies designed to create academic environments that aid collaboration and maximize student potential. With our inclusion under the Intelligent Classroom umbrella, institutions can purchase Mediasite bundled with other technology solutions through Dell's extensive network of partnerships with industry leaders. Our role in the Intelligent Classroom further benefits Sonic Foundry by extending to Mediasite the trust that the Dell brand inspires in its customers and prospects.

**The importance of search:** We believe search lies at the heart of efficient, web-based communication. Finding a specific document or phrase has become a necessary part of working and learning. Faced with thousands of hours of online streamed information, users could easily be overwhelmed with the need to find that one minute of content they require. Furthermore, organizations are not just going to need powerful tools to help workers internally find what they need, when they need it; leading businesses and education institutions will also want to be found by external audiences to help build their brands, customer base and reputation online.



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

These growing repositories drive further interest in deploying advanced search technology. Currently, we have over one thousand Mediasite recorders installed within presentation venues around the world. In December 2005, Sonic Foundry launched Mediasite.com to showcase the public lectures, briefings and conference sessions of many education, government and corporate entities. Mediasite.com is the first search portal which aggregates publicly-available presentations of audio, video and graphic content, currently indexing over 11,000 public presentations containing almost 9,000 hours of content.

Work on search technology began back in the early 1990s through the initial efforts of Carnegie Mellon University and its Informedia project. Since that time, Sonic Foundry has continued to advance and commercialize the technology to its present state. Mediasite.com also serves as a beta testing environment for new search technology initiatives involving speech recognition, phonetic speech, optical character recognition, language processing and contextual analysis to identify key words that are found within the graphics, audio and video of multimedia communications online.

**Products and Services**

The Mediasite solution family includes:

Mediasite Recorders to capture multimedia presentations

Mediasite Server Software to stream, archive and manage online presentation content

Mediasite Hosting Services to provide a stress-free, pay-as-you go content hosting alternative

SmartServe Services to provide annual software maintenance and technical support

**Mediasite Recorders** streamline the capture and creation of multimedia presentations for people who simply need to share their information or message with others. With the touch of a single button, Mediasite Recorders capture all the elements of a multimedia presentation - video, audio and presentation graphics - and combine these into an interactive media-rich presentation that can be immediately viewed via the web. The simple workflow of the Mediasite Recorder allows presenters to share their knowledge online without changing how they normally present. We offer Mediasite Recorders for the following environments:

A room-based Mediasite Recorder (RL440) for presentation facilities like conference and training rooms, lecture halls, auditoriums and classrooms

A mobile Mediasite Recorder (ML440) for portability to off-site events, conferences, trade shows, or multiple venues throughout an organization

Accompanying all Mediasite Recorders is the Mediasite Rich Editor, a desktop software tool allowing users to edit their presentations before publishing them to the web.

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**Mediasite Server Software** provides a unified web communications platform to webcast presentations over the internet for live or on-demand access and archive presentations in online catalogs. We believe that as online multimedia libraries grow, effective management and security of this institutional knowledge becomes critical. Mediasite Server allows organizations to:

Organize and index their content in searchable online catalogs

Secure presentations and Mediasite system access for authorized users

Customize and brand their presentation content and incorporate audience interactivity through polls and Q&A

Report on viewing activity to see who is watching what presentations, when and for how long

Enable closed captioning and other accessibility capabilities for users with visual or hearing disabilities

Manage and remotely control Mediasite Recorders

Integrate Mediasite content into learning or course management systems, content management systems or custom portals

**Mediasite Hosting Services** enable organizations to quickly and easily take advantage of the Mediasite web communications platform, without having to wade through the IT or network complexities associated with their own infrastructure. Available in Quick Start and Turnkey offerings, these pay-as-you-go services provide hosting,

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

delivery and management of online multimedia content using Sonic Foundry's hosting data center and infrastructure. Mediasite Hosting Services allow organizations of all sizes to jump start their web communications initiatives quickly and effortlessly. They provide a low-risk way to implement online multimedia communications before bringing hosting requirements in-house and can offer a hassle-free long-term solution.

**SmartServe Services** provide Mediasite customers annually renewable maintenance and support plans on their Mediasite solution giving them access to Sonic Foundry technical skills and Mediasite software updates. With a SmartServe contract, customers are entitled to software upgrades and updates for Mediasite Recorders and Servers; unlimited technical support assistance; extension of their Recorder hardware warranty; advance Recorder hardware replacement; and authorized access to the SmartServe Portal where they can access software downloads, documentation, knowledge base articles, tutorials, user forums and technical resources at any time. The majority of our customers purchase SmartServe contracts when they purchase Mediasite. Through SmartServe we also offer additional fee-based technical services including installation, training and consulting.

**Future Product Directions**

Our ongoing engineering efforts center on expanding Mediasite's content intelligence, extensibility and scalability particularly within the Mediasite Server software and related software add-ons. Future Mediasite development is targeted toward:

Incorporating powerful, key-word searching within archived multimedia presentations and enhancing multimedia content navigation and personalization. Powering these solutions will be our in-house technologies for understanding and analyzing images, language and speech. We expect to leverage our previous media analysis experience with the former Publisher product line for video search and retrieval as well as ongoing research to develop advanced media analysis solutions that complement Mediasite.

Integrating with other enterprise content applications and allowing users to access Mediasite presentations from corporate portals, course management systems and other content management repositories.

Supporting content playback experiences on popular portable computing devices.

Further enabling of Mediasite content to be accessible and meaningful to viewers with visual or hearing disabilities (e.g. captioning of rich media content).

Ensuring the scalability and performance of multimedia presentation capture, distribution and management in large and distributed implementations.

Providing Recorder hardware options that economically scale across large organizations.

**Segment Information**

The Company has determined that it operates in only one segment in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131) as it does not disaggregate profit and loss information on a segment basis for internal management reporting purposes to its chief operating decision maker. Therefore, such information is not presented.



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The segment sales data that follow are consistent with our current internal reporting structure.

### Net Sales by Major Product

Total billings for Mediasite product and support outside the United States totaled 17%, 18% and 13% in 2006, 2005 and 2004, respectively.

Billings for Mediasite product and support services to our two largest world-wide customers were 11% each in 2005 and 2004, while no individual customer was over 10% in 2006.

We do not disaggregate assets on a segment basis for internal management reporting, and, therefore, such information is not presented.

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**Selling and Marketing**

We sell and market our offerings through a sales force that manages a reseller channel of value-added resellers, system integrators, consultants and distributors. These third party representatives have a unique specialization and understanding of both audio/video systems and IT networking. In fiscal 2006, we utilized over 100 resellers who demonstrated these qualifications and sold our products to nearly 600 total end users. Our focus has been primarily in the United States and primarily to customers we have identified as having the greatest potential for high use: presenters, trainers, lecturers, marketers and leaders who have a routine need to communicate to many people in the higher education, government, health industry and certain corporate markets. Despite our primary attention on the North American market, reseller and customer interest outside of North America has grown and accordingly, we allocated five sales professionals to address international demand. To date, we have sold our products to customers in 23 countries outside the United States. Total billings for Mediasite product and support outside the United States totaled 17%, 18% and 13% in fiscal 2006, 2005 and 2004, respectively. Billings for Mediasite product and support services to our two largest world-wide customers were 11% each in fiscal 2005 and 2004, while no individual customer was over 10% in fiscal 2006.

Vertical market expansion - Currently, half our revenues are realized from the education and distance learning markets. Government and corporate markets lag education users in adoption of web communications, but revenues from corporate customers increased as a percentage of total revenues in fiscal 2006 to approximately 31% from 24% in fiscal 2005. We believe each of our vertical markets will continue to grow and that our corporate channel will continue to narrow the gap with education and distance learning as market awareness of web presentation and conferencing solutions expand. Similarly, we are seeing expanded interest from associations, legal, medical, defense, engineering and marketing organizations and may use targeted programs to focus on such groups specifically to build new markets as others become more established.

Repeat orders - Most customers buy a single system, often a mobile unit, to test the full capability of the Mediasite system. Larger enterprises and facilities have followed up with multiple unit orders following a test of the capabilities of the system. For this reason, we have specifically targeted larger entities that have more than 500 employees and multiple offices and that have found service provider solutions in conferencing more costly. In fiscal 2006, 42% of billings were preexisting customers compared to 46% in fiscal 2005.

Renewals - As is typical in the industry, we offer service contract extensions for a fee to our customer base.

Marketing efforts span the spectrum of reseller sales demonstrations, tradeshow, web page information, webcasts, brochures, direct mail, e-mail campaigns, print advertisement and white papers. We often request and receive press release quotes and written or multimedia testimonials from satisfied, high-profile reference customers, particularly those that demonstrate innovative and valuable uses of the Mediasite product. We solicit respected industry magazines and trade organizations to review our product and use advisors as introductions to new channels or customers. We have a large database of potential customers in the government, education and corporate marketplaces and have established a selected process of targeting specific verticals that have a direct and demonstrated need for our offerings.

**Operations**

We contract with a third party to build the hardware of our Mediasite Recorder products and typically purchase quantities sufficient to fill specific customer orders, including purchases of inventory by resellers. Quantities are maintained in inventory by our third party provider and shipped directly to the end customer or reseller. The hardware manufacturer provides a limited one-year warranty on the hardware, which we pass on to our customers who purchase our support plan. We have an alternate source for manufacture of some of the products we produce and believe there are numerous additional sources and alternatives to the existing production process. To date, we have not experienced any material difficulties or delays in the manufacture and assembly of our system products, or material returns due to product defects.

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**OTHER INFORMATION**

**Competition**

The market for one-to-many multimedia web communication is relatively new, and we face competition from other companies that provide related digital media applications. Companies like WebEx, Microsoft and Citrix offer web conferencing applications. Although part of the overall web communications landscape, these solutions are designed primarily for smaller group collaborative communications versus one-to-many communications. Adobe, Accordent and other vendors provide presentation authoring and capture capabilities, but we believe these companies currently lack the breadth or depth of content management capabilities required for online multimedia presentations in an enterprise-wide deployment. Current and potential customers may choose to develop their own home-grown web communications software and services which may compete with Mediasite. We may also compete indirectly with larger system integrators who embed or integrate competing technologies into their custom-built product offerings. It is possible that we may work with these larger integrators on one customer bid and compete with them on another.

The more successful we are in the growing market for online multimedia, the more competitors are likely to emerge. We believe that the principal competitive factors in our market include:

Ease of use and application transparency to the user

Content management and scalability to address enterprise requirements

Reliability and performance

Security of content, applications and services

Ability to integrate with third-party solutions and services

Customer service and support

A significant reference-able customer base

Ability to introduce new products and services to the market in a timely manner

Pricing

**Intellectual Property**

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The status of United States patent protection in the Internet industry is not well defined and will evolve as the U.S. Patent and Trademark Office grants additional patents. We currently have one patent that has been issued, four patent applications pending in the United States, one which was recently allowed. We may seek additional patents in the future. We do not know if our pending patent applications or any future patent application will result in any patents being issued with the scope of the claims we seek, if such patents are issued at all. We do not know whether the patent which was recently approved or any patents we may receive in the future will be challenged, invalidated or be of any value. It is difficult to monitor unauthorized use of technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States, and our competitors may independently develop technology similar to ours. We will continue to seek patent and other intellectual property protections, when appropriate, for those aspects of our technology that we believe constitute innovations providing significant competitive advantages. Our pending, and any future, patent applications may not result in the issuance of valid patents.

Our success depends in part upon our rights to proprietary technology. We rely on a combination of copyright, trade secret, trademark and contractual protection to establish and protect our proprietary rights. We have filed for eight U.S. and six foreign country trademarks, of which six U.S. and four foreign country trademarks are registered. We require our employees to enter into confidentiality and nondisclosure agreements upon commencement of employment. Before we will disclose any confidential aspects of our services, technology or business plans to customers, potential business distribution partners and other non-employees, we routinely require such persons to enter into confidentiality and nondisclosure agreements. In addition, we require all employees, and those consultants involved in the deployment of our services, to agree to assign to us any proprietary information, inventions or other intellectual property they generate, or come to possess, while employed by us. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our services or technology. These precautions may not prevent misappropriation or infringement of our intellectual property.

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

Third parties may infringe or misappropriate our copyrights, trademarks and similar proprietary rights. In addition, we may be subject to claims of alleged infringement of patents and other intellectual property rights of third parties. We may be unaware of filed patent applications which have not yet been made public and which relate to our services.

Intellectual property claims may be asserted against us in the future. Intellectual property litigation is expensive and time-consuming and could divert management's attention away from running our business. Intellectual property litigation could also require us to develop non-infringing technology or enter into royalty or license agreements. These royalty or license agreements, if required, may not be available on acceptable terms, if at all. Our failure or inability to develop non-infringing technology or license the proprietary rights on a timely basis would harm our business.

**Research and Development**

We believe that our future success will depend in part on our ability to continue to develop new business, and to enhance our existing business. Accordingly, we invest a significant amount of our resources in research and development activities. During the fiscal years ended September 30, 2006 and 2005, we spent \$2.2 million and \$1.8 million on internal research and development activities in our business. These amounts represent 18% and 22% of total revenues in each of those years.

**Employees**

As of September 30, 2006, 2005 and 2004, we had 72, 54, and 47 full-time employees, respectively. Our employees are not represented by a labor union, nor are they subject to a collective bargaining agreement. We have never experienced a work stoppage and believe that our employee relations are satisfactory.

**ITEM 1A. RISK FACTORS**

The occurrences or any of the following risks could materially and adversely affect our business, financial condition and operating results.

*We may need to raise additional capital if we do not quickly become profitable.*

Based on our cash balance at September 30, 2006 of \$2.8 million and our expectation that we will generate positive cash from operations in fiscal 2007, we anticipate having sufficient cash resources for at least the next twelve months. Despite our belief that we have sufficient cash to fund operations in 2007, we may decide to raise additional cash from the sale of new shares of common stock or issuance of debt in 2007. The business environment may not be conducive to raising additional debt or equity financing. If we borrow money, we may incur significant interest charges, which could harm our profitability. Holders of debt would also have rights, preferences or privileges senior to those of existing holders of our common stock. If we raise additional equity, the terms of such financing may dilute the ownership interests of current investors and cause our stock price to fall significantly. We may not be able to secure financing upon acceptable terms at all. If we cannot raise funds on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could seriously harm our business, operating results, and financial condition.

*We have a history of losses.*

For the year ended September 30, 2006, we had a gross margin of \$9.35 million on revenues of \$12.6 million with which to cover sales, marketing, research, development and general administrative costs. Our sales, marketing, research, development and general administration costs have historically been a significant percentage of our revenues, due partly to the expense of developing leads and the relatively long period required to convert leads into sales associated with



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

selling products that are not yet considered mainstream technology investments. For the year ended September 30, 2006, our operating expenses exceeded our gross margin by 38%. Although we expect our operating losses as a percentage of revenues to continue to decline and reach break-even during fiscal 2007, we may never achieve profitability.

*If a sufficient number of customers do not accept our products, our business may not succeed.*

We cannot predict how the market for our products will develop, and part of our strategic challenge will be to convince enterprise customers of the productivity, improved communications, cost savings and other benefits of our products. Our future revenues and revenue growth rates will depend in large part on our success in delivering these products effectively and creating market acceptance for these products. If we fail to do so, our products will not achieve widespread market acceptance, and we may not generate significant revenues to offset our development and sales and marketing costs, which will hurt our business.

*We may not be able to innovate to meet the needs of our target market.*

Our future success will continue to depend upon our ability to develop new products or product enhancements that address future needs of our target markets and to respond to these changing standards and practices. Our revenue could be reduced if we do not capitalize on our current market leadership by timely developing innovative new products or product enhancements that will increase the likelihood that our products will be accepted in preference to the products of our current and future competitors. Our ability to develop new products or product enhancements may require increases in research and development costs. Such increases may cause our near-term operational results to suffer.

*Multiple unit sales may fail to materialize.*

We need to sell multiple units to educational, corporate and government institutions in order to sell most efficiently and become profitable. In fiscal 2006, 42% of unit revenues were to existing customers compared to 46% in fiscal 2005. At September 30, 2006, 210 customers had purchased multiple units compared to 89 customers at September 30, 2005. While we have addressed a strategy to leverage existing customers and close multiple unit transactions, a customer may choose not to make expected purchases of our products. The failure of our customers to adopt our products throughout their organizations by making expected purchases will harm our business.

*If our marketing and lead generation efforts are not successful, our business will be harmed.*

We believe that continued marketing efforts will be critical to achieve widespread acceptance of our products. Our marketing campaign may not be successful given the expense required. For example, failure to adequately generate and develop sales leads could cause our future revenue growth to decrease. In addition, our inability to generate and cultivate sales leads into key accounts in targeted, large organizations, where there is the potential for significant use of our products, could have a material effect on our business. We may not be able to identify and secure the number of strategic sales leads necessary to help generate marketplace acceptance of our products. If our marketing or lead-generation efforts are not successful, our business and operating results will be harmed.

*The length of our sales and deployment cycle is uncertain, which may cause our revenues and operating results to vary significantly from quarter to quarter and year to year.*

During our sales cycle, we spend considerable time and expense providing information to prospective customers about the use and benefits of our products without generating corresponding revenues. Our expense levels are relatively fixed in the short-term and based in part on our expectations of future revenues. Therefore, any delay in our sales cycle could cause significant variations in our operating results, particularly because a relatively small number of customer orders represent a large portion of our revenues.

We anticipate that some of our largest sources of revenues will be government entities, educational institutions and large corporations that often require long testing and approval processes before making a decision to purchase our products. In general, the process of selling our products to

a potential customer may involve lengthy negotiations. As a



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

result, we anticipate that our sales cycle will be unpredictable. Our sales cycle will also be subject to delays as a result of customer-specific factors over which we have little or no control, including budgetary constraints and internal approval procedures.

Our products are aimed toward a broadened business user base within our key markets. These products are relatively early in their product life cycles and we are relatively inexperienced with their sales cycle. We cannot predict how the market for our products will develop and part of our strategic challenge will be to convince targeted users of the productivity, improved communications, cost savings and other benefits. Accordingly, it is likely that delays in our sales cycles with these products will occur and this could cause significant variations in our operating results.

***We currently depend on international sales and our business strategy includes growing international sales. Any economic downturn, changes in laws, changes in currency exchange rates or political unrest in other countries could have a material adverse effect on our business.***

For the fiscal year ended September 30, 2006, total revenues derived from international sales were approximately \$2.1 million, representing approximately 17% of total revenues. For the fiscal year ended September 30, 2005, revenues derived from international sales were approximately \$1.5 million, representing approximately 18% of total revenues. Our international operations have historically exposed us to longer accounts receivable and payment cycles. Additional, because our sales are denominated in U.S. dollars, changes in exchange rates could harm our foreign business by raising the price of our products in foreign countries.

Our international operations expose us to a variety of other risks that could impede our financial condition and growth. These risks include the following:

potentially adverse tax consequences;

difficulties in complying with regulatory requirements and standards;

trade restrictions and changes in tariffs; and

uncertainty of the effective protection of our intellectual property rights in certain foreign countries.

If any of these risks described above materialize, our international sales could decrease and our foreign operations could suffer.

***If our planned expansion of the Federal sector is not achieved, our business will be harmed.***

One of our strategies is to expand our business in the Federal sector. This sector includes defense contractors, the United States military, Department of Defense organizations, and Homeland Security. In securing contracts and doing business with these organizations, we must comply with laws and regulations relating to the award, administration and performance of U.S. government contracts. If we are unable to comply with these laws and regulations, or if the cost of compliance becomes too high, we will have misallocated resources to this sector and our business will be harmed.

***If we do not grow sales to key partners, our business will be harmed.***

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We have entered into financial relationships with key partners. One of our objectives is to grow our business with certain of these key partners. If we are unable to do so, either because we cannot integrate our operations or because our products do not satisfy key partner demands, our business will be harmed.

***Our marketing and sales resources are limited and may not be sufficient to achieve widespread acceptance of our products.***

The success of our marketing efforts in large part is dependent upon our marketing and sales resources. If we are unable to significantly increase our marketing and sales resources our marketing campaign may not be successful and our business and operating results will be harmed. Substantial increases in market and sales resources may, however, cause near term operational results to suffer.

***There is a great deal of competition in the market for our products, which could lower the demand for our products.***

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The market for one-to-many multimedia web communication is relatively new, and we face competition from other companies that provide related digital media applications. Companies like WebEx, Microsoft and Citrix offer web conferencing applications. Although part of the overall web communications landscape, these solutions are designed primarily for smaller group collaborative communications versus one-to-many communications. Adobe, Accordent and other vendors provide presentation authoring and capture capabilities, but currently lack the breadth or depth of content management capabilities required for online multimedia presentations in an enterprise-wide deployment. Current and potential customers may choose to develop their own home-grown web communications software and services which may compete with Mediasite. We may also compete indirectly with larger system integrators who embed or integrate competing technologies into their custom-built product offerings. If one of these alternative approaches is received more favorably in the marketplace, a new approach or technology is developed or an existing or new competitor markets more effectively than we do or we otherwise do not compete effectively, our business will be harmed. In addition, the more successful we are in the emerging markets our products address, the more competitors are likely to emerge, including turnkey media application, streaming media platform developers, digital music infrastructure providers, and digital media applications service providers (including for digital musical subscription). Many of our competitors have far greater financial resources than we do, and could easily and in a short period of time overtake the marketplace and severely harm our business. We may also face competition from foreign suppliers and competition from Course Management Systems (CMS) or education information technology (IT) companies.

The presence of these competitors could reduce the demand for our systems, and we may not have the financial resources to compete successfully.

***Our customers may use our products to share confidential and sensitive information, and if our system security is breached, our reputation could be harmed and we may lose customers.***

Our customers may use our products to share confidential and sensitive information, the security of which is critical to their business. Third parties may attempt to breach our security or that of our customers. Customers may take inadequate security precautions with their sensitive information and we may inadvertently make that information public on our [www.mediasite.com](http://www.mediasite.com) website. We may be liable to our customers for any breach in security, and any breach could harm our reputation and cause us to lose customers. In addition, customers are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays or loss of data. We may be required to expend significant capital and other resources to further protect against security breaches or to resolve problems caused by any breach, including litigation-related expenses if we are sued.

***The technology underlying our products and services is complex and may contain unknown defects that could harm our reputation, result in product liability or decrease market acceptance of our products.***

The technology underlying our products is complex and includes software that is internally developed, software licensed from third parties and hardware purchased from third parties. These products may contain errors or defects, particularly when first introduced or when new versions or enhancements are released. We may not

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

discover defects that affect our current or new applications or enhancements until after they are sold. Any defects in our products and services could:

Damage our reputation;

Cause our customers to initiate product liability suits against us;

Increase our product development resources;

Cause us to lose sales; and

Delay market acceptance of our products.

Our insurance coverage may not be sufficient to cover our complete liability exposure.

*If we are viewed only as a commodity supplier, our margins and valuations will shrink.*

We need to provide value-added services in order to avoid being viewed as a commodity supplier. This entails building long-term customer relationships and developing features that will distinguish our products. If we fail to do so, our margins will shrink, and our stock may become less valued to investors.

*Our success depends upon the proprietary aspects of our technology.*

Our success and ability to compete depend to a significant degree upon the protection of our proprietary technology. We currently have one patent that has been issued, four patent applications pending in the United States, one which was recently allowed. We may seek additional patents in the future. Our current patent applications cover different aspects of the technology used in our products which is important to our ability to compete. However, it is possible that:

our pending patent applications may not result in the issuance of patents;

any patents acquired by or issued to us may not be broad enough to protect us;

any issued patent could be successfully challenged by one or more third parties, which could result in our loss of the right to prevent others from exploiting the inventions claimed in those patents;

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current and future competitors may independently develop similar technology, duplicate our services or design around any of our patents; and

effective patent protection, including effective legal-enforcement mechanisms against those who violate our patent-related assets, may not be available in every country in which we do or plan to do business.

***We also rely upon trademarks, copyrights and trade secrets to protect our technology, which may not be sufficient to protect our intellectual property.***

We also rely on a combination of laws, such as copyright, trademark and trade secret laws, and contractual restrictions, such as confidentiality agreements and licenses, to establish and protect our technology. We have filed for eight U.S. and six foreign country trademarks, of which six U.S. and four foreign country trademarks are registered. These forms of intellectual property protection are critically important to our ability to establish and maintain our competitive position. However,

third parties may infringe or misappropriate our copyrights, trademarks and similar proprietary rights;

laws and contractual restrictions may not be sufficient to prevent misappropriation of our technology or to deter others from developing similar technologies;

effective trademark, copyright and trade secret protection, including effective legal-enforcement mechanisms against those who violate our trademark, copyright or trade secret assets, may be unavailable or limited in foreign countries;

other companies may claim common law trademark rights based upon state or foreign laws that precede the federal registration of our marks; and

policing unauthorized use of our services and trademarks is difficult, expensive and time-consuming, and we may be unable to determine the extent of any unauthorized use.

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

Reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third parties to benefit from our technology without paying us for it, which would significantly harm our business.

*If other parties bring infringement or other claims against us, we may incur significant costs or lose customers.*

Other companies may obtain patents or other proprietary rights that would limit our ability to conduct our business and could assert that our technologies infringe their proprietary rights. We could incur substantial costs to defend any legal proceedings, even if without merit, and intellectual property litigation could force us to cease using key technology, obtain a license, or redesign our products. In the course of our business, we may sell certain systems to our customers, and in connection with such sale, we may agree to indemnify these customers from claims made against them by third parties for patent infringement related to these systems. In particular, claims are currently being made by holders of patents against educational institutions using streaming in their curriculum. We could be subject to similar claims, which could harm our business.

*If we lose the services of Rimas P. Buinevicius, our Chief Executive Officer, or Monty R. Schmidt, our Chief Technology Officer, our business may be harmed.*

Our success will depend on our senior executives. In particular, the loss of the services of our Chief Executive Officer, Rimas P. Buinevicius, or our co-founder and Chief Technology Officer, Monty R. Schmidt, would harm our business. Although we have long-term employment agreements with Messrs. Buinevicius and Schmidt, we do not have life insurance policies on any of our senior executives.

*We face risks associated with government regulation of the internet, and related legal uncertainties.*

Currently, few existing laws or regulations specifically apply to the Internet, other than laws generally applicable to businesses. Many Internet-related laws and regulations, however, are pending and may be adopted in the United States, in individual states and local jurisdictions and in other countries. These laws may relate to many areas that impact our business, including encryption, network and information security, and the convergence of traditional communication services, such as telephone services, with Internet communications, taxes and wireless networks. These types of regulations could differ between countries and other political and geographic divisions both inside and outside the United States. Non-U.S. countries and political organizations may impose, or favor, more and different regulation than that which has been proposed in the United States, thus furthering the complexity of regulation. In addition, state and local governments within the United States may impose regulations in addition to, inconsistent with, or stricter than federal regulations. The adoption of such laws or regulations, and uncertainties associated with their validity, interpretation, applicability and enforcement, may affect the available distribution channels for, and the costs associated with, our products and services. The adoption of such laws and regulations may harm our business.

*The price of our stock has been volatile and we could be delisted from the Nasdaq Global Market.*

Our common stock price, like that of many companies in the Internet industry, has been and may continue to be extremely volatile, and there is a risk we could be delisted from the Nasdaq Global Market. The market price of our common stock has been and may continue to be subject to significant fluctuations as a result of variations in our quarterly operating results and volatility in the financial markets. Our stock has traded below \$1.00 on multiple occasions, including during fiscal 2006, and we previously received notice from the Nasdaq Global Market that we need to comply with the requirements for continued listing on the Nasdaq Global Market or be delisted, although we have demonstrated compliance and have been informed that the hearing file was closed. If our stock trades below \$1.00 for 30 consecutive business days, we may receive another notice from the Nasdaq Global Market that we need to comply with the requirements for continued listing on the Nasdaq Global Market within 90 calendar days from such notification or be delisted. If our stock is delisted from the Nasdaq Global Market, an investor could find it more difficult to dispose of, or to obtain accurate quotations as to the market value of, our common stock. Additionally, our stock may be subject to penny stock regulations if it is delisted from the Nasdaq Global Market. If our common stock were subject to penny stock regulations, which apply to certain equity securities not traded on the Nasdaq Global Market which have a market price of less than \$5.00 per share, subject to limited exceptions, additional disclosure would be required by broker-dealers in connection with any trades involving such stock.



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

***Exercise of outstanding options and warrants will result in further dilution.***

The issuance of shares of common stock upon the exercise of our outstanding options and warrants will result in dilution to the interests of our stockholders, and may reduce the trading price of our common stock.

At September 30, 2006, we had outstanding options and warrants to acquire 5.3 million shares of common stock, 1.1 million of which are subject to future vesting; included in the foregoing are 4.6 million options which have been granted under our 1995 Employee Stock Option Plan, our 1999 Non-Qualified Stock Option Plan and our Non-Employee Director Stock Option Plan, 3.5 million of which are immediately exercisable.

To the extent that these stock options or warrants are exercised, dilution to the interests of our stockholders will likely occur. Additional options and warrants may be issued in the future at prices not less than 85% of the fair market value of the underlying security on the date of grant. Exercises of these options or warrants, or even the potential of their exercise may have an adverse effect on the trading price of our common stock. The holders of our options or our warrants are likely to exercise them at times when the market price of the common stock exceeds the exercise price of the securities. Accordingly, the issuance of shares of common stock upon exercise of the options and warrants will likely result in dilution of the equity represented by the then outstanding shares of common stock held by other stockholders. Holders of our options and warrants can be expected to exercise or convert them at a time when we would, in all likelihood, be able to obtain any needed capital on terms, which are more favorable to us than the exercise terms provided, by these options and warrants.

***We may need to make acquisitions or form strategic alliances or partnerships in order to remain competitive in our market, and potential future acquisitions, strategic alliances or partnerships could be difficult to integrate, disrupt our business and dilute stockholder value.***

We may acquire or form strategic alliances or partnerships with other businesses in the future in order to remain competitive or to acquire new technologies. As a result of these acquisitions, strategic alliances or partnerships, we may need to integrate products, technologies, widely dispersed operations and distinct corporate cultures. The products, services or technologies of the acquired companies may need to be altered or redesigned in order to be made compatible with our software products and services, or the software architecture of our customers. These integration efforts may not succeed or may distract our management from operating our existing business. Our failure to successfully manage future acquisitions, strategic alliances or partnerships could seriously harm our operating results. In addition, our stockholders would be diluted if we finance the acquisition, strategic alliances or partnerships by incurring convertible debt or issuing equity securities.

***Our corporate compliance program cannot guarantee that we are in compliance with all potentially applicable regulations.***

As a publicly traded company we are subject to significant regulations, including the Sarbanes-Oxley Act of 2002, some of the provisions of which are not yet applicable to us. While we have developed and instituted a corporate compliance program based on what we believe are the current best practices and continue to update the program in response to newly implemented regulatory requirements and guidance, we cannot assure that we are or will be in compliance with all potentially applicable regulations. For example, we cannot assure that in the future our management will not find a material weakness in connection with its annual review of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act, which, under proposed SEC rules, would require us as a non-accelerated filer to provide a report by management assessing the effectiveness of our internal control over financial reporting for our fiscal year ending September 30, 2008 and provide an auditor's attestation report for our fiscal year ending September 30, 2009. If our non-affiliate market capitalization is \$75 million or greater at March 31, 2007, as it was as of October 12, 2006, we will be required to be fully compliant with both the management assessment and auditor attestation at the end of fiscal 2007. We also cannot assure that we could



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

correct any such weakness to allow our management to assess the effectiveness of our internal control over financial reporting as of the end of our fiscal year in time to enable our independent registered public accounting firm to attest that such assessment will have been fairly stated in our Annual Report on Form 10-K to be filed with the Securities and Exchange Commission or attest that we have maintained effective internal control over financial reporting as of the end of our fiscal year. If we fail to comply with any of these regulations, we could be subject to a range of regulatory actions, fines, or other sanctions or litigation. In addition, if we must disclose any material weakness in our internal control over financial reporting, this may cause our stock price to decline.

***We are subject to risks associated with governmental regulation and legal uncertainties.***

It is likely that a number of laws and regulations may be adopted in the United States and other countries with respect to the Internet that might affect us. Those laws may relate to areas such as:

changes in telecommunications regulations;

copyright and other intellectual property rights;

encryption;

personal privacy concerns, including the use of cookies and individual user information;

e-commerce liability;

email, network and information security.

Changes in telecommunications regulations could substantially increase the costs of communicating on the Internet or over Voice over Internet Protocol (VoIP) networks. This, in turn, could slow the growth in the internet use of VoIP networks and thereby decrease the demand for our services. Several telecommunications carriers are advocating that the Federal Communications Commission regulate the Internet and VoIP networks in the same manner as other telecommunications services by imposing access fees. Recent events suggest that the FCC may begin regulating the Internet and VoIP networks in such a way. In addition, we operate our services throughout the United States and state regulatory authorities may seek to regulate aspects of our services as telecommunications activities.

Other countries and political organizations are likely to impose or favor more and different regulations than those that have been proposed in the United States, thus furthering the complexity of the regulation. The adoption of such laws or regulations, and uncertainties associated with their validity and enforcement, may affect the available distribution channels for and costs associated with our services, and may affect the growth of the Internet or VoIP networks. Such laws or regulations may therefore harm our business.

***Provisions of our charter documents and Maryland law could also discourage an acquisition of our company that would benefit our stockholders.***

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Provisions of our articles of incorporation and by-laws may make it more difficult for a third party to acquire control of our company, even if a change in control would benefit our stockholders. Our articles of incorporation authorize our board of directors, without stockholder approval, to issue one or more series of preferred stock, which could have voting and conversion rights that adversely affect or dilute the voting power of the holders of common stock. Furthermore, our articles of incorporation provide for a classified board of directors, which means that our stockholders may vote upon the retention of only one or two of our seven directors each year. Moreover, Maryland corporate law restricts certain business combination transactions with interested stockholders and limits voting rights upon certain acquisitions of control shares.

### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006****ITEM 2. PROPERTIES**

Our principal office is located in Madison, Wisconsin in a leased facility of approximately 19,000 square feet. The building serves as our corporate headquarters, accommodating our General and Administrative, Research and Development and Sales and Marketing departments. We believe this facility is adequate and suitable for our needs. The current lease term for this office expires on October 1, 2011. In addition, we lease 2,000 square feet in a building in downtown Pittsburgh, Pennsylvania on a month-to-month basis.

**ITEM 3. LEGAL PROCEEDINGS**

None

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

There were no matters submitted to a vote of security holders during the fourth quarter ended September 30, 2006.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock was initially traded on the American Stock Exchange under the symbol SFO, beginning with our initial public offering in April of 1998. On April 24, 2000, our common stock began trading on the Nasdaq National Market under the symbol SOFO. The following table sets forth, for the periods indicated, the high and low sale prices per share of our common stock as reported on the Nasdaq National Market, now known as the Nasdaq Global Market.

|  | High    | Low     |
|--|---------|---------|
| <b>Year Ended September 30, 2007:</b>    |         |         |
| First Quarter (through November 7, 2006) | \$ 3.25 | \$ 2.24 |
| <b>Year Ended September 30, 2006:</b>    |         |         |
| First Quarter                            | 1.34    | 0.98    |
| Second Quarter                           | 2.08    | 0.86    |
| Third Quarter                            | 2.50    | 1.57    |
| Fourth Quarter                           | 2.36    | 1.63    |
| <b>Year Ended September 30, 2005:</b>    |         |         |
| First Quarter                            | 1.85    | 1.32    |
| Second Quarter                           | 1.65    | 1.14    |
| Third Quarter                            | 1.45    | 1.05    |
| Fourth Quarter                           | 1.45    | 1.10    |

The Company has not paid any cash dividends and does not intend to pay any cash dividends in the foreseeable future.

At November 7, 2006 there were 497 common stockholders of record. Many shares are held by brokers and other institutions on behalf of shareholders.



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**Equity Compensation Plan Information**

| Plan category  | Number of securities<br>to be issued upon<br>exercise of<br>outstanding options,<br>warrants and rights<br>(a) | Weighted average<br>exercise price<br>of<br>outstanding<br>options,<br>warrants<br>and rights<br>(b) | Number of<br>securities<br>remaining<br>available for<br>future issuance<br>(c) |
|--|--|--|---|
| Equity compensation plans approved by security holders (1)     | 2,792,067  | \$ 2.82  | 2,716,649   |
| Equity compensation plans not approved by security holders (2) | 1,810,107  | 1.17   | 759,475   |
| <b>Total</b>   | <b>4,602,174</b>   | <b>\$ 2.17</b>   | <b>3,476,124</b>  |

(1) Consists of Employee Stock Option Plan and the Directors Stock Option Plan. For further information regarding these plans, reference is made to Note 5 of the financial statements.

(2) Consists of the Non-Qualified Stock Option Plan. For further information regarding this plan, reference is made to Note 5 of the financial statements.

**(A) RECENT SALES OF UNREGISTERED SECURITIES**

None

**(B) USE OF PROCEEDS FROM REGISTERED SECURITIES**

None

**(C) ISSUER PURCHASES OF EQUITY SECURITIES**

None

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006****ITEM 6. SELECTED FINANCIAL DATA**

The selected financial and operating data were derived from our consolidated financial statements. The selected financial data set forth below is qualified in its entirety by, and should be read in conjunction with, Management's Discussion and Analysis of Financial Condition and Results of Operations and our financial statements and notes thereto appearing elsewhere in this annual report on Form 10-K (in thousands except per share data).

|  | Years Ended September 30, |           |           |           |           |
|--|---------------------------|-----------|-----------|-----------|-----------|
|  | 2006                      | 2005      | 2004      | 2003      | 2002      |
| <b>Statement of Operations Data:</b>   |                           |           |           |           |           |
| Revenue  | \$ 12,564                 | \$ 8,342  | \$ 4,413  | \$ 1,264  | \$ 859    |
| Gross margin   | 9,349                     | 5,588     | 2,654     | 376       | 479       |
| Loss from operations   | (3,560)                   | (4,356)   | (5,607)   | (7,530)   | (7,876)   |
| Loss from continuing operations before cumulative effect of change in accounting principle | (3,483)                   | (4,169)   | (5,508)   | (7,549)   | (8,314)   |
| Loss from operations of discontinued operations  |                           |           |           | (2,930)   | (3,691)   |
| Gain on disposal of discontinued operations  |                           |           | 132       | 11,932    |           |
| Cumulative effect of change in accounting principle  |                           |           |           |           | (44,732)  |
| Net income (loss)  | (3,483)                   | (4,169)   | (5,376)   | 1,453     | (56,737)  |
| Income (loss) per common share before cumulative effect of change in accounting principle: |                           |           |           |           |           |
| Continuing operations  | \$ (0.11)                 | \$ (0.14) | \$ (0.18) | \$ (0.27) | \$ (0.31) |
| Discontinued operations  |                           |           |           | 0.32      | (0.14)    |
| Cumulative effect of change in accounting principle  |                           |           |           |           | (1.67)    |
| Basic net income (loss) per common share   | \$ (0.11)                 | \$ (0.14) | \$ (0.18) | \$ 0.05   | \$ (2.12) |
| Diluted net income (loss) per common share   | \$ (0.11)                 | \$ (0.14) | \$ (0.18) | \$ 0.05   | \$ (2.12) |
| Weighted average common shares: - Basic  | 32,015                    | 30,363    | 29,457    | 27,794    | 26,812    |
| - Diluted  | 32,015                    | 30,363    | 29,457    | 28,375    | 26,812    |
| <b>Balance Sheet Data at September 30:</b>   |                           |           |           |           |           |
| Cash and cash equivalents  | \$ 2,751                  | \$ 4,271  | \$ 7,583  | \$ 12,623 | \$ 3,704  |
| Working capital (deficit)  | 2,198                     | 4,205     | 7,560     | 11,025    | (496)     |
| Total assets   | 16,912                    | 16,245    | 18,631    | 22,801    | 27,643    |
| Long-term liabilities  | 519                       | 49        |           |           | 503       |
| Stockholders' equity   | 11,601                    | 13,121    | 16,566    | 20,231    | 17,984    |

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

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

The financial and business analysis below provides information that the Company believes is relevant to an assessment and understanding of the Company's consolidated financial position and results of operations. This financial and business analysis should be read in conjunction with the consolidated financial statements and related notes.

When used in this Report, the words "anticipate," "expect," "plan," "believe," "seek," "estimate" and similar expressions are intended to identify forward-looking statements. These are statements that relate to future periods and include, but are not limited to, statements about the features, benefits and performance of our products, our ability to introduce new product offerings and increase revenue from existing products, expected expenses including those related to sales and marketing, research and development and general and administrative, our beliefs regarding the health and growth of the market for products, anticipated increase in our customer base, expansion of our products functionalities, expected revenue levels and sources of revenue, expected impact, if any, of legal proceedings, the adequacy of liquidity and capital resources, and expected growth in business. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, market acceptance for our products, our ability to attract and retain customers and distribution partners for existing and new products, our ability to control our expenses, our ability to recruit and retain employees, the ability of distribution partners to successfully sell our products, legislation and government regulation, shifts in technology, global and local business conditions, our ability to effectively maintain and update our products and service portfolio, the strength of competitive offerings, the prices being charged by those competitors, and the risks discussed elsewhere herein. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Overview

Sonic Foundry, Inc. is a technology leader in the emerging web communications marketplace, providing enterprise solutions and services that link an information-driven world. The company's principal product line, Mediasite<sup>®</sup>, is a web communication and content management system that automatically and cost-effectively webcasts lectures and presentations. Trusted by Fortune 500 companies, top education institutions and Federal, state and local government agencies for a variety of critical communication needs, Mediasite is the leading one-to-many multimedia communication solution for capturing knowledge and sharing it online.

Critical Accounting Policies

We have identified the following as critical accounting policies to our Company and have discussed the development, selection of estimates and the disclosure regarding them with the audit committee of the board of directors:

Revenue recognition and allowance for doubtful accounts;

Impairment of long-lived assets;

Valuation allowance for net deferred tax assets; and

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Accounting for stock based compensation.

*Revenue Recognition and Allowance for Doubtful Accounts*

### General

Revenue is recognized when persuasive evidence of an arrangement exists, delivery occurs or services are rendered, the sales price is fixed or determinable and collectibility is reasonably assured. Revenue is deferred when undelivered products or services are essential to the functionality of delivered products, customer acceptance is uncertain, significant obligations remain, or the fair value of undelivered elements is unknown. The Company does



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

not offer customers the right to return product, other than for warranty repairs. The Company's policy is to reduce revenue if it incurs an obligation for price rebates or other such programs during the period the obligation is reasonably estimated to occur. The following policies apply to the Company's major categories of revenue transactions.

**Products**

Products are considered delivered, and revenue is recognized, when title and risk of loss have been transferred to the customer. Under the terms and conditions of the sale, this occurs at the time of shipment to the customer. Product revenue currently represents sales of our Mediasite product and Mediasite related products such as server software revenue.

**Services**

We sell support contracts to our Mediasite customers, typically one year in length, and record the related revenue ratably over the contractual period. Our support contracts cover phone and electronic technical support availability over and above the level provided by our distributors, software upgrades, advance replacement and an extension of the standard hardware warranty from 90 days to one year. The manufacturer we contract with to build the units performs hardware warranty service. We also sell installation and training services and host customer Mediasite content. Revenue for those services is recognized when performed in the case of installation and training services and is recognized ratably over the contract period for hosting services. Service amounts invoiced to customers in excess of revenue recognized are recorded as deferred revenue until the revenue recognition criteria are met.

**Other**

Other revenue consists of software licensing and custom software development performed under time and materials or fixed fee arrangements that is not related to Mediasite and amounts charged for shipping and handling. Software licensing is recorded when persuasive evidence of an arrangement exists, delivery occurs, the sales price is fixed or determinable and collectibility is reasonably assured. Custom software development includes fees recorded pursuant to long-term contracts (including research grants), using the percentage of completion method of accounting, when significant customization or modification of a product is required. Shipping and handling is recorded at the time of shipment to the customer.

**Revenue Arrangements that Include Multiple Elements**

Revenue for transactions that include multiple elements such as hardware, software, training, support or content hosting agreements is allocated to each element based on its relative fair value and recognized for each element when the revenue recognition criteria have been met for such element. Fair value is generally determined based on the price charged when the element is sold separately. In the absence of fair value of a delivered element, revenue is allocated first to the fair value of the undelivered elements and the residual revenue to the delivered elements. The Company recognizes revenue for delivered elements only when all of the following criteria are satisfied: undelivered elements are not essential to the functionality of delivered elements, uncertainties regarding customer acceptance are resolved, and the fair value for all undelivered elements is known.

**Shipping and Handling**

Costs related to shipping and handling are included in cost of revenue for all periods presented.

**Credit Evaluation**

We perform ongoing credit evaluations of our customers' financial condition and generally do not require collateral. We maintain allowances for potential credit losses and such losses have been within our expectations.



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

*Impairment of long-lived assets*

We assess the impairment of goodwill and capitalized software development costs on an annual basis or whenever events or changes in circumstances indicate that the fair value of these assets is less than the carrying value. Factors we consider important which could trigger an impairment review include the following:

poor economic performance relative to historical or projected future operating results;

significant negative industry, economic or company specific trends;

changes in the manner of our use of the assets or the plans for our business; and

loss of key personnel

If we determine that the fair value of goodwill is less than its carrying value, based upon the annual test or the existence of one or more of the above indicators of impairment, we would then measure impairment based on a comparison of the implied fair value of goodwill with the carrying amount of goodwill. To the extent the carrying amount of goodwill is greater than the implied fair value of goodwill, we would record an impairment charge for the difference.

We evaluate all of our long-lived assets, including intangible assets other than goodwill, for impairment in accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. We evaluate all of our long-lived assets and intangible assets, including intangible assets other than goodwill, for impairment. Long-lived assets and intangible assets other than goodwill are evaluated for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on expected undiscounted cash flows attributable to that asset. Should events indicate that any of our long-lived assets are impaired; the amount of such impairment will be measured as the difference between the carrying value and the fair value of the impaired asset and recorded in earnings during the period of such impairment.

*Valuation allowance for net deferred tax assets*

Deferred income taxes are provided for temporary differences between financial reporting and income tax basis of assets and liabilities, and are measured using currently enacted tax rates and laws. Deferred income taxes also arise from the future benefits of net operating loss carryforwards. A valuation allowance equal to 100% of the net deferred tax assets has been recognized due to uncertainty regarding future realization.

*Accounting for stock based compensation*

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized in the year ended September 30, 2006 includes the cost for all stock options granted prior to, but not yet vested as of October 1, 2005. This cost was based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. The cost for all share-based awards granted subsequent to September 30, 2005, represents the grant-date fair value that was estimated in accordance with the provisions of SFAS 123R. Results for prior periods have not been restated. Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period.

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Upon the adoption of SFAS 123R, the Company changed its option valuation model from the Black-Scholes model to a lattice valuation model for all stock options granted subsequent to September 30, 2005. The lattice valuation model is a more flexible analysis to value employee Options because of its ability to incorporate inputs that change over time, such as actual exercise behavior of Option holders. The Company used historical data to estimate the Option exercise and employee departure behavior used in the lattice valuation model. Expected volatility is based on historical volatility of the Company's stock. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The Company considers all employees to have similar exercise behavior and therefore has not identified separate homogenous groups for valuation. The expected term of Options granted is derived from the output of the option pricing model and represents the period of time that Options granted are expected to be outstanding. The risk-free rate for periods within the contractual term of the Options is based on the U.S. Treasury yields in effect at the time of grant.

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006****RESULTS OF OPERATIONS**

Our current business was established in fiscal 2002 upon the acquisition of Mediasite, Inc. in October 2001. Our Media Services and Desktop Software businesses were sold in fiscal 2003 and reported under the caption of discontinued operations. You should read the following discussion of our results of operations and financial condition in conjunction with our consolidated financial statements and related notes thereto included in Item 8 of this Annual Report on Form 10-K.

**Revenue**

Revenues from our business include the sales of Mediasite and server software products and related services contracts, such as customer support, content hosting and equipment rental, sold separately as well as fees charged for the licensing of indexing related software and custom software development. We market our products to educational institutions, corporations and government agencies that need to deploy, manage, index and distribute video content on Internet-based networks. We reach both our domestic and international markets through reseller networks, a direct sales effort and partnerships with system Integrators.

**2006 compared to 2005**

Revenues in 2006 totaled \$12.6 million, compared to \$8.3 million in 2005. Revenues consisted of the following:

Product sales of Mediasite increased from \$6.9 million in 2005 to \$9.9 million in 2006 due to many factors including increased sales and marketing efforts, increased multiple unit sales, repeat purchases from existing customers (46% of 2005 billings were from preexisting customers compared to 42% in 2006), the fiscal 2006 release of an enterprise class server software application and other product enhancements.

|  | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|
| Units sold                                     | 553         | 467         |
| Mobile to rack ratio                           | 1 to 1      | 1.5 to 1    |
| Average sales price, excluding support (000 s) | \$17.9      | \$14.8      |
| Mediasite gross margins, excluding support     | 72%         | 66%         |

Services revenue represents the portion of fees charged for Mediasite SmartServe service contracts amortized over the length of the contract, typically 12 months, as well as training, installation, rental and content hosting services. Services revenue increased from \$975 thousand in 2005 to \$2.5 million in 2006. The increase in support revenue was due primarily to support contracts on new Mediasite capture units as well as renewals of support contracts entered into in prior years. At September 30, 2006 \$2.0 million of unrecognized support revenue remained in unearned revenues, of which we expect to recognize approximately \$685 thousand in the upcoming quarter.

Other revenue relates to freight charges billed separately to our customers, reimbursed expenses, and certain custom software engineering projects

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In 2005, we recorded revenue of \$163 thousand, in a single transaction, for the license of software code designed for indexing of media and video filters.

Other revenues also include \$221 thousand of grant revenue in 2005 compared to \$31 thousand in 2006, pursuant to a \$496 thousand grant awarded by the Department of Justice in October 2003. We do not expect to request additional funds to further advance the technology.

### **2005 compared to 2004**

Revenues in 2005 totaled \$8.3 million, compared to \$4.4 million in 2004. Revenues consisted of the following:

Product sales of Mediasite increased from \$3.4 million in 2004 to \$6.9 million in 2005 due to many factors including increased sales and marketing efforts, multiple unit sales, repeat purchases from existing customers (46% of 2005 revenues were from preexisting customers compared to 35% in 2004), addition of our server software product, release of new versions of Mediasite and product enhancements.

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006**

|  | 2005     | 2004     |
|--|----------|----------|
| Units sold                                     | 467      | 269      |
| Mobile to rack ratio                           | 1.5 to 1 | 2.5 to 1 |
| Average sales price, excluding support (000 s) | \$14.8   | \$12.8   |
| Mediasite gross margins, excluding support     | 66%      | 60%      |

Services revenue represents the portion of fees charged for Mediasite SmartServe service contracts amortized over the length of the contract, typically 12 months, as well as training and installation services. Services revenue increased from \$425 thousand in 2004 to \$975 thousand in 2005, due primarily to support contracts on an increasing number of new Mediasite sales as well as renewals of support contracts entered into in prior years. At September 30, 2005 \$957 thousand of unrecognized support revenue remained in unearned revenues.

Other revenue relates to freight charges billed separately to our customers, software licensing fees for our Publisher product and certain custom software engineering projects

In 2005, we recorded revenue of \$163 thousand, in a single transaction, for the license of software code designed for indexing of media and video filters.

Other revenues also include \$221 thousand of grant revenue in 2005 compared to \$245 thousand in 2004, pursuant to a \$496 thousand grant awarded by the Department of Justice in October 2003.

**Gross Margin**

Total gross margins for 2006 were \$9.3 million or 74% compared to \$5.6 million or 67% in 2005. High margin customer support revenue and licensing of server software applications accounted for the majority of the increase in gross margin percentage over 2005 levels. The significant components of cost of systems include:

Material and freight costs for the Mediasite capture units. The gross margin on Mediasite sales varies with product mix; our rack units typically carry a higher margin than our mobile units do. Mediasite services revenue, server license fees and DOJ grant revenue do not carry a cost over and above staff costs included in operating expenses significantly enhancing Mediasite product margins. Mediasite sales should typically result in gross margins of approximately 60% - 70%.

Amortization of Mediasite, Inc. related acquisition amounts assigned to purchased technology and other identified intangibles. Such purchased intangibles will be fully amortized during the quarter ended December 31, 2006.

During 2006 we amortized the capitalized costs for the design of tooling to make our own system components. We expect additional amortization expense for tooling and other product development of approximately \$220 over the next year.

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No royalty fees on Publisher revenues were incurred in fiscal 2006 nor do we expect to incur any significant payments in the future. Margins are expected to continue to increase in the near term as total revenues increase, non-cash amortization of purchased technology costs remain constant, and as the mix of revenues reflects a greater percentage of higher margin services revenue, server software license fees, consulting and hosting revenues.

### **Operating Expenses**

#### **Selling and Marketing Expenses**

Selling and marketing expenses include wages and commissions for sales, marketing, business development and technical support personnel, trade show expenses, print advertising and various promotional expenses for our products. Timing of these costs may vary greatly depending on introduction of new products and services, entrance into new markets or participation in major tradeshow.



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**2006 compared to 2005**

The \$2.4 million increase in sales and marketing expense from 2005 to 2006 resulted from numerous items. Significant differences include:

Growth in revenues and sales staff led to an increase of \$2.1 million in wages, commissions, benefits, recruiting, travel and related administrative costs. Our sales staff increased from 31 to 42.

Non-cash stock compensation of \$296 thousand associated with the adoption of SFAS 123R on October 1, 2005. As of September 30, 2006 we had 42 employees in Selling, Marketing and Customer Support, an increase of 11 employees from 2005. We anticipate approximately 50% growth in selling and marketing headcount in fiscal 2007.

**2005 compared to 2004**

The \$1.45 million increase in sales and marketing expense from 2004 to 2005 resulted from numerous items. Significant differences include:

Growth in revenues and sales staff led to an increase of \$1.2 million in wages, commissions, benefits, travel and related administrative costs. Our sales staff increased from 20 to 31.

\$250 thousand increase in advertising and tradeshow expense due to additional tradeshow attendance and increased print advertising.

**General and Administrative Expenses**

General and administrative ( G&A ) expenses consist of personnel and related costs associated with the facilities, finance, legal, human resource and information technology departments, as well as other expenses not fully allocated to functional areas.

**2006 compared to 2005**

G&A expenses increased \$177 thousand, or 6%, from \$2.9 million in 2005 to \$3.0 million in 2006. Major components of the change include:

Non-cash stock compensation associated with the adoption of SFAS 123R of \$70 thousand contributed to the increase in salary and wage expense.

Miscellaneous expenses increased approximately \$95 thousand over the prior year due to utilization of credits in 2005 to reduce certain retirement and other expenses.

As of September 30, 2006 we had 9 full-time employees in G&A. We do not anticipate significant growth in G&A headcount in fiscal 2007.

**2005 compared to 2004**

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G&A expenses increased \$40 thousand, or 1%, from \$2.82 million in 2004 to \$2.86 million in 2005. Major components of the change include:

Wage and benefit expenses increased nearly \$170 thousand due in part to non-cash stock compensation associated with the separation of an employee, annual wage and incentive increases, and increased cost of benefits.

This increase was partially offset as we utilized available credits to reduce certain retirement and other expenses by over \$110 thousand.

Other variances included an increase in facility expense due in part to increased square footage under lease, and a decrease in professional fees including accounting and legal services.

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**Product Development Expenses**

Product development (R&D) expenses include salaries and wages of the software research and development staff and an allocation of benefits, facility and administrative expenses. Fluctuations in product development expenses correlate directly to changes in headcount.

**2006 compared to 2005**

R&D expenses increased \$435 thousand, or 24%, from \$1.8 million in 2005 to \$2.2 million in 2006. Salaries, commissions and benefits were the primary reason for the increase, accounting for \$294 thousand of the increase over the prior year. Non-cash stock compensation of \$119 thousand associated with the adoption of FAS 123R also contributed to the increase. In 2006, 77% of R&D expenses related to salaries and benefits.

As of September 30, 2006 we had 21 employees in R&D compared to 15 as of September 30, 2005. We do not anticipate significant growth in R&D headcount in fiscal 2007. No fiscal 2006 software development efforts qualify for capitalization under SFAS No. 86 Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed.

**2005 compared to 2004**

R&D expenses increased \$194 thousand, or 12%, from \$1.6 million in 2004 to \$1.8 million in 2005. Salaries, commissions and benefits were the primary reason for the increase, accounting for \$163 thousand of the increase over the prior year. Additional contributors to the increase included facilities related expenses. In 2005, 79% of R&D costs related to salaries and benefits.

**Other Income**

Other income included primarily interest income in 2006, 2005 and 2004. We are currently investing in certificates of deposit and overnight investment vehicles.

**Discontinued Operations**

*Media Services*

We completed the sale of assets utilized in the Media Services business on May 16, 2003 with Deluxe Media Services ( Deluxe ). The transaction included all assets utilized in our Media Services business primarily affecting business conducted from and employees in our Santa Monica, California and Toronto, Canada facilities. Under terms of the agreement, Deluxe acquired the Media Services business for approximately \$5.6 million including cash of \$4.5 million plus an estimate of \$1.1 million for net working capital and assumption of certain capital leases. We received \$5.2 million at close with the remainder due upon the final determination of actual working capital. We received \$350 thousand of the remainder in September 2003 and received a final payment of \$241 thousand in January 2004. We recorded a gain on sale of discontinued operations of \$185 thousand in 2004 to reflect the amount that the January 2004 payment and other settlements exceeded the working capital estimates. Overall, we recorded a loss on disposition of the Media Services business of \$1.8 million.

The 2003 loss from operations of discontinued operations includes a \$1.8 million loss related to the Media Services business, on revenues of \$4.9 million.

*Desktop Software*

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We sold our Desktop Software Business on July 30, 2003 to a subsidiary of Sony Pictures Digital for \$19 million cash and assumption of certain trade payables, accrued liabilities and capital leases associated with the Desktop Software business. The negotiated price of the transaction contemplated net working capital balances at March 31, 2003 with any difference between the values at March 31, 2003 and the date of close to be reflected as a post closing adjustment. Our

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

net working capital decreased during the period preceding close due to improved collections of customer accounts, leading to an adjustment in the purchase price of \$497 thousand which was paid to Sony Pictures Digital in December 2003. We recorded a gain on the disposal of the Desktop Software business in fiscal 2003 of \$13.9 million and recorded a \$53 thousand loss in 2004 to account for the final settlement of working capital.

The 2003 loss from operations of discontinued operations includes a \$1.1 million loss related to the Desktop Software business, on revenues of \$12.0 million.

**LIQUIDITY AND CAPITAL RESOURCES**

We have funded our operations to date primarily from public and private placement offerings of equity securities, debt, and from the 2003 sales of our Desktop Software and Media Services businesses. On September 30, 2006, 2005 and 2004, we had cash and cash equivalents of \$2.8, \$4.3 and \$7.6 million, respectively.

**2006 compared to 2005**

Cash used in operating activities totaled \$2.2 million in 2006 compared to \$3.3 million in 2005. The decrease in cash outflows related to a \$686 thousand reduction in net loss, a \$1 million increase in unearned revenues, and reduced cash requirements in accounts payable and accrued liabilities. These factors were partially offset by an increase in accounts receivable due to increased Mediasite revenues in 2006.

Cash used in investing activities totaled \$582 thousand in 2006 compared to cash used in investing activities of \$435 thousand in 2005. Investing activities for each of these two years were due to the purchases of property and equipment.

Cash provided by financing activities in 2006 totaled \$1.25 million compared to \$470 thousand in 2005. Financing activities included \$1.27 million from the issuance of common stock and from exercise of common stock purchase options and warrants, partially offset by capital lease payments.

**2005 compared to 2004**

Cash used in operating activities totaled \$3.3 million in 2005 compared to \$6.2 million in 2004. The decrease in cash outflows related to a \$1.2 million reduction in net loss, and reduced cash requirements in accounts payable and accrued liabilities. These factors were partially offset by an increase in accounts receivable due to increased Mediasite revenues in 2005.

Cash used in investing activities totaled \$435 thousand in 2005 compared to cash used in investing activities of \$271 thousand in 2004. Investing activities for 2005 were due to the purchases of property and equipment. Investing activities for 2004 were due to purchases of property and equipment as well, partially offset by \$132 thousand proceeds received from the sale of discontinued businesses.

Cash provided by financing activities in 2005 totaled \$470 thousand compared to \$1.5 million in 2004. Financing activities in 2005 included \$470 thousand of issuance of common stock from exercise of common stock purchase options and warrants while 2004 included \$1.5 million of such proceeds, partially offset by capital lease payments.

We expect to reach cash flow breakeven in fiscal 2007 and believe we can fund operations with cash on hand through that point. Despite our belief that we had sufficient cash to fund operations in 2006, we believed it was prudent to raise additional cash through the issuance of common stock. In November 2005, we issued 747 thousand shares and 149 thousand common stock purchase warrants to certain individual investors, and received proceeds of \$725 thousand.

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We expect to continue to acquire property and equipment in fiscal 2007 including equipment associated with our anticipated growth in employees, expansion of our services offering and development of a new hardware component in our Mediasite product. We may evaluate further operating or capital lease opportunities and issuance of term notes to finance certain equipment acquisitions and may evaluate a revolving line of credit to support

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006**

working capital needs. We became eligible to file a registration statement on Form S-3 when our non-affiliate market capitalization exceeded \$75 million on October 12, 2006, and we expect to file such a registration statement in the near future to provide us with additional equity capital to fund long-term cash requirements and/or pursue complementary business strategies if and when we determine it advisable to do so.

**Contractual Obligations**

The following summarizes our contractual obligations at September 30, 2006 and the effect those obligations are expected to have on our liquidity and cash flow in future periods (in thousands):

| <b>Contractual Obligations:</b> | <b>Total</b> | <b>Less than<br/>1 Year</b> | <b>Years<br/>2-3</b> | <b>Years<br/>4-5</b> | <b>Over 5<br/>years</b> |
|---------------------------------|--------------|-----------------------------|----------------------|----------------------|-------------------------|
| Purchase commitments            | \$ 603       | \$ 603                      | \$                   | \$                   | \$                      |
| Operating lease obligations     | 1,693        | 461                         | 721                  | 511                  |                         |
| Capital lease obligations       | 120          | 50                          | 74                   | 10                   |                         |

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Derivative Financial Instruments**

We are not party to any derivative financial instruments or other financial instruments for which the fair value disclosure would be required under SFAS No. 133, Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments. Our cash equivalents consist of overnight investments in money market funds that are carried at fair value. Accordingly, we believe that the market risk of such investments is minimal.

**Interest Rate Risk**

Our cash equivalents are subject to interest rate fluctuations, however, we believe this risk is immaterial due to the short-term nature of these investments.

**Foreign Currency Exchange Rate Risk**

All international sales of our products are denominated in US dollars.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Sonic Foundry, Inc.

We have audited the accompanying consolidated balance sheets of Sonic Foundry, Inc. and subsidiaries as of September 30, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended September 30, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of September 30, 2006 and 2005 and the consolidated results of their operations and their cash flows for each of the three years in the period ended September 30, 2006, in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Schedule II, listed in the Index at Item 15(a) is presented for purposes of additional analysis and is not a required part of the basic financial statements. This schedule has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

**GRANT THORNTON LLP**

Madison, Wisconsin

October 27, 2006



**Table of Contents****Sonic Foundry, Inc.****Consolidated Balance Sheets**

(in thousands except for share and per share data)

|   | September 30,    |                  |
|---|------------------|------------------|
|   | 2006             | 2005             |
| <b>Assets</b>   |                  |                  |
| Current assets:   |                  |                  |
| Cash and cash equivalents   | \$ 2,751         | \$ 4,271         |
| Accounts receivable, net of allowances of \$160 and \$115   | 3,442            | 2,232            |
| Inventories   | 398              | 414              |
| Prepaid expenses and other current assets   | 399              | 363              |
| <b>Total current assets</b>   | <b>6,990</b>     | <b>7,280</b>     |
| Property and equipment:   |                  |                  |
| Leasehold improvements  | 893              | 185              |
| Computer equipment  | 2,275            | 1,570            |
| Furniture and fixtures  | 422              | 185              |
| <b>Total property and equipment</b>   | <b>3,590</b>     | <b>1,940</b>     |
| Less accumulated depreciation and amortization  | 1,296            | 933              |
| <b>Net property and equipment</b>   | <b>2,294</b>     | <b>1,007</b>     |
| Other assets:   |                  |                  |
| Goodwill and other intangible assets, net   | 7,575            | 7,626            |
| Capitalized software development costs, net of amortization of \$1,346 and \$1,067  | 53               | 332              |
| <b>Total other assets</b>   | <b>7,628</b>     | <b>7,958</b>     |
| <b>Total assets</b>   | <b>\$ 16,912</b> | <b>\$ 16,245</b> |
| <b>Liabilities and stockholders' equity</b>   |                  |                  |
| Current liabilities:  |                  |                  |
| Accounts payable  | \$ 1,521         | \$ 1,323         |
| Accrued liabilities   | 1,225            | 780              |
| Unearned revenue  | 2,005            | 957              |
| Current portion of capital lease obligation   | 41               | 15               |
| <b>Total current liabilities</b>  | <b>4,792</b>     | <b>3,075</b>     |
| Long-term portion of capital lease  | 78               | 28               |
| Other liabilities   | 441              | 21               |
| <b>Total liabilities</b>  | <b>5,311</b>     | <b>3,124</b>     |
| Stockholders' equity:   |                  |                  |
| Preferred stock, \$.01 par value, authorized 5,000,000 shares; none issued  |                  |                  |
| 5% preferred stock, Series B, voting, cumulative, convertible, \$.01 par value (liquidation preference at par), authorized 10,000,000 shares, none issued |                  |                  |
| Common stock, \$.01 par value, authorized 100,000,000 shares; 32,266,217 and 30,910,409 shares issued and 32,195,967 and 30,840,159 shares outstanding    | 322              | 309              |
| Additional paid-in capital  | 172,033          | 170,083          |
| Accumulated deficit   | (160,560)        | (157,077)        |

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|   |                  |                  |
|---|------------------|------------------|
| Receivable for common stock issued                | (26)             | (26)             |
| Treasury stock, at cost, 70,250 shares            | (168)            | (168)            |
| Total stockholders' equity                        | 11,601           | 13,121           |
| <b>Total liabilities and stockholders' equity</b> | <b>\$ 16,912</b> | <b>\$ 16,245</b> |

See accompanying notes

**Table of Contents****Sonic Foundry, Inc.****Consolidated Statements of Operation**

(in thousands except for share and per share data)

|   | Years Ended September 30, |            |            |
|---|---------------------------|------------|------------|
|   | 2006                      | 2005       | 2004       |
| <b>Continuing Operations</b>                |                           |            |            |
| <b>Revenue:</b>                             |                           |            |            |
| Product sales                               | \$ 9,902                  | \$ 6,928   | \$ 3,443   |
| Services                                    | 2,506                     | 975        | 425        |
| Other                                       | 156                       | 439        | 545        |
| Total revenue                               | 12,564                    | 8,342      | 4,413      |
| Cost of revenue                             | 3,215                     | 2,754      | 1,759      |
| <b>Gross margin</b>                         | 9,349                     | 5,588      | 2,654      |
| <b>Operating expenses:</b>                  |                           |            |            |
| Selling and marketing expenses              | 7,630                     | 5,277      | 3,826      |
| General and administrative expenses         | 3,041                     | 2,864      | 2,826      |
| Product development expenses                | 2,238                     | 1,803      | 1,609      |
| Total operating expenses                    | 12,909                    | 9,944      | 8,261      |
| <b>Loss from operations</b>                 | (3,560)                   | (4,356)    | (5,607)    |
| Other income, net                           | 77                        | 187        | 99         |
| <b>Loss from continuing operations</b>      | (3,483)                   | (4,169)    | (5,508)    |
| Gain on disposal of discontinued operations |                           |            | 132        |
| <b>Net loss</b>                             | \$ (3,483)                | \$ (4,169) | \$ (5,376) |
| <b>Loss per common share:</b>               |                           |            |            |
| Continuing operations                       | \$ (0.11)                 | \$ (0.14)  | \$ (0.18)  |
| Discontinued operations                     |                           |            |            |
| Basic net loss per common share             | \$ (0.11)                 | \$ (0.14)  | \$ (0.18)  |
| Diluted net loss per common share           | \$ (0.11)                 | \$ (0.14)  | \$ (0.18)  |
| Weighted average common shares              | Basic                     |            |            |
|   |                           | 32,015,310 | 30,363,000 |
|   | Diluted                   |            |            |
|   |                           | 32,015,310 | 30,363,000 |

See accompanying notes

Table of Contents

## Sonic Foundry, Inc.

## Consolidated Statements of Stockholders' Equity

For the Years Ended September 30, 2006, 2005 and 2004

(in thousands)

|   | Common<br>stock | Additional<br>paid-in<br>capital | Accumulated<br>deficit | Receivables<br>for<br>common<br>stock<br>issued | Treasury<br>stock | Total     |
|---|-----------------|----------------------------------|------------------------|---|-------------------|-----------|
| <b>Balance, September 30, 2003</b>            | \$ 287          | \$ 168,106                       | \$ (147,532)           | \$ (462)  | \$ (168)          | \$ 20,231 |
| Issuance of common stock                      |                 | 13                               |                        |   |                   | 13        |
| Issuance of common stock warrants and options |                 | 194                              |                        |   |                   | 194       |
| Exercise of common stock warrants and options | 11              | 1,070                            |                        | 423   |                   | 1,504     |
| Net loss                                      |                 |                                  | (5,376)                |   |                   | (5,376)   |
| <b>Balance, September 30, 2004</b>            | 298             | 169,383                          | (152,908)              | (39)  | (168)             | 16,566    |
| Issuance of common stock warrants and options |                 | 254                              |                        |   |                   | 254       |
| Exercise of common stock warrants and options | 11              | 446                              |                        | 13  |                   | 470       |
| Net loss                                      |                 |                                  | (4,169)                |   |                   | (4,169)   |
| <b>Balance, September 30, 2005</b>            | 309             | 170,083                          | (157,077)              | (26)  | (168)             | 13,121    |
| Stock compensation                            |                 | 485                              |                        |   |                   | 485       |
| Issuance of common stock                      | 7               | 668                              |                        |   |                   | 675       |
| Issuance of common stock warrants and options |                 | 245                              |                        |   |                   | 245       |
| Exercise of common stock warrants and options | 6               | 552                              |                        |   |                   | 558       |
| Net loss                                      |                 |                                  | (3,483)                |   |                   | (3,483)   |
| <b>Balance, September 30, 2006</b>            | \$ 322          | \$ 172,033                       | \$ (160,560)           | \$ (26)   | \$ (168)          | \$ 11,601 |

See accompanying notes

**Table of Contents****Sonic Foundry, Inc.****Consolidated Statements of Cash Flows**

(in thousands)

|  | <b>Years Ended September 30,</b> |                 |                 |
|--|----------------------------------|-----------------|-----------------|
|  | <b>2006</b>                      | <b>2005</b>     | <b>2004</b>     |
| <b>Operating activities</b>  |                                  |                 |                 |
| Net loss   | \$ (3,483)                       | \$ (4,169)      | \$ (5,376)      |
| Adjustments to reconcile net loss to net cash used in operating activities:                |                                  |                 |                 |
| Gain on disposal of discontinued operations  |                                  |                 | (132)           |
| Amortization of goodwill and other intangibles, and capitalized software development costs | 330                              | 330             | 330             |
| Depreciation and amortization of property and equipment                                    | 364                              | 306             | 246             |
| Non-cash compensation charges and charges for stock warrants and options                   | 740                              | 276             | 205             |
| Other non-cash items   | 45                               | (30)            |                 |
| Changes in operating assets and liabilities:   |                                  |                 |                 |
| Accounts receivable  | (1,255)                          | (876)           | (716)           |
| Inventories  | 16                               | (43)            | (260)           |
| Prepaid expenses and other assets  | (86)                             | (97)            | (78)            |
| Accounts payable, accrued liabilities and other liabilities                                | 94                               | 472             | (736)           |
| Unearned revenue   | 1,048                            | 484             | 279             |
| <b>Net cash used in operating activities</b>   | <b>(2,187)</b>                   | <b>(3,347)</b>  | <b>(6,238)</b>  |
| <b>Investing activities</b>  |                                  |                 |                 |
| Proceeds from sale of discontinued operations, net   |                                  |                 | 132             |
| Purchases of property and equipment  | (582)                            | (435)           | (403)           |
| <b>Net cash used in investing activities</b>   | <b>(582)</b>                     | <b>(435)</b>    | <b>(271)</b>    |
| <b>Financing activities</b>  |                                  |                 |                 |
| Proceeds from issuance of common stock, net of issuance costs                              | 1,273                            | 470             | 1,517           |
| Payments on long-term debt and capital leases  | (24)                             |                 | (48)            |
| <b>Net cash provided by financing activities</b>   | <b>1,249</b>                     | <b>470</b>      | <b>1,469</b>    |
| Net decrease in cash and cash equivalents  | (1,520)                          | (3,312)         | (5,040)         |
| Cash and cash equivalents at beginning of period   | 4,271                            | 7,583           | 12,623          |
| <b>Cash and cash equivalents at end of period</b>  | <b>\$ 2,751</b>                  | <b>\$ 4,271</b> | <b>\$ 7,583</b> |
| <b>Supplemental cash flow information:</b>   |                                  |                 |                 |
| Income taxes paid (refunded)   | \$ 9                             | \$ 32           | \$ (6)          |
| <b>Noncash transactions:</b>   |                                  |                 |                 |
| Capital lease acquisitions   | 101                              | 43              |                 |
| Property and equipment financed by accounts payable or other accrued liabilities           | 968                              | 60              |                 |
| Issuance of warrants for consulting services   |                                  | 125             | 194             |
| Other non-cash items   |                                  | 90              |                 |

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**1. Basis of Presentation and Significant Accounting Policies**

***Business***

Sonic Foundry, Inc. (the Company) is in the business of developing automated media application software and systems. Our current operations were formed in October 2001 when we acquired the assets and assumed certain liabilities of Mediasite, Inc.

In fiscal 2003, we were engaged in two lines of business in addition to our current operations – Media Services and Desktop Software. Media Services provided format conversion, tape duplication, film restoration and other services to the media, broadcast and entertainment industries, and was sold May 2003. The desktop software business designed, developed, marketed and supported software products for digitizing, converting, editing and publishing audio, video, and/or multimedia content and was sold July 2003.

***Principles of Consolidation***

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany transactions and balances have been eliminated. In 2006, 2005 and 2004, net loss equaled comprehensive loss as there were no items of comprehensive income.

***Use of Estimates***

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America (US GAAP), management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

***Revenue Recognition***

**General**

Revenue is recognized when persuasive evidence of an arrangement exists, delivery occurs or services are rendered, the sales price is fixed or determinable and collectibility is reasonably assured. Revenue is deferred when undelivered products or services are essential to the functionality of delivered products, customer acceptance is uncertain, significant obligations remain, or the fair value of undelivered elements is unknown. The Company does not offer customers the right to return product, other than for warranty repairs. The Company's policy is to reduce revenue if it incurs an obligation for price rebates or other such programs during the period the obligation is reasonably estimated to occur. The following policies apply to the Company's major categories of revenue transactions.

**Products**

Products are considered delivered, and revenue is recognized, when title and risk of loss have been transferred to the customer. Under the terms and conditions of the sale, this occurs at the time of shipment to the customer. Product revenue currently represents sales of our Mediasite Recorder and related products such as server software revenue.

**Services**

We sell support contracts to our Mediasite customers, typically one year in length and record the related revenue ratably over the contractual period. Our support contracts cover phone and electronic technical support availability over and above the level provided by our distributors, software upgrades, advance replacement and an extension of the standard hardware warranty from 90 days to one year. The manufacturer we

contract with to build

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

the units performs hardware warranty service. We also sell installation and training services and host customer Mediasite content. Revenue for those services is recognized when performed in the case of installation and training services and is recognized ratably over the contract period for hosting services. Service amounts invoiced to customers in excess of revenue recognized are recorded as deferred revenue until the revenue recognition criteria are met.

**Other**

Other revenue consists of software licensing of our Publisher product, custom software development performed under time and materials or fixed fee arrangements and amounts charged for shipping and handling. Software licensing is recorded when persuasive evidence of an arrangement exists, delivery occurs, the sales price is fixed or determinable and collectibility is reasonably assured. Custom software development includes fees recorded pursuant to long-term contracts (including research grants), using the percentage of completion method of accounting, when significant customization or modification of a product is required. Shipping and handling is recorded at the time of shipment to the customer.

**Revenue Arrangements that Include Multiple Elements**

Revenue for transactions that include multiple elements such as hardware, software, training, support or content hosting agreements is allocated to each element based on its relative fair value and recognized for each element when the revenue recognition criteria have been met for such element. Fair value is generally determined based on the price charged when the element is sold separately. In the absence of fair value of a delivered element, revenue is allocated first to the fair value of the undelivered elements and the residual revenue to the delivered elements. The Company recognizes revenue for delivered elements only when all of the following criteria are satisfied: undelivered elements are not essential to the functionality of delivered elements, uncertainties regarding customer acceptance are resolved, and the fair value for all undelivered elements is known.

**Shipping and Handling**

The Company's shipping and handling costs billed to customers are included in other revenue. Costs related to shipping and handling is included in cost of revenue.

**Concentration of Credit Risk and Other Risks and Uncertainties**

The Company's cash and cash equivalents are deposited with two major financial institutions. At times, deposits in these institutions exceed the amount of insurance provided on such deposits. The Company has not experienced any losses on such amounts and believes that it is not exposed to any significant credit risk on these balances.

We perform ongoing credit evaluations of our customers' financial condition and generally do not require collateral. We maintain allowances for potential credit losses and such losses have been within our expectations. We had billings for Mediasite product and support services as a percentage of total billings to two customers of approximately 11% each in 2004, while no individual customer was over 10% in 2006 or 2005.

***Cash and Cash Equivalents***

For the purposes of the statement of cash flows, the Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents include amounts invested in certificates of deposit of \$1.0 and \$3.1 million at September 30, 2006 and 2005.

***Trade Accounts Receivable***



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The majority of the Company's accounts receivable are due from companies in, or resellers to, the education industry. Credit is extended based on evaluation of a customer's financial condition and, generally, collateral is not

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006**

required. Accounts receivable are due within 30 days and are stated at amounts due from customers net of an allowance for doubtful accounts. Accounts outstanding longer than the contractual payment terms are considered to be past due. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customer's current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes-off accounts receivable when they become uncollectible, and payments subsequently received on such receivables are credited to the allowance for doubtful accounts. Interest is not accrued on past due receivables.

***Inventory Valuation***

Inventory consists of raw materials and supplies used in the assembly of Mediasite units, work-in-process and finished Mediasite units. Inventory of completed Mediasite units and spare parts are carried at the lower of cost or market, with cost determined on a first-in, first-out basis.

Inventory consists of the following (in thousands):

|                            | <b>September 30,</b> |             |
|----------------------------|----------------------|-------------|
|                            | <b>2006</b>          | <b>2005</b> |
| Raw materials and supplies | \$ 10                | \$ 10       |
| Work in process            |                      | 38          |
| Finished goods             | 388                  | 366         |
|                            | \$ 398               | \$ 414      |

***Software Development Costs***

Internal software development costs are capitalized after technological feasibility is established. The capitalized cost is then amortized on a straight-line basis over the estimated product life, or on the ratio of current revenues to total projected product revenue, whichever is greater. To date, the period between achieving technological feasibility, which the Company has defined as the establishment of a working model which typically occurs when the beta testing commences, and the general availability of such software has been short and software development costs qualifying for capitalization have been insignificant. Accordingly, the Company has not capitalized any internal software development costs.

In 2002, the Company capitalized \$1.4 million of software development related to the Mediasite Inc. transaction. Such costs are amortized by computing the greater of (a) the ratio that current gross revenues for the product bear to the total of current and anticipated future gross revenues or (b) the straight-line amortization over the remaining estimated economic useful life (five years) of the product. Capitalized software development costs are reported at the lower of unamortized cost or net realizable value. Capitalized software development costs at September 30, 2006 and 2005 are net of accumulated amortization of \$1.35 and \$1.07 million, respectively.

***Property and Equipment***

Property and equipment are recorded at cost and are depreciated using the straight-line method for financial reporting purposes. The estimated useful lives used to calculate depreciation are as follows:

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|                        | Years         |
|------------------------|---------------|
| Leasehold improvements | 5 to 10 years |
| Computer equipment     | 3 to 5 years  |
| Furniture and fixtures | 7 years       |

Accelerated methods are used for income tax purposes.

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

***Impairment of Long-Lived Assets***

In accordance with the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 144, Accounting for the Impairment of Long-lived Assets, the Company reviews long-lived assets, including property and equipment, capitalized software development costs and other intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Goodwill is reviewed for impairment annually. If the sum of the expected undiscounted cash flows is less than the carrying value of the related asset or group of assets, a loss is recognized for the difference between the fair value and carrying value of the asset or group of assets. As of September 30, 2006 the Company has recognized no such losses.

***Advertising Expense***

Advertising costs included in selling and marketing, are expensed when the advertising first takes place. Advertising expense was \$114 thousand, \$195 thousand, and \$102 thousand for years 2006, 2005, and 2004, respectively.

***Research and Development Costs***

Research and development costs are expensed in the period incurred.

***Income Taxes***

Deferred income taxes are provided for temporary differences between financial reporting and income tax basis of assets and liabilities, and are measured using currently enacted tax rates and laws. Deferred income taxes also arise from the future benefits of net operating loss carryforwards. A valuation allowance equal to 100% of the net deferred tax assets has been recognized due to uncertainty regarding the future realization of these assets.

***Fair Value of Financial Instruments***

The Company's financial instruments consist primarily of cash and cash equivalents, accounts receivable, accounts payable and debt instruments. The book values of cash and cash equivalents, accounts receivable, and accounts payable are considered to be representative of their respective fair values. The carrying value of capital lease obligations, including the current portion, approximates fair market value as the fixed rate approximates the current market rate of interest available to the Company.

***Stock Based Compensation***

Effective October 1, 2005, the Company adopted the provisions of SFAS No. 123R, Share-Based Payment – an Amendment of FASB Statement Nos. 123 and 95 (SFAS 123R) for its stock option plans. The Company previously accounted for these plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations and disclosure requirements established by SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation – Transition and Disclosure.

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized for the year ended September 30, 2006 includes the cost for all stock options granted prior to, but not yet vested as of October 1, 2005. This cost was based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. The cost for all share-based awards granted subsequent to September 30, 2005, represents the grant-date fair value that was estimated in accordance with the provisions of SFAS 123R. Results for prior periods have not been restated. Compensation cost for options will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period. There were no capitalized stock-based compensation costs at September 30, 2006. Stock-based compensation expense in the table below does not reflect any income tax effect, which is consistent with the Company's treatment of

net operating loss carry forwards and offsetting valuation allowance.

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006**

Upon the adoption of SFAS 123R, the Company changed its option valuation model from the Black-Scholes model to a lattice valuation model for all stock options granted subsequent to September 30, 2005. The lattice valuation model is a more flexible analysis to value options because of its ability to incorporate inputs that change over time, such as actual exercise behavior of option holders. The Company uses historical data to estimate the option exercise and employee departure behavior in the lattice valuation model. Expected volatility is based on historical volatility of the Company's stock. The Company uses historical data to estimate option exercise and employee termination within the valuation model. The Company considers all employees to have similar exercise behavior and therefore has not identified separate homogenous groups for valuation. The expected term of options granted is derived from the output of the option pricing model and represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual term of the options is based on the U.S. Treasury yields in effect at the time of grant.

The fair value of each option grant is estimated using the assumptions in the following table:

| Method                  | Years Ended September 30, |               |                 |
|-------------------------|---------------------------|---------------|-----------------|
|                         | 2006                      | 2005          | 2004            |
|                         | Lattice                   | Black-Scholes | Black-Scholes   |
| Expected life (years)   | 4.9 - 5.5 years           | 3 years       | 3 years         |
| Risk-free interest rate | 4.5% - 5.0%               | 3.1% - 4.2%   | 1.9% - 3.2%     |
| Expected volatility     | 69.4% - 71.1%             | 73.9% - 97.9% | 101.2% - 177.5% |
| Expected dividend yield | 0%                        | 0%            | 0%              |

The following table illustrates the effect on net loss and net loss per share as if the Company had applied the fair-value recognition provisions of SFAS 123 to all stock option plans for the years ended September 30, 2005 and 2004 presented for purposes of this pro forma disclosure.

| (in thousands)   | Years Ended September 30, |            |
|--|---------------------------|------------|
|  | 2005                      | 2004       |
| Net loss as reported   | \$ (4,169)                | \$ (5,376) |
| Less stock-based compensation using fair value method                          | (522)                     | (353)      |
| Less impact of discounted employee stock purchase plan using fair value method |                           | (7)        |
| Pro forma net loss   | \$ (4,691)                | \$ (5,736) |
| Loss per share   |                           |            |
| Net loss as reported basic and diluted   | \$ (0.14)                 | \$ (0.18)  |
| Pro forma net loss basic and diluted   | \$ (0.15)                 | \$ (0.19)  |

**Per Share Computation**

Basic and diluted net loss per share information for all periods is presented under the requirements of SFAS No. 128, Earnings per Share. Basic earnings per share has been computed using the weighted-average number of shares of common stock outstanding during the period, less shares that may be repurchased, and excludes any dilutive effects of options and warrants. If the Company had reported net income during the periods presented below, diluted net income per share would have been computed using common equivalent shares related to outstanding options and warrants to purchase common stock. The numerator for the calculation of basic and diluted earnings per share is net income (loss). The following table sets forth the computation of basic and diluted weighted average shares used in the earnings per share calculations:



**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006**

|   | Years ended September 30, |            |            |
|---|---------------------------|------------|------------|
|   | 2006                      | 2005       | 2004       |
| Denominator for basic earnings per share<br>- weighted average common shares  | 32,015,000                | 30,363,000 | 29,457,000 |
| Effect of dilutive options and warrants (treasury method)   |                           |            |            |
| Denominator for diluted earnings per share<br>- adjusted weighted average common shares   | 32,015,000                | 30,363,000 | 29,457,000 |
| Securities outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive: |                           |            |            |
| Options and warrants  | 5,264,000                 | 5,816,000  | 6,342,000  |

**Recent Accounting Pronouncements**

In June 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN No. 48 is not expected to have any significant effect on the Company's consolidated financial position or results of operations.

In May 2005, FASB issued SFAS No. 154, *Accounting Changes and Error Corrections (SFAS 154)*. SFAS 154 replaces APB Opinion No. 20 and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and applies to all voluntary changes in accounting principle, and changes the requirements for accounting for and reporting of a change in accounting principle. APB 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of change the cumulative effect of changing to the new accounting principle whereas SFAS 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impracticable. SFAS 154 enhances the consistency of financial information between periods. SFAS 154 will be effective in fiscal years beginning after December 15, 2006. Early adoption is permitted. The Company does not expect that the adoption of SFAS 154 will have a material impact on its results of operations or financial position.

**2. Commitments**

The Company leases certain equipment under a capital lease agreement expiring April 2010. Minimum lease payments, including principal and interest, are summarized in the table below. The Company had no capital leases at September 30, 2004.

| Fiscal Year (in thousands) | Capital |
|----------------------------|---------|
| 2007                       | \$ 50   |
| 2008                       | 50      |
| 2009                       | 24      |
| 2010                       | 10      |
| Thereafter                 |         |
| Total                      | \$ 134  |



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The Company leases certain facilities and equipment under operating lease agreements expiring at various times through September 30, 2008. Total rent expense related to continuing operations on all operating leases was approximately \$312, \$289, and \$170 thousand for the years ended September 30, 2006, 2005, and 2004, respectively.

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006**

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. The Company has an obligation to purchase a remaining \$603 thousand over the next fiscal quarter, which is not recorded on the Company's Balance Sheet. At September 30, 2005, the Company had obligations of \$1.5 million.

The Company engaged a manufacturer to build a replacement component for its Mediasite product according to proprietary designs. The Company had a commitment of approximately \$164 thousand to the manufacturer at September 30, 2005. There were no similar obligations under such commitments as of September 30, 2006.

The Company enters into license agreements that generally provide indemnification against intellectual property claims for its customers as well as indemnification agreements with certain service providers, landlords and other parties in the normal course of business. The Company has not incurred any material costs as a result of such indemnifications and has not accrued any liabilities related to such obligations in its consolidated financial statements.

The following is a schedule by year of future minimum lease payments under operating leases:

| <b>Fiscal Year (in thousands)</b> | <b>Operating</b> |
|-----------------------------------|------------------|
| 2007                              | \$ 461           |
| 2008                              | 472              |
| 2009                              | 249              |
| 2010                              | 253              |
| 2011                              | 258              |
| Thereafter                        |                  |
| <b>Total</b>                      | <b>\$ 1,693</b>  |

**3. Common Stock Warrants**

The Company has issued restricted common stock purchase warrants to various consultants and other third parties. Each warrant represents the right to purchase one share of common stock. All warrants are currently exercisable. The Company granted 494,481 warrants in fiscal 2006 with a weighted average fair value of \$0.66.

| <b>Exercise Prices</b> | <b>Warrants Outstanding at<br/>September 30, 2005</b> | <b>Expiration<br/>Date</b> |
|------------------------|---|----------------------------|
| \$ 0.99 to 1.91        | 510,126   | 2007 to 2011               |
| 2.11 to 2.94           | 142,500   | 2007 to 2011               |
| 11.23                  | 8,900   | 2010                       |
|                        | 661,526   |                            |

**4. Stock Options and Employee Stock Purchase Plan**

The Company maintains a qualified employee stock option plan under which the Company may grant options to acquire up to 7.0 million shares of common stock. The Company also maintains a non-qualified plan under which 3.8 million shares of common stock can be issued and a

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directors stock option plan under which 900 thousand shares of common stock may be issued to non-employee directors. Each non-employee director who is re-elected or who is continuing as a member of the Board of Directors on the annual meeting date and on each subsequent meeting of stockholders is granted options to purchase 20 thousand shares of common stock.

Each option entitles the holder to purchase one share of common stock at the specified option price. The exercise price of each option granted under the plans was set at the market price of the Company's common stock at the close of trading on the respective grant date. Options vest at various intervals and expire at the earlier of termination of employment, discontinuance of service on the board of directors, ten years from the grant date or at such times as are set by the Company at the date of grant.

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

The number of shares available for grant under these plans at September 30 is as follows:

|  | <b>Employee<br/>Stock Option<br/>Plan</b> | <b>Non-Qualified<br/>Stock Option<br/>Plan</b> | <b>Director Stock<br/>Option Plan</b> |
|--|---|--|---------------------------------------|
| Shares available for grant at September 30, 2003 | 353,087                                   | 492,036  | 240,000                               |
| Amendment to increase shares available in plan   | 3,000,000                                 |  | 300,000                               |
| Options granted                                  | (185,000)                                 |  | (140,000)                             |
| Options forfeited                                | 315,225                                   | 153,665  |                                       |
| Shares available for grant at September 30, 2004 | 3,483,312                                 | 645,701  | 400,000                               |
| Options granted                                  | (893,000)                                 | (96,000)                                       | (100,000)                             |
| Options forfeited                                | 278,336                                   | 53,774   |                                       |
| Shares available for grant at September 30, 2005 | 2,868,648                                 | 603,475  | 300,000                               |
| Options granted                                  | (612,000)                                 | (99,000)                                       | (100,000)                             |
| Options forfeited                                | 260,001                                   | 255,000  |                                       |
| Shares available for grant at September 30, 2006 | 2,516,649                                 | 759,475  | 200,000                               |

The following table summarizes information with respect to outstanding stock options.

|  | <b>2006</b>    |  | <b>Years Ended September 30,<br/>2005</b> |  | <b>2004</b>    |  |
|--|----------------|--|---|--|----------------|--|
|  | <b>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Options</b>                            | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> |
| Outstanding at beginning of year                               | 4,587,764      | \$ 2.28  | 4,125,953                                 | \$ 2.34  | 5,070,078      | \$ 2.37  |
| Granted  | 811,000        | 1.51   | 1,089,000                                 | 1.39   | 325,000        | 1.69   |
| Exercised  | (281,589)      | 0.99   | (295,079)                                 | 1.39   | (800,235)      | 1.18   |
| Forfeited  | (515,001)      | 2.74   | (332,110)                                 | 12.96  | (468,890)      | 4.20   |
| Outstanding at end of year                                     | 4,602,174      | \$ 2.17  | 4,587,764                                 | \$ 2.28  | 4,125,953      | \$ 2.34  |
| Exercisable at end of year                                     | 3,477,660      |  | 3,581,417                                 |  | 3,273,436      |  |
| Weighted average fair value of options granted during the year | \$ 0.82        |  | \$ 0.97                                   |  | \$ 1.62        |  |

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006**

The options outstanding at September 30, 2006 have been segregated into five ranges for additional disclosure as follows:

| Exercise Prices   | Options Outstanding                       | Options Outstanding                         | Weighted Average Exercise Price | Options Exercisable                       | Options Exercisable             |
|-------------------|---|---|---------------------------------|---|---------------------------------|
|                   | Options Outstanding at September 30, 2006 | Weighted Average Remaining Contractual Life |                                 | Options Exercisable at September 30, 2006 | Weighted Average Exercise Price |
| \$ 0.42 to \$0.99 | 370,802                                   | 6.19  | \$ 0.46                         | 361,302                                   | \$ 0.45                         |
| 1.01 to 1.94      | 3,612,031                                 | 6.72  | 1.26                            | 2,593,685                                 | 1.18                            |
| 2.00 to 2.50      | 385,650                                   | 4.59  | 2.30                            | 288,982                                   | 2.32                            |
| 3.13 to 6.61      | 172,191                                   | 2.61  | 4.54                            | 172,191                                   | 4.54                            |
| 15.50 to 59.88    | 61,500                                    | 3.49  | 58.80                           | 61,500                                    | 58.80                           |

As of September 30, 2006, there was \$438 thousand of total unrecognized compensation cost related to non-vested share-based compensation, including \$116 thousand of estimated forfeitures. The cost is expected to be recognized over a weighted-average life of 1.6 years.

A summary of the status of the entity's non-vested shares as of September 30, 2006 and for the year then ended is presented below:

|   | Weighted Average |            |
|---|------------------|------------|
|   | Grant Date       |            |
|   | Shares           | Fair Value |
| Non-vested shares at October 1, 2005    | 1,006,347        | \$ 0.94    |
| Granted                                 | 811,000          | 0.82       |
| Vested                                  | (566,163)        | 0.74       |
| Forfeited                               | (126,669)        | 1.11       |
| Non-vested shares at September 30, 2006 | 1,124,514        | \$ 1.06    |

Stock-based compensation recorded in the year ended September 30, 2006 of \$485 thousand was allocated \$296 thousand to selling and marketing expenses, \$70 thousand to general and administrative expenses and \$119 thousand to product development expenses. Cash received from option exercises under all stock option plans for the years ended September 30, 2006 and 2005 was \$279 thousand and \$196 thousand, respectively. There were no tax benefits realized for tax deductions from option exercises for the years ended September 30, 2006 and 2005, respectively. The Company currently expects to satisfy share-based awards with registered shares available to be issued.

The Company maintained an Employee Stock Purchase Plan (Stock Purchase Plan), which allowed for the issuance of 1.0 million shares of common stock. There were 16 thousand shares issued under the plan in the year ended September 30, 2004. All employees of the Company who had completed three months of employment were eligible to participate in the Stock Purchase Plan, provided the employee would not hold 5% or more of the total combined voting power of the Company. Shares were purchased at the end of a specified period at the lower of 85% of the market value at the beginning or the end of the specified period through accumulation of payroll deductions. The Stock Purchase Plan was terminated on June 30, 2004.

**5. Income Taxes**

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Income tax expense (benefit) consists of the following (in thousands):

|                                       | Years Ended September 30, |         |         |
|---------------------------------------|---------------------------|---------|---------|
|                                       | 2006                      | 2005    | 2004    |
| Federal income tax                    | \$                        | \$      | \$      |
| Deferred income tax expense (benefit) | (1,522)                   | (1,515) | (2,489) |
| Change in valuation allowance         | 1,522                     | 1,515   | 2,489   |
| Income tax expense (benefit)          | \$                        | \$      | \$      |

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006**

The reconciliation of income tax expense (benefit) computed at the U.S. federal statutory rate to income tax expense (benefit) is as follows (in thousands):

|  | Years Ended September 30, |            |            |
|--|---------------------------|------------|------------|
|  | 2006                      | 2005       | 2004       |
| Income tax expense (benefit) at U.S. statutory rate of 34% | \$ (1,184)                | \$ (1,417) | \$ (1,828) |
| State income tax expense (benefit)                         | (174)                     | (208)      | (269)      |
| Permanent differences, net                                 | (70)                      | (34)       | (145)      |
| Adjustment of temporary differences to income tax returns  | (94)                      | 144        | (247)      |
| Change in valuation allowance                              | 1,522                     | 1,515      | 2,489      |
| Income tax benefit   | \$                        | \$         | \$         |

The significant components of the deferred tax accounts recognized for financial reporting purposes are as follows (in thousands):

|   | September 30, |           |
|---|---------------|-----------|
|   | 2006          | 2005      |
| Deferred tax assets:  |               |           |
| Net operating loss and other carryforwards  | \$ 28,236     | \$ 26,967 |
| Common stock warrants   | 1,214         | 925       |
| Allowance for doubtful accounts   | 62            | 45        |
| Other   | 12            | 9         |
| Total deferred tax assets   | 29,524        | 27,946    |
| Deferred tax liability-depreciation of property and equipment   |               | (23)      |
| Deferred tax liability-amortization of goodwill, other intangible assets and capitalized software development costs | (651)         | (572)     |
| Net deferred tax liabilities  | \$ (651)      | \$ (595)  |
| Valuation allowance   | (28,873)      | (27,351)  |
| Net deferred tax assets   | \$            | \$        |

At September 30, 2006, the Company had net operating loss carry forwards of approximately \$71 million for both U.S. Federal and state tax purposes, which expire in varying amounts between 2013 and 2026. Utilization of the Company's net operating loss may be subject to substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. Such an annual limitation could result in the expiration of the net operating loss carry forwards before utilization. In addition, the Company has research and development tax credit carryforwards of approximately \$562 thousand, which expire in varying amounts beginning 2011. The Company's net deferred tax asset has been offset by a valuation allowance of the same amount. The valuation allowance has been recorded due to the uncertainty of realization of the deferred tax asset.

**6. Savings Plan**

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The Company's defined contribution 401(k) savings plan covers substantially all employees meeting certain minimum eligibility requirements. Participating employees can elect to defer a portion of their compensation and contribute it to the plan on a pretax basis. The Company may also match certain amounts and/or provide additional discretionary contributions, as defined. The Company made discretionary contributions of \$168, \$139, and \$83 thousand during the years ended September 30, 2006, 2005 and 2004, respectively.

### **7. Related-Party Transactions**

The Company paid fees of \$122, \$109, and \$183 thousand during the years ended September 30, 2006, 2005 and 2004, respectively, to a law firm whose partner is a director and stockholder of the Company. The Company had accrued liabilities for unbilled services of \$130, \$108, and \$95 thousand for the years ended September 30, 2006, 2005 and 2004, respectively, to the same law firm.



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

The Company recorded Mediasite product and customer support revenue related to \$602 and \$663 thousand of billings during the years ended September 30, 2006 and 2005 to Mediasite KK, a Japanese reseller in which the Company has an equity interest. Mediasite KK owed the Company \$173 and \$187 thousand on such billings at September 30, 2006 and 2005, respectively.

During the years ended September 30, 2006, 2005 and 2004, the Company had a loan outstanding to an executive totaling \$26. The loan is backed by company stock.

**8. Goodwill and Other Intangible Assets**

The Company accounts for goodwill and their intangible assets in accordance with SFAS No. 142 Goodwill and Other Intangible Assets . SFAS No. 142 requires that goodwill and intangible assets that have indefinite useful lives not be amortized but, instead, tested at least annually for impairment. We assess the impairment of goodwill and capitalized software development costs on an annual basis or whenever events or changes in circumstances indicate that the fair value of these assets is less than the carrying value. Factors we consider important which could trigger an impairment review include the following:

poor economic performance relative to historical or projected future operating results;

significant negative industry, economic or company specific trends;

changes in the manner of our use of the assets or the plans for our business; and

loss of key personnel

If we determine that the fair value of goodwill is less than its carrying value, based upon the annual test or the existence of one or more of the above indicators of impairment, we would then measure impairment based on a comparison of the implied fair value of goodwill with the carrying amount of goodwill. To the extent the carrying amount of goodwill is greater than the implied fair value of goodwill, we would record an impairment charge for the difference.

The Company tested goodwill recognized in connection with the acquisition of Mediasite at July 1, 2006 and determined it was not impaired. Subsequent impairment charges for Mediasite or other acquisitions, if any, will be reflected as an operating expense in the statement of operations.

The following tables present details of the Company's total intangible assets at September 30, 2006 and 2005:

| (in thousands)      | Life<br>(years) | Gross | Accumulated<br>Amortization<br>at<br>September 30,<br>2005 | Balance at<br>September 30,<br>2005 | Accumulated<br>Amortization<br>at<br>September 30,<br>2006 | Balance at<br>September 30,<br>2006 |
|---------------------|-----------------|-------|--|-------------------------------------|--|-------------------------------------|
| <b>Amortizable:</b> |                 |       |  |                                     |  |                                     |

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|                          |   |          |        |          |                 |
|--------------------------|---|----------|--------|----------|-----------------|
| License agreement        | 5 | \$ 120   | \$ 96  | \$ 24    | \$ 120          |
| Trade name               | 5 | 130      | 104    | 26       | 130             |
|                          |   | 250      | 200    | 50       | 250             |
| Non-amortizable goodwill |   | 7,576    |        | 7,576    | 7,576           |
| Total                    |   | \$ 7,826 | \$ 200 | \$ 7,626 | \$ 250 \$ 7,576 |

**Table of Contents****Sonic Foundry, Inc.****Annual Report on Form 10-K****For the Year Ended September 30, 2006****9. Segment Information**

The Company has determined that it operates in only one segment in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131) as it does not disaggregate profit and loss information on a segment basis for internal management reporting purposes to its chief operating decision maker.

The Company's long-lived assets maintained outside the United States are insignificant.

The following summarizes revenue by geographic region (in thousands):

|               | Years Ended September 30, |                 |                 |
|---------------|---------------------------|-----------------|-----------------|
|               | 2006                      | 2005            | 2004            |
| United States | \$ 10,481                 | \$ 6,881        | \$ 3,838        |
| Europe        | 911                       | 462             | 32              |
| Asia          | 709                       | 688             | 345             |
| Other         | 463                       | 311             | 198             |
| <b>Total</b>  | <b>\$ 12,564</b>          | <b>\$ 8,342</b> | <b>\$ 4,413</b> |

**10. Quarterly Financial Data (unaudited)**

The following table sets forth selected quarterly financial and stock price information for the years ended September 30, 2006 and 2005. The operating results are not necessarily indicative of results for any future period.

| (in thousands except per share data) | Quarterly Financial Data |           |           |           |           |           |           |           |
|--------------------------------------|--------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
|                                      | Q4- 06                   | Q3- 06    | Q2- 06    | Q1- 06    | Q4- 05    | Q3- 05    | Q2- 05    | Q1- 05    |
| Revenues                             | \$ 4,092                 | \$ 3,647  | \$ 2,953  | \$ 1,872  | \$ 2,510  | \$ 2,175  | \$ 2,066  | \$ 1,591  |
| Gross margin                         | 3,110                    | 2,835     | 2,092     | 1,312     | 1,737     | 1,399     | 1,397     | 1,055     |
| Loss from continuing operations      | (353)                    | (603)     | (968)     | (1,636)   | (820)     | (1,124)   | (966)     | (1,446)   |
| Net loss                             | (341)                    | (583)     | (947)     | (1,612)   | (763)     | (1,065)   | (941)     | (1,400)   |
| Basic and diluted net loss per share | \$ (0.01)                | \$ (0.02) | \$ (0.03) | \$ (0.05) | \$ (0.02) | \$ (0.03) | \$ (0.03) | \$ (0.05) |

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

Not applicable.

**ITEM 9A. CONTROLS AND PROCEDURES****Disclosure Controls and Procedures**

Based on evaluations as of the end of the period covered by this report, our principal executive officer and principal financial officer, with the participation of our management team, have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e), and 15d-15(e) under the Securities Exchange Act) were effective.



**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**Changes in Internal Control Over Financial Reporting**

During the period covered by this report, we have not made any change to our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information required by Item 10 of Form 10-K with respect to directors and executive officers is incorporated herein by reference to the information contained in the section entitled "Proposal One: Election of Directors and Executive Officers of Sonic Foundry, Inc.", respectively, in the Company's definitive Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Company's 2006 Annual Meeting of Stockholders, which will be filed no later than January 28, 2007 (the "Proxy Statement").

Item 405 of Regulation S-K calls for disclosure of any known late filings or failure by an insider to file a report required by Section 16(a) of the Securities Act. This information is contained in the Section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement and is incorporated herein by reference.

Item 401 of Regulation S-K calls for disclosure of whether or not the Company has a financial expert serving on the audit committee of its Board of Directors, and if so who that individual is. This information is contained in the Section entitled "Meetings and Committees of Directors" in the Proxy Statement and is incorporated herein by reference.

Sonic Foundry has adopted a code of ethics that applies to all officers and employees, including Sonic Foundry's principal executive officer, its principal financial officer, and persons performing similar functions. This code of ethics is available, without charge, to any investor who requests it. Request should be addressed in writing to Mr. Kenneth A. Minor, Corporate Secretary, 222 West Washington Avenue, Suite 775, Madison, Wisconsin 53703.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by Item 11 of Form 10-K is incorporated herein by reference to the information contained in the sections entitled "Directors Compensation", "Executive Compensation and Related Information" and "Compensation Committee Interlocks and Insider Participation" in the Proxy Statement.

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

The information required by Item 12 of Form 10-K is incorporated herein by reference to the information contained in the sections entitled "Security Ownership of Certain Beneficial Owners and Management" in the Proxy Statement.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

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The information required by Item 13 of Form 10-K is incorporated herein by reference to the information contained in the section entitled Certain Transactions in the Proxy Statement.

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by Item 14 of Form 10-K is incorporated herein by reference to the information contained in the section entitled Ratification of Appointment of Independent Auditors Fiscal 2005 and 2006 Audit Fee Summary in the Proxy Statement.

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) The following financial statements are filed as part of this report:

1. Financial Statements furnished are listed in the Table of Contents provided in response to Item 8.
2. Financial Statement Schedule II of the Company is included in this Report. All other Financial Statement Schedules have been omitted since they are either not required, not applicable or the information is otherwise included in the financial statements.
3. Exhibits.
  - 3.1 Amended and Restated Articles of Incorporation of the Registrant.
  - 3.2 Amended and Restated By-Laws of the Registrant, filed as Exhibit No. 3.2 to the Registration Statement, and hereby incorporated by reference.
  - 10.1\* Registrant's 1995 Stock Option Plan, as amended, filed as Exhibit No. 4.1 to the Registration Statement on Form S-8 on September 8, 2000, and hereby incorporated by reference.
  - 10.2\* Registrant's Non-Employee Directors' Stock Option Plan, filed as Exhibit No. 10.2 to the Registration Statement, and hereby incorporated by reference.
  - 10.3\* Employment Agreement between Registrant and Rimas Buinevicius dated as of January 1, 2001, filed as Exhibit 10.4 to the Quarterly Report on Form 10-Q for the quarter ended December 31, 2000, and hereby incorporated by reference.
  - 10.4\* Employment Agreement between Registrant and Monty R. Schmidt dated as of January 1, 2001, filed as Exhibit 10.5 to the Quarterly Report on Form 10-Q for the quarter ended December 31, 2000, and hereby incorporated by reference.
  - 10.5\* Registrant's Amended 1999 Non-Qualified Plan, filed as Exhibit 4.1 to Form S-8 on December 21, 2001, and hereby incorporated by reference.
  - 10.6 Commercial Lease between West Washington Associates LLC and Sonic Foundry, Inc. regarding 222 West Washington Ave., Suite 775, Madison, WI, dated August 1, 2003 filed as Exhibit 10.21 to Form 10-K filed on December 23, 2003 and hereby incorporated by reference.
  - 10.7 Amendments to Commercial Lease between West Washington Associates LLC and Sonic Foundry, Inc. regarding 222 West Washington Ave., Suite 775, Madison, WI, dated May 17, 2006 and June 5, 2006.





**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

|      |  |
|------|--|
| 21   | List of Subsidiaries   |
| 23   | Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm     |
| 31.1 | Section 302 Certification of Chief Executive Officer                             |
| 31.2 | Section 302 Certification of Chief Financial Officer                             |
| 32   | Section 906 Certification of Chief Executive Officer and Chief Financial Officer |

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\* Compensatory Plan or Arrangement

(b) Exhibits See exhibit index in Item 15(a)3 of this Report.

(c) Financial Statement Schedule see Item 15(a)2 of this Report

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**SIGNATURES**

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

**Sonic Foundry, Inc.**

**(Registrant)**

**By:** /s/ Rimas P. Buinevicius  
Rimas P. Buinevicius  
Chairman and Chief Executive Officer

**Date:** November 15, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities and on the dates indicated.

| <b>Signature</b>            | <b>Title</b>                          | <b>Date</b>       |
|-----------------------------|---------------------------------------|-------------------|
| /s/ Rimas P. Buinevicius    | Chairman and Chief Executive Officer  | November 15, 2006 |
| /s/ Monty R. Schmidt        | Chief Technology Officer and Director | November 15, 2006 |
| /s/ Kenneth A. Minor        | Chief Financial Officer and Secretary | November 15, 2006 |
| /s/ Frederick H. Kopko, Jr. | Director                              | November 15, 2006 |
| /s/ Arnold B. Pollard       | Director                              | November 15, 2006 |
| /s/ David C. Kleinman       | Director                              | November 15, 2006 |
| /s/ Paul S. Peercy          | Director                              | November 15, 2006 |
| /s/ Gary R. Weis            | Director                              | November 15, 2006 |

**Table of Contents**

**Sonic Foundry, Inc.**

**Annual Report on Form 10-K**

**For the Year Ended September 30, 2006**

**SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS**

**(In thousands)**

|   | <b>Balance at<br/>Beginning of<br/>Period</b> | <b>Additions<br/>Charged to Costs<br/>and Expenses</b> | <b>Deductions<br/>Write-offs</b> | <b>Balance at<br/>End of<br/>Period</b> |
|---|---|--|----------------------------------|---|
| <b><u>Year ended September 30, 2006</u></b> |   |  |                                  |   |
| Accounts receivable reserve                 | \$ 115  | \$ 72  | \$ 27                            | \$ 160                                  |
| <b><u>Year ended September 30, 2005</u></b> |   |  |                                  |   |
| Accounts receivable reserve                 | \$ 98   | \$ 35  | \$ 18                            | \$ 115                                  |
| <b><u>Year ended September 30, 2004</u></b> |   |  |                                  |   |
| Accounts receivable reserve                 | \$ 40   | \$ 58  |                                  | \$ 98                                   |