

SONIC FOUNDRY INC  
Form 10-Q  
August 08, 2006  
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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 June 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)

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

(Address of principal executive offices)

(608) 443-1600

**39-1783372**  
(I.R.S. Employer

Identification No.)

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(Registrant's telephone 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 July 31, 2006
Common Stock, \$0.01 par value	32,195,967

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

(Unaudited)

	June 30, 2006	September 30, 2005
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 2,315	\$ 4,271
Accounts receivable, net of allowances of \$110 and \$115	3,338	2,232
Inventories	241	414
Prepaid expenses and other current assets	413	363
<b>Total current assets</b>	<b>6,307</b>	<b>7,280</b>
Property and equipment:		
Leasehold improvements	193	185
Computer equipment	2,193	1,570
Furniture and fixtures	185	185
<b>Total property and equipment</b>	<b>2,571</b>	<b>1,940</b>
Less accumulated depreciation	1,199	933
<b>Net property and equipment</b>	<b>1,372</b>	<b>1,007</b>
Other assets:		
Goodwill and other intangibles, net	7,589	7,626
Capitalized software development costs, net of accumulated amortization of \$1,277 and \$1,067	122	332
<b>Total other assets</b>	<b>7,711</b>	<b>7,958</b>
<b>Total assets</b>	<b>\$ 15,390</b>	<b>\$ 16,245</b>
<b>Liabilities and stockholders equity</b>		
Current liabilities:		
Accounts payable	\$ 1,227	\$ 1,323
Accrued liabilities	753	780
Unearned revenue	1,569	957
Current portion of capital lease obligation	40	15
<b>Total current liabilities</b>	<b>3,589</b>	<b>3,075</b>
Long-term portion of capital lease obligation	89	28
Other liabilities	17	21
<b>Total liabilities</b>	<b>3,695</b>	<b>3,124</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		

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Common stock, \$.01 par value, authorized 100,000,000 shares; 32,161,093 and 30,910,409 issued and 32,090,962 and 30,840,159 shares outstanding at June 30, 2006 and September 30, 2005, respectively	322	309
Additional paid-in capital	171,788	170,083
Accumulated deficit	(160,219)	(157,077)
Receivable for common stock issued	(28)	(26)
Treasury stock, at cost, 70,250 shares	(168)	(168)
Total stockholders' equity	11,695	13,121
<b>Total liabilities and stockholders' equity</b>	<b>\$ 15,390</b>	<b>\$ 16,245</b>

See accompanying notes

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

	<b>Three Months Ended June 30,</b>		<b>Nine Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Revenue:</b>				
Product sales	\$ 2,967	\$ 1,855	\$ 6,601	\$ 4,859
Services	663	248	1,730	614
Other	17	72	141	359
Total revenue	3,647	2,175	8,472	5,832
Cost of revenue	812	776	2,233	1,981
<b>Gross margin</b>	<b>2,835</b>	<b>1,399</b>	<b>6,239</b>	<b>3,851</b>
<b>Operating expenses:</b>				
Selling and marketing expenses	2,101	1,415	5,569	3,779
General and administrative expenses	744	650	2,206	2,236
Product development expenses	593	458	1,671	1,372
Total operating expenses	3,438	2,523	9,446	7,387
<b>Loss from operations</b>	<b>(603)</b>	<b>(1,124)</b>	<b>(3,207)</b>	<b>(3,536)</b>
Other income, net	20	59	65	130
<b>Net loss</b>	<b>\$ (583)</b>	<b>\$ (1,065)</b>	<b>\$ (3,142)</b>	<b>\$ (3,406)</b>
<b>Net loss per common share:</b>				
basic and diluted	\$ (0.02)	\$ (0.03)	\$ (0.10)	\$ (0.11)
Weighted average common shares				
basic and diluted	31,994,713	30,479,709	31,663,048	30,202,031

See accompanying notes

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

	<b>Nine months ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Operating activities</b>		
Net loss	\$ (3,142)	\$ (3,406)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of other intangibles, and capitalized software development costs	247	247
Depreciation and amortization of property and equipment	267	225
Provision for doubtful accounts	(5)	35
Other non-cash items		(30)
Non-cash compensation charges and charges for stock warrants and options	539	250
Changes in operating assets and liabilities:		
Accounts receivable	(1,101)	(615)
Inventories	173	106
Prepaid expenses and other current assets	(47)	(143)
Accounts payable and accrued liabilities	(123)	(199)
Other long-term liabilities	(4)	
Unearned revenue	612	272
Total adjustments	558	148
Net cash used in operating activities	(2,584)	(3,258)
<b>Investing activities</b>		
Purchases of property and equipment	(531)	(284)
Net cash used in investing activities	(531)	(284)
<b>Financing activities</b>		
Proceeds from issuance of common stock, net of issuance costs	1,174	473
Payments on capital leases	(15)	
Net cash provided by financing activities	1,159	473
Net decrease in cash	(1,956)	(3,069)
Cash and cash equivalents at beginning of period	4,271	7,583
Cash and cash equivalents at end of period	\$ 2,315	\$ 4,514
<b>Supplemental cash flow information:</b>		
Income taxes paid		
Non-cash operating and investing activities -		
Property and services acquired by barter	\$ 40	\$ 90
Property and equipment financed by capital lease	61	
See accompanying notes		





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**Sonic Foundry, Inc.**

**Notes to Consolidated Financial Statements**

**June 30, 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, 2005. 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 and nine month periods ended June 30, 2006 are not necessarily indicative of the results that might be expected for the year ending September 30, 2006.

***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.

**Other**

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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.

**Table of Contents****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 and Customer Concentration**

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.

***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, 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):

	6/30/06	9/30/05
Raw materials and supplies	\$ 10	\$ 10
Work in process		38
Finished goods	231	366
	\$ 241	\$ 414

***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.



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Effective October 1, 2005, the Company adopted the provisions of Statement of Financial Accounting Standard 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 nine month period ended June 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 June 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.

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	Three months ended	
	June 30,	
	2006	2005
	Lattice	Black-Scholes
Expected life (years)	5.3 years	3 years
Risk-free interest rate	5.00%	3.77%
Expected volatility	71.09%	76.27%
Expected dividend yield	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 three months ended June 30, 2005 and is presented for purposes of this pro forma disclosure.

(in thousands)	Three months ended	Nine months ended
	June 30, 2005	June 30, 2005
Net loss as reported	\$ (1,065)	\$ (3,406)
Stock-based compensation expense determined under fair value based method for options	(137)	(449)
Pro forma net loss	\$ (1,202)	\$ (3,855)
Pro forma net loss per share as reported basic and diluted	(0.03)	(0.11)
Pro forma net loss per share basic and diluted	\$ (0.04)	\$ (0.13)



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The value of the options is estimated using a Black Scholes option-pricing method and amortized to expense over the options vesting period. A summary of option activity as of June 30, 2006 and changes during the nine months then ended is presented below (in thousands, except per share data):

<b>Options</b>	<b>Shares</b>	<b>Weighted-Average Exercise Price</b>	<b>Weighted-Average Remaining Contractual Period</b>	<b>Aggregate Intrinsic Value</b>
Outstanding October 1, 2005	4,587,764	\$ 2.28	6.4	\$ 2,920,570
Granted	644,000	1.41	9.5	215,990
Exercised	(266,584)	1.02	6.1	193,442
Forfeited	(514,334)	2.74	5.9	215,227
<b>Outstanding June 30, 2006</b>	<b>4,450,846</b>	<b>\$ 2.18</b>	<b>6.4</b>	<b>\$ 1,998,311</b>
Exercisable at June 30, 2006	3,386,332	\$ 2.41	5.6	\$ 1,700,108

The weighted average grant date fair value of options granted during the nine months ended June 30, 2006 was \$0.76. As of June 30, 2006, there was \$525 thousand of total unrecognized compensation cost related to non-vested share-based compensation, including \$94 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 June 30, 2006 and for the nine months then ended is presented below:

	<b>Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Non-vested shares at October 1, 2005	1,006,347	\$ 0.94
Granted	644,000	0.76
Vested	(459,831)	0.73
Forfeited	(126,002)	1.11
<b>Non-vested shares at June 30, 2006</b>	<b>1,064,514</b>	<b>\$ 1.03</b>

Stock-based compensation recorded in the three month period ended June 30, 2006 of \$104 thousand was allocated \$63 thousand to selling and marketing expenses, \$14 thousand to general and administrative expenses and \$27 thousand to product development expenses. Stock-based compensation recorded in the nine month period ended June 30, 2006 of \$358 thousand was allocated \$219 thousand to selling and marketing expenses, \$52 thousand to general and administrative expenses and \$87 thousand to product development expenses. Cash received from option exercises under all stock option plans for the three months ended June 30, 2006 and 2005 was \$273 thousand and \$194 thousand, respectively. Cash received from option exercises under all stock option plans for the nine months ended June 30, 2006 and 2005 was \$394 thousand and \$384 thousand, respectively. There were no tax benefits realized for tax deductions from option exercises for the three months ended June 30, 2006 and 2005, respectively. The Company currently expects to satisfy share-based awards with registered shares available to be issued.

**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:

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	Three Months Ended		Nine Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
<b>Denominator</b>				
Denominator for basic and diluted loss per share weighted average common shares	31,994,713	30,479,709	31,663,048	30,202,031
Securities outstanding during each year, but not included in the computation of diluted earnings per share because they are antidilutive:				
Options and warrants	5,182,372	5,729,218	5,182,372	5,729,218

***New Accounting Pronouncement***

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 provide 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 Interpretation No. 48 is not expected to have any significant effect on the Company's consolidated financial position or results of operations.

**2. Related Party Transactions**

During the three and nine month periods ended June 30, 2006, the Company recorded Mediasite product and services revenue related to \$31 thousand and \$430 thousand respectively of billings to MSKK, a Japanese reseller in



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which the Company has an equity interest. During the three and nine month period ended June 30, 2005, the Company recorded Mediasite product and services revenue related to \$92 thousand and \$468 respectively of billings to MSKK.

### **3. Purchase Commitments**

The Company enters into unconditional purchase commitments on a regular basis for the supply of Mediasite product. Obligations to purchase approximately \$1.6 million over the next fiscal quarter remain. This commitment is not recorded on the Company's Balance Sheet. The obligations under this commitment are expected to be completed over the next two fiscal quarters. The Company had \$919 thousand of purchase commitments as of June 30, 2005.

## **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, 2005. 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 in the business of developing complete, economical, timesaving and easy-to-use solutions for one-to-many communications (our Rich Media business). The Rich Media business was formed in October 2001, when our wholly-owned subsidiary, Sonic Foundry Systems Group, Inc. acquired the assets and assumed certain liabilities of Mediasite, Inc. Our internally developed software code, coupled with our acquired systems technology, includes advanced publishing tools and media access technologies operating across multiple digital delivery platforms to significantly enhance a host of enterprise-based media applications. Our solutions are based on unique technologies that enhance media communications through the extensive use of rich media, defined as a media element that combines graphics, text, video, audio and metadata in a single data file. Our technology evolved from a four-year Carnegie Mellon University research effort funded by major government (DARPA, NSF, NASA) and private organizations (CNN, Intel, Boeing, Microsoft, Motorola, Bell Atlantic). Our core product is the family of Mediasite presentation recorders ( Mediasite ), complete presentation recording systems for live or on-demand viewing over the Internet, intranet or recording to physical media. Related products and services include server software applications and customer support, installation, training and content hosting services.

### **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 Interpretation 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 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.

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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. For the US operations, 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 in the nine month period ended June 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.

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 sales of Mediasite and server software products and related services contracts, such as 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.

*Q3-2006 compared to Q3-2005*

Revenues in Q3-2006 totaled \$3.65 million compared to Q3-2005 sales of \$2.18 million. Revenue consisted of the following:

Product revenue from sale of Mediasite capture units

	Q3-2006	Q3-2005
Units sold	145	131
Mobile to rack ratio	0.9 to 1	1.5 to 1
Average sales price, excluding support (000 \$)	\$20.5	\$14.2
Mediasite gross margins, excluding support	77%	64%

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 \$248 thousand in Q3-2005 to \$663 thousand in Q3-2006 which includes \$123 thousand in revenue from installation, training and on-site support contracts. The increase in support revenue is due to support contracts on new Mediasite capture units as well as renewals of support contracts entered into in prior years. At June 30, 2006 \$1.57 million of unrecognized support revenue remained in unearned revenues, of which we expect to realize \$550 thousand in the upcoming quarter.

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

We expect quarterly revenues to continue to increase significantly through the next several quarters.

*YTD-2006 (nine months) compared to YTD-2005 (nine months)*

Revenues for YTD-2006 totaled \$8.47 million compared to YTD-2005 revenues of \$5.83 million. Revenues included the following:

\$6.6 million product revenue from the sale of 374 Mediasite units versus \$4.86 million from the sale of 337 Mediasite units in 2005.

\$1.73 million from Mediasite support plans, installation, training, rental and content hosting services versus \$614 thousand in 2005.

Other revenue includes \$41 thousand of freight reimbursement fees and \$70 of purchased hardware components compared to \$20 thousand of freight revenue and \$20 thousand of royalties in 2005.

\$30 thousand from the Department of Justice research grant in 2006 versus \$156 thousand in 2005.

\$163 thousand for the license of software code designed for indexing of rich media and video filters in 2005.

## **Gross Margin**

Total gross margins for Q3-2006 were \$2.84 million or 78% compared to Q3-2005 of \$1.40 million or 64%. The significant components of cost of revenue include:

Material and freight costs for the Mediasite capture units. Costs for Q3-2006 Mediasite material and other costs amounted to \$665 thousand, along with \$14 thousand and \$41 thousand of freight and labor costs, resulting in Mediasite gross margins including support revenue of 78%. Total YTD material costs for 2006 amounted to \$1.8 million, along with \$37 thousand and \$106 thousand of freight and labor costs, resulting in Mediasite gross margins of 73%. Costs for Q3-2005 and YTD-2005 amounted to \$681 thousand and \$1.70 million and resulting gross margins of 64% and 65%. The gross margin on Mediasite sales varies with product mix; our rack units typically carry a higher margin than our mobile units. Mediasite services 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 margins for Fiscal 2006 to remain in the 75-80% range.

Amortization of Mediasite acquisition amounts assigned to purchased technology and other identified intangibles effect both periods at approximately \$92 thousand per quarter and will continue through fiscal 2006 for the identified intangibles of the Mediasite purchase.

## **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.

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*Q3-2006 compared to Q3-2005*

Selling and marketing expenses increased \$686 thousand or 48% from \$1.4 million in Q3-2005 to \$2.1 million in Q3-2006 resulting from:

Q3-2006 salary, commissions, bonuses and benefits exceeded Q3-2005 by over \$450 thousand due to the growth in sales staff.

Q3-2006 travel, supplies, postage, meeting and allocated expenses increased \$180 thousand as a result of an increase in staff.

Q3-2006 non-cash stock compensation of \$63 thousand associated with the adoption of SFAS 123R on October 1, 2005.

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*YTD-2006 compared to YTD-2005*

The \$1.79 million or 47% increase from YTD-2005 to YTD-2006 resulted from increases in many of the same items mentioned in the quarter discussion above. YTD increases in the major categories include:

YTD-2006 salary, commissions, and benefits exceeded YTD-2005 by \$1.04 million due to the growth in revenues impacting related commissions, and salary expense for additional sales representatives.

YTD-2006 advertising, tradeshow, market research, public relations fees and demonstration equipment costs increased \$65 thousand over the prior year.

YTD-2006 support costs including travel, utilities and other facility related expenses increased by \$660 thousand over the prior year due to the addition of sales representatives, including \$219 thousand of non-cash stock compensation expense associated with the adoption of SFAS 123R.

As of June 30, 2006 we had 35 full-time employees in Selling and Marketing. We anticipate continued growth in selling and marketing headcount in the remainder of fiscal 2006.

**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.

*Q3-2006 compared to Q3-2005*

G&A expenses increased \$94 thousand from \$650 thousand in Q3-2005 compared to \$744 thousand in Q3-2006. Some significant differences between the periods include:

Professional fees increased over \$113 thousand from the prior year due to consulting, advisory board and investor relation costs.

Q3-2006 includes non-cash stock compensation of \$14 thousand associated with the adoption of SFAS 123R on October 1, 2005.

The above increased costs were partially offset by reduced supplies and estimates for uncollectible accounts.

*YTD-2006 compared to YTD-2005*

YTD G&A expenses are consistent showing just a 1% or \$30 thousand decrease from YTD-2005 to YTD-2006. Significant variances include lower professional fees, insurance and taxes contributing to a variance of almost \$120 thousand. YTD-2006 included non-cash stock compensation expense associated with the adoption of SFAS 123R of \$52 thousand and increased facilities costs associated with the headcount growth which partially offset other decreased costs.

As of June 30, 2006 we had 8 full-time employees in G&A. We do not anticipate significant growth in G&A headcount in fiscal 2006.

**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.





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### *Q3-2006 compared to Q3-2005*

R&D expenses increased \$135 thousand, or 29% from \$458 thousand in Q3-2005 to \$593 thousand in Q3-2006. Some significant differences between the periods include:

Increased salaries and benefits of \$86 thousand

Q3-2006 non-cash stock compensation of \$27 thousand associated with the adoption of SFAS 123R.

As of June 30, 2006 we had 19 full-time employees in Research and Development. We do not anticipate significant growth in R&D headcount in fiscal 2006. We do not anticipate that any fiscal 2006 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.

### *YTD-2006 compared to YTD-2005*

YTD-2006 R&D expenses increased \$299 thousand, or 22% from YTD-2005. As mentioned in the quarter discussion above, salaries, commissions and benefits were the primary reason for the increase, accounting for nearly \$180 thousand of the increase over the prior year. Additional contributors to the increase included facilities related expenses and non-cash stock compensation of \$87 thousand associated with the adoption of SFAS 123R. In YTD-2006, 75% of R&D costs related to salaries and benefits.

### **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 was \$2.58 million in YTD-2006 compared to YTD-2005 of \$3.26 million with a decrease of \$674 thousand or 21%. Significant differences in YTD-2006 compared to YTD-2005 included a larger increase in net accounts receivable, offset by a larger increase in deferred revenue in YTD-2006.

Cash used in investing activities was \$531 thousand in YTD-2006 compared to a use of \$284 thousand in YTD-2005. Cash used in investing activities was for the purchase of property and equipment.

Cash provided by financing activities was \$1.2 million in YTD-2006 compared to cash provided of \$473 thousand in YTD-2005. The amount received in both years include proceeds from the exercise of common stock options and warrants as well as the receipt of \$725 thousand from the sale of common stock in the current year.

We expect cash from operations exclusive of working capital changes to reach breakeven during the fiscal quarter ending September 30, 2006 and believe we can fund operations, working capital and other cash needs with cash on hand through that point. Despite our belief that we have 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 of common stock and 149 thousand common stock purchase warrants to certain individual investors, and received net proceeds of \$725 thousand.

We expect to continue to acquire property and equipment in fiscal 2006 and 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 have no plans to pursue any debt arrangements at this time but may evaluate further operating or capital lease opportunities to finance certain equipment acquisitions. In order to fund long-term cash requirements and/or pursue complimentary business strategies, we may evaluate the issuance of additional stock to investors or strategic partners.

The Company entered into an unconditional purchase agreement during the quarter ended March 2006 for supply of Mediasite capture product. Obligations to purchase \$1.6 million over the next fiscal quarter remain. This commitment is not recorded on the Company's Balance Sheet. The obligations under this commitment are expected to be completed over the next two fiscal quarters. Purchase commitments as of June 30, 2005 totaled \$919 thousand.



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**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 June 30, 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 are reasonably likely to affect the Company's internal control over financial reporting.

**ITEM 6. EXHIBITS**

<b>NUMBER</b>	<b>DESCRIPTION</b>
3.1	Amended and Restated Articles of Incorporation of the Registrant, filed as Exhibit No. 3.1 to the registration statement on amendment No. 2 to Form SB-2 dated April 3, 1998 (Reg. No. 333-46005) (the "Registration Statement"), and hereby incorporated by reference.
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.

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- 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 Amended and Restated License Agreement effective October 15, 2001 between Carnegie Mellon University and Mediasite, Inc. filed as Exhibit No. 10.31 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2002, and hereby incorporated by reference.
  - 10.7 Asset Purchase Agreement among Deluxe Media Services, Inc. the Registrant, Sonic Foundry Media Services, Inc. and International Image Services, Inc., dated April 30, 2003 filed as Exhibit 99.2 to Form 8-K filed on May 21, 2003, and hereby incorporated by reference.
  - 10.8 Amended and Restated Asset Purchase Agreement, incorporated by reference from Appendix A of Schedule 14A filed on June 19, 2003 and hereby incorporated by reference.
  - 10.9 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.
  - 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.

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\* 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)

August 8, 2006

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

August 8, 2006

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