

SONIC FOUNDRY INC  
Form 10-Q  
February 05, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the Quarterly period ended December 31, 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)

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

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

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222 West Washington Ave, Suite 775, Madison, WI 53703

(Address of principal executive offices)

(608) 443-1600

(Registrant's telephone)

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number including area code)

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

Indicate by check mark whether the registrant 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 Exchange Act). Yes  No

State the number of shares outstanding of each of the issuer's common equity as of the last practicable date:

| Class                          | Outstanding<br>February 1, 2007 |
|--------------------------------|---------------------------------|
| Common Stock, \$0.01 par value | 35,304,922                      |

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**Table of Contents****Sonic Foundry, Inc.****Consolidated Balance Sheets****(in thousands, except for share data)**

(Unaudited)

|  | <b>December 31,<br/>2006</b> | <b>September 30,<br/>2006</b> |
|--|------------------------------|-------------------------------|
| <b>Assets</b>  |                              |                               |
| Current assets:  |                              |                               |
| Cash and cash equivalents  | \$ 12,054                    | \$ 2,751                      |
| Accounts receivable, net of allowances of \$200 and 160  | 3,396                        | 3,442                         |
| Inventories  | 297                          | 398                           |
| Prepaid expenses and other current assets  | 423                          | 399                           |
| <b>Total current assets</b>  | <b>16,170</b>                | <b>6,990</b>                  |
| Property and equipment:  |                              |                               |
| Leasehold improvements   | 975                          | 893                           |
| Computer equipment   | 2,328                        | 2,275                         |
| Furniture and fixtures   | 450                          | 422                           |
| <b>Total property and equipment</b>  | <b>3,753</b>                 | <b>3,590</b>                  |
| Less accumulated depreciation  | 1,452                        | 1,296                         |
| <b>Net property and equipment</b>  | <b>2,301</b>                 | <b>2,294</b>                  |
| Goodwill and other intangibles, net of amortization of \$1,400 and \$1,346   | 7,575                        | 7,628                         |
| <b>Total assets</b>  | <b>\$ 26,046</b>             | <b>\$ 16,912</b>              |
| <b>Liabilities and stockholders equity</b>   |                              |                               |
| Current liabilities:   |                              |                               |
| Accounts payable   | \$ 1,908                     | \$ 1,521                      |
| Accrued liabilities  | 868                          | 1,225                         |
| Unearned revenue   | 1,931                        | 2,005                         |
| Current portion of capital lease obligation  | 41                           | 41                            |
| <b>Total current liabilities</b>   | <b>4,748</b>                 | <b>4,792</b>                  |
| Long-term portion of capital lease   | 68                           | 78                            |
| <b>Other liabilities</b>   | <b>418</b>                   | <b>441</b>                    |
| <b>Total liabilities</b>   | <b>5,234</b>                 | <b>5,311</b>                  |
| Stockholders equity:   |                              |                               |
| Preferred stock, \$.01 par value, authorized 5,000,000 shares; none issued and outstanding   |                              |                               |
| 5% preferred stock, Series B, voting, cumulative, convertible, \$.01 par value (liquidation preference at par), authorized 10,000,000 shares, none issued and outstanding                          |                              |                               |
| Common stock, \$.01 par value, authorized 100,000,000 shares; 35,340,054 and 32,266,217 issued and 35,269,804 and 32,195,967 outstanding at December 31, 2006 and September 30, 2006, respectively | 353                          | 322                           |
| Additional paid-in capital   | 182,649                      | 172,033                       |
| Accumulated deficit  | (161,989)                    | (160,560)                     |
| Receivable for common stock issued   | (33)                         | (26)                          |

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|   |                  |                  |
|---|------------------|------------------|
| Treasury stock, at cost, 70,250 shares            | (168)            | (168)            |
| <b>Total stockholders' equity</b>                 | <b>20,812</b>    | <b>11,601</b>    |
| <b>Total liabilities and stockholders' equity</b> | <b>\$ 26,046</b> | <b>\$ 16,912</b> |

See accompanying notes

**Table of Contents****Sonic Foundry, Inc.****Consolidated Statements of Operations****(in thousands, except for per share data)****(Unaudited)**

|                                     | <b>Three Months Ended December 31,</b> |                   |
|-------------------------------------|--|-------------------|
|                                     | <b>2006</b>                            | <b>2005</b>       |
| <b>Revenue:</b>                     |  |                   |
| Product sales                       | \$ 2,586                               | \$ 1,346          |
| Services                            | 878                                    | 415               |
| Other                               | 9                                      | 111               |
| <b>Total revenue</b>                | <b>3,473</b>                           | <b>1,872</b>      |
| Cost of revenue                     | 773                                    | 560               |
| <b>Gross margin</b>                 | <b>2,700</b>                           | <b>1,312</b>      |
| <b>Operating expenses:</b>          |  |                   |
| Selling and marketing expenses      | 2,504                                  | 1,718             |
| General and administrative expenses | 970                                    | 696               |
| Product development expenses        | 675                                    | 534               |
| <b>Total operating expenses</b>     | <b>4,149</b>                           | <b>2,948</b>      |
| <b>Loss from operations</b>         | <b>(1,449)</b>                         | <b>(1,636)</b>    |
| Other income, net                   | 20                                     | 24                |
| <b>Net loss</b>                     | <b>\$ (1,429)</b>                      | <b>\$ (1,612)</b> |
| <b>Net loss per common share:</b>   |  |                   |
| basic and diluted                   | \$ (0.04)                              | \$ (0.05)         |
| Weighted average common shares      |  |                   |
| basic and diluted                   | 32,362,612                             | 31,275,301        |

See accompanying notes

**Table of Contents****Sonic Foundry, Inc.****Consolidated Statements of Cash Flows****(in thousands)****(Unaudited)**

|   | <b>Three months ended December 31,</b> |             |
|---|--|-------------|
|   | <b>2006</b>                            | <b>2005</b> |
| <b>Operating activities</b>   |  |             |
| Net loss  | \$ (1,429)                             | \$ (1,612)  |
| Adjustments to reconcile net loss to net cash used in operating activities:   |  |             |
| Amortization of other intangibles, and capitalized software development costs | 53                                     | 82          |
| Depreciation and amortization of property and equipment                       | 156                                    | 84          |
| Non-cash compensation charges and charges for stock warrants and options      | 149                                    | 199         |
| Other non-cash items  | (25)                                   |             |
| Provision for doubtful accounts   | 40                                     |             |
| Changes in operating assets and liabilities:                                  |  |             |
| Accounts receivable   | 6                                      | 576         |
| Inventories   | 92                                     | (184)       |
| Prepaid expenses and other current assets                                     | 24                                     | 82          |
| Accounts payable and accrued liabilities                                      | 30                                     | (780)       |
| Other long-term liabilities   | (23)                                   | (2)         |
| Unearned revenue  | (88)                                   | 143         |
| Total adjustments   | 414                                    | 200         |
| Net cash used in operating activities   | (1,015)                                | (1,412)     |
| <b>Investing activities</b>   |  |             |
| Purchases of property and equipment   | (163)                                  | (164)       |
| Net cash used in investing activities   | (163)                                  | (164)       |
| <b>Financing activities</b>   |  |             |
| Proceeds from issuance of common stock, net of issuance costs                 | 10,491                                 | 725         |
| Payments on capital leases  | (10)                                   | (3)         |
| Net cash provided by financing activities                                     | 10,481                                 | 722         |
| Net increase (decrease) in cash   | 9,303                                  | (854)       |
| Cash and cash equivalents at beginning of period                              | 2,751                                  | 4,271       |
| Cash and cash equivalents at end of period                                    | \$ 12,054                              | \$ 3,417    |

See accompanying notes

**Table of Contents**

**Sonic Foundry, Inc.**

**Notes to Consolidated Financial Statements**

**December 31, 2006**

**(Unaudited)**

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

Sonic Foundry, Inc. (the Company) is in the business of developing automated rich media application software and systems (our Rich Media business).

***Interim Financial Data***

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States ( GAAP ) for complete financial statements and should be read in conjunction with the Company's annual report filed on Form 10-K for the fiscal year ended September 30, 2006. In the opinion of management, all adjustments (consisting only of adjustments of a normal and recurring nature) considered necessary for a fair presentation of the results of operations have been included. Operating results for the three-month period ended December 31, 2006 are not necessarily indicative of the results that might be expected for the year ended September 30, 2007.

***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 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.



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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.

Reclassifications

Certain amounts reported in previous periods have been reclassified to conform to the current period presentation.

***Cash and Cash Equivalents***

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

***Inventory Valuation***

Inventory consists of raw materials and supplies used in the assembly of Mediasite units, 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):

|                            | 12/31/06 | 9/30/06 |
|----------------------------|----------|---------|
| Raw materials and supplies | \$ 10    | \$ 10   |
| Finished goods             | 287      | 388     |



**Table of Contents*****Stock Based Compensation***

The Company maintains an employee qualified 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 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 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.

Effective October 1, 2005, the Company adopted the provisions of Statement of Financial Accounting Standards 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 Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation, (SFAS 123), as amended by Statement of Financial Accounting Standards 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 three month period ended December 31, 2006 includes the cost associated with stock options vesting during the period which were 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 December 31, 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.

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.

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

| Method                  | Three months ended December 31, |                      |
|-------------------------|---------------------------------|----------------------|
|                         | 2006                            | 2005                 |
| Expected life (years)   | Lattice<br>5.7 years            | Lattice<br>4.9 years |
| Risk-free interest rate | 4.67%                           | 4.46%                |
| Expected volatility     | 62.91%                          | 70.83%               |
| Expected Dividend yield | 0%                              | 0%                   |

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The value of the options is estimated using a lattice option-pricing method and amortized to expense over the options vesting period. A summary of option activity as of December 31, 2006 and changes during the three months then ended is presented below:

| Options                          | Shares    | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Period | Aggregate Intrinsic Value |
|----------------------------------|-----------|---------------------------------|---|---------------------------|
| Outstanding October 1, 2006      | 4,602,174 | \$ 2.17                         | 6.3   | \$ 4,598,905              |
| Granted                          | 323,000   | 3.63                            | 9.9   | 0                         |
| Exercised                        | (63,837)  | 1.29                            | 6.3   | 164,967                   |
| Forfeited                        | (20,000)  | 1.85                            | 9.7   | 23,600                    |
| Outstanding December 31, 2006    | 4,841,337 | \$ 2.28                         | 6.3   | \$ 15,081,758             |
| Exercisable at December 31, 2006 | 3,595,150 | \$ 2.35                         | 5.3   | \$ 11,820,748             |

A summary of the status of the Company's non-vested shares as of December 31, 2006 and changes during the three months then ended is presented below:

| Non-vested Shares         | 2006      |  | 2005      |  |
|---------------------------|-----------|--|-----------|--|
|                           | Shares    | Weighted-Average Grant Date Fair Value | Shares    | Weighted-Average Grant Date Fair Value |
| Non-vested at October 1   | 1,124,514 | \$ 1.06                                | 1,006,347 | \$ 0.88                                |
| Granted                   | 323,000   | 1.96                                   | 346,000   | 0.63                                   |
| Vested                    | (181,330) | 0.86                                   | (205,660) | 0.57                                   |
| Forfeited                 | (20,000)  | 1.04                                   | (1,000)   | 0.66                                   |
| Non-vested at December 31 | 1,246,184 | \$ 1.21                                | 1,145,687 | \$ 0.86                                |

The weighted average grant date fair value of options granted during the three months ended December 31, 2006 was \$1.96. As of December 31, 2006, there was \$771 thousand of total unrecognized compensation cost related to non-vested share-based compensation, net of \$239 thousand of estimated forfeitures. The cost is expected to be recognized over a weighted-average life of 1.7 years.

Stock-based compensation recorded in the three month period ended December 31, 2006 of \$149 thousand was allocated \$95 thousand to selling and marketing expenses, \$19 thousand to general and administrative expenses and \$35 thousand to product development expenses. Cash received from Option exercises under all stock option plans for the three months ended December 31, 2006 and 2005 was \$86 thousand and \$10 thousand, respectively. There were no tax benefits realized for tax deductions from Option exercises for the three months ended December 31, 2006 and 2005, respectively. The Company currently expects to satisfy share-based awards with registered shares available to be issued.

**Table of Contents****Per share computation**

The numerator for the calculation of basic and diluted earnings per share is net loss. The following table sets forth the computation of basic and diluted loss per share:

|   | <b>Three months ended December 31,</b> |             |
|---|--|-------------|
|   | <b>2006</b>                            | <b>2005</b> |
| <b>Denominator</b>  |  |             |
| Denominator for basic and diluted loss per share – weighted average common shares   | 32,362,612                             | 31,275,301  |
| Securities outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive: |  |             |
| Options and warrants  | 5,492,863                              | 5,820,571   |

**New 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 September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statement*. Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. We do not believe SAB 108 will have a material impact on our results of operations or financial position.

**2. Related Party Transactions**

During the three month period ending December 31, 2006, the Company paid fees of \$53 thousand to a law firm whose partner is a director and stockholder of the Company. The Company had accrued liabilities for unbilled services of \$121 and \$120 thousand for the period ended December 31, 2006 and 2005 respectively, to the same law firm.

During the three month period ended December 31, 2006, the Company recorded Mediasite product and customer support revenue related to \$115 thousand of billings to MSKK, a Japanese reseller in which the Company has an equity interest. No billings were recorded during the three months ended December 31, 2005.

During the three month period ended December 31, 2006, the Company entered into a transaction with an entity in which a member of the Company's Board of Directors is a significant shareholder. The transaction included a \$57,000 sale of the Company's product in exchange for advertising services. No sales were recorded during the three months ended December 31, 2005.

As of December 31, 2006 and 2005, the Company had a loan outstanding to an executive totaling \$26 thousand. This loan is secured by company stock.

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**3. Purchase Commitments**

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. Obligations to purchase approximately \$686 thousand over the next two fiscal quarters remain. This commitment is not recorded on the Company's Balance Sheet. There are no obligations under this commitment past September 30, 2007. The Company had \$890 thousand of purchase commitments as of December 31, 2005.

The Company engaged a manufacturer to build a replacement component for its Mediasite product according to designs proprietary to the Company. The Company had a commitment of approximately \$15 thousand to the manufacturer at December 31, 2006 and \$147 thousand at December 31, 2005. The project is expected to be completed during this fiscal year.

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

#### **Risks and Uncertainties**

The following discussion of the consolidated financial position and results of operations of the Company should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this form 10-Q and the Company's annual report filed on form 10-K for the fiscal year ended September 30, 2006. In addition to historical information, this discussion contains forward-looking statements such as statements of the Company's expectations, plans, objectives and beliefs. These statements use such words as may, will, expect, anticipate, believe, plan, and other similar terminology.

Actual results could differ materially from expectations due to changes in the market acceptance of our products, competition, market introduction or product development delays; all of which would impact our strategy to develop a network of inside regional sales managers and distribution partners that target customer opportunities for multi-unit and repeat purchases. If the Company does not achieve multi-unit and repeat purchases our business will be harmed.

Other factors that may impact actual results include: our ability to effectively integrate acquired businesses, global and local business conditions, legislation and governmental regulations, competition, our ability to effectively maintain and update our product portfolio, shifts in technology, political or economic instability in local markets, and currency and exchange rate fluctuations, as well as other issues which may be identified from time to time in Sonic Foundry's Securities and Exchange Commission filings and other public announcements.

#### **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, 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.

#### **New 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.

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### **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

Accounting for stock-based compensation.

#### *Revenue Recognition and Allowance for Doubtful Accounts*

We recognize revenue for product sales and licensing of software products upon shipment, provided that collection is determined to be probable and no significant obligations remain. The Company does not offer rights of return and typically delivers products either to value added resellers based on end-user customer orders or direct to the end user. We sell post-contract support ( PCS ) contracts on our Mediasite units. Revenue is recorded separately from the sale of the product and recognized over the life of the support contract using vendor specific objective evidence of the value of the support services. Please refer to Note 1 of our Notes to Consolidated Financial Statements for further information on our revenue recognition policies.

The preparation of our consolidated financial statements also requires us to make estimates regarding the collectability of our accounts receivables. We specifically analyze the age of accounts receivable and historical bad debts, customer concentrations, customer credit-worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts.

#### *Impairment of long-lived assets*

We assess the impairment of goodwill and other intangible assets 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.



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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*. 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.

**Table of Contents***Accounting for stock-based compensation*

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost recognized for the three month period ended December 31, 2006 includes the cost associated with stock options vesting during the period which were 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.

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.

**Results of Operations****Revenue**

Revenues from our business include the sale or license of Mediasite and server software products and related service contracts, such as customer support, content hosting, equipment rental, and event services 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.

Revenues in Q1-2007 increased \$1.6 million, or 84% from Q1-2006 sales of \$1.9 million to \$3.5 million. Sales consisted of the following:

Product revenue from sale of Mediasite capture units

|  | Q1-2007  | Q1-2006  |
|--|----------|----------|
| Units sold                                       | 132      | 79       |
| Mobile to rack ratio                             | 1.4 to 1 | 1.8 to 1 |
| Average sales price, excluding services (000 \$) | \$19.6   | \$17.1   |
| Mediasite gross margins, excluding support       | 74%      | 68%      |

Service 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, event and content hosting services. Services revenue increased from \$415 thousand in Q1-2006 to \$878 thousand in Q1-2007, due primarily to support contracts on new Mediasite capture units as well as renewals of support contracts entered into in prior years. At December 31, 2006 \$1.9 million of unrecognized service revenues remained in unearned revenues, of which we expect to realize \$735 thousand in the upcoming quarter.

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

We expect quarterly revenues to increase significantly through Fiscal 2007.



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### **Gross Margin**

Total gross margins for Q1-2007 were \$2.7 million or 78% compared to Q1-2006 of \$1.3 million or 70%. The significant components of cost of revenue include:

Material and freight costs for the Mediasite capture units. Costs for Q1-2007 Mediasite material and other costs amounted to \$638 thousand, along with \$82 thousand of freight and labor costs, resulted in Mediasite gross margins including support revenue of 79% compared to \$432 thousand of material and other costs, \$46 thousand of freight and labor costs, and resulting gross margins of 74% in Q1-2006. The gross margin on Mediasite sales varies with product mix; our rack units typically carry a higher margin than our mobile units. Mediasite customer support revenues, server and certain custom engineering software projects do not carry a cost over and above limited royalty fees and staff cost included in operating expenses - significantly enhancing Mediasite product margins. We expect gross margins to exceed 80% in Fiscal 2007.

Mediasite acquisition amounts assigned to purchased technology and other identified intangibles are fully amortized as of December 31, 2006. Amortization expense was approximately \$53 thousand this quarter, and \$82 in Q1-2006.

### **Operating Expenses**

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

Selling and marketing expenses include wages and commissions for sales, marketing, business development and technical support personnel, 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 tradeshows.

#### *Q1-2007 compared to Q1-2006*

Selling and marketing expenses increased \$786 thousand or 46% from \$1.7 million in Q1-2006 to \$2.5 million in Q1-2007 resulting from:

Q1-2007 salary, commissions, bonuses and benefits exceeded Q1-2006 by \$384 thousand due to the growth in sales staff.

Q1-2007 travel, supplies, postage, and allocated expenses increased \$240 thousand because of an increase in staff.

Q1-2007 advertising and tradeshow expenses increased \$151 thousand due to increased marketing efforts.

As of December 31, 2006 we had 49 employees in selling and marketing. We anticipate continued growth in selling and marketing headcount in the remainder of fiscal 2007.

#### **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.

#### *Q1-2007 compared to Q1-2006*

G&A expenses increased \$274 thousand or 39% from \$696 thousand in Q1-2006 to \$970 thousand in Q1-2007. Some significant differences between the periods include:

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Professional fees increased \$104 thousand from the prior year due to accounting, legal and consulting costs.

Depreciation and facility expense increased \$131 thousand due to increased office space, leasehold improvements and fixed asset additions.

Commissions and bonus expense increased \$180 over the prior year due to increased staff, and increased revenue projections.

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These increases were partially offset by a greater portion of expenses allocated to sales and marketing and product development based on headcount.

As of December 31, 2006 we had 14 full-time employees in G&A. We anticipate moderate growth in G&A headcount in fiscal 2007.

### **Product Development Expenses**

Product development 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.

#### *Q1-2007 compared to Q1-2006*

R&D expenses increased \$141 thousand, or 26% from \$534 thousand in Q1-2006 to \$675 thousand in Q1-2007. The most significant differences between the periods was increased salaries and benefits of \$116 thousand due to growth in product development staff.

As of December 31, 2006 we had 22 employees in Research and Development. We do not anticipate significant growth in R&D headcount in fiscal 2007. We do not anticipate that any fiscal 2007 software development efforts will qualify for capitalization under SFAS No. 86

Accounting for the Cost of Computer Software to be Sold, Leased, or Otherwise Marketed.

### **Other Income**

Other income is primarily interest income. We are currently investing in certificates of deposit and overnight investment vehicles.

### **Liquidity and Capital Resources**

Cash used in operating activities decreased in Q1-2007. Cash used was approximately \$1 million, down from Q1-2006 of \$1.4 million. Q1-2007 had modest changes in working capital components while Q1-2006 included a \$780 thousand reduction in accounts payable and accrued liabilities, and a partially offsetting reduction in accounts receivable of \$576 thousand associated with the timing of payments and collections.

Cash used in investing activities was \$163 thousand in Q1-2007 compared to a use of \$164 thousand in Q1-2006 for the purchase of property and equipment.

Cash provided by financing activities was \$10.5 million in Q1-2007 compared to cash provided of \$722 thousand in Q1-2006. In Q1-2007, we received \$10.4 million from the sale of common stock, net of issuance costs, and \$86 thousand in option and warrant exercise proceeds compared to the receipt of \$725 thousand from the sale of common stock in Q1-2006.

We expect to reach cash flow breakeven during fiscal 2007 and believe we can fund operations with cash on hand through that point. In December 2006, we issued 3 million shares of common stock in a public offering, and received net proceeds of \$10.4 million for support of continuing research and development efforts and capital expenditures in areas including advancement of our search technology, intellectual property protection, as well as other business development activities, working capital needs, and general corporate purposes. In November 2005, we issued 747 thousand shares of common stock and 149 thousand common stock purchase warrants to certain individual investors in a private placement, and received net proceeds of \$725 thousand.

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 working capital needs.

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The Company entered into an unconditional purchase agreement during the quarter ended December 2006 for supply of Mediasite capture product. Obligations to purchase \$686 thousand over the next two fiscal quarters remain. This commitment is not recorded on the Company's Balance Sheet. Purchase commitments as of December 31, 2005 totaled \$890 thousand.

The Company engaged a manufacturer to build a replacement component for its Mediasite product according to designs proprietary to the Company. The Company had a commitment of approximately \$15 thousand to the manufacturer at December 31, 2006, and \$147 thousand at December 31, 2005. The project is expected to be completed during this fiscal year.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

#### **Derivative Financial Instruments**

The Company is 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. The Company's 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**

The Company's 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 4. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

Based on evaluations at December 31, 2006, 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) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC.

#### **Changes in Internal Controls**

During the period covered by this quarterly report on Form 10-Q, the Company has not made any changes to its internal control over financial reporting (as referred to in Paragraph 4(c) of the Certifications of the Company's principal executive officer and principal financial officer included as exhibits to this report) that have materially affected, or is reasonably likely to affect the Company's internal control over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 6. EXHIBITS**

| NUMBER | DESCRIPTION   |
|--------|---|
| 3.1    | Amended and Restated Articles of Incorporation of the Registrant, filed as Exhibit No. 3.1 to the Registrant's Annual Report on Form 10-k for the fiscal year ended September 30, 2006, and hereby incorporated by reference.   |
| 3.2    | Amended and Restated By-Laws of the Registrant, filed as Exhibit No. 3.2 to Amendment No.2 to the registration statement on form SB-2 dated April 3, 1998 (Reg. No. 333-46005) (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, filed as exhibit 10.7 to Form 10-K on November 16, 2006, and hereby incorporated by reference. |
| 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  |

Registrant will furnish upon request to the Securities and Exchange Commission a copy of all exhibits, annexes and schedules attached to each contract referenced in item 10.

\* Compensatory Plan or Arrangement



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**SIGNATURES**

Pursuant to the requirement 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)

February 5, 2007

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

February 5, 2007

By: /s/ Kenneth A. Minor  
Kenneth A. Minor  
Chief Financial Officer and Secretary